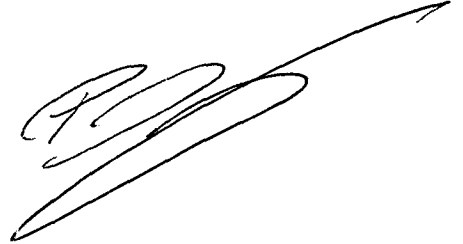


**THE APPLICATION OF ROUSSEAU'S THEORY OF  
SOCIAL CONTRACT TO CORPORATE GOVERNANCE**

**Paula Diane Baron BA/LLB (Tas)**

**A thesis submitted in fulfilment of the requirements for the  
degree of Master of Laws (Research) in the University of  
Tasmania (March, 1995)**

This thesis contains no material which has been accepted for the award of any other degree or diploma in any tertiary institution and, to the best of my knowledge and belief, the thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

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## Abstract

Much of the literature in the area of Australian corporate law reveals dissatisfaction with our current regulatory scheme. Despite extensive (and ongoing) legislative reforms, the scheme continues to be criticised as costly, complex and largely inefficient in regulating corporate abuse. The objective of this thesis is to consider a new model of corporate governance, both internal (that is, between the members and the management of the corporation) and external (that is, between the corporation and the state). This model is based upon the theory of contractual rights and obligations proposed by Jean Jacques Rousseau in *The Social Contract*. The value of this model is that it recognises and seeks to reconcile the inherent tension which underlies all associations (be they family, state or corporation): that of individual self-interest on the one hand and the collective good on the other.

In this thesis, I shall argue that our ideas of what a corporation is and how it should be governed have been largely constructed by liberal theory. The corporation and its regulation, then, are not absolutes, but social and historical constructs which we are free to reject or modify as we see fit. By examining the ways in which the values and assumptions of liberalism are made explicit in corporate law; then by comparing the traditional model of corporate law with that based upon Rousseau's social contract theory, I shall seek to show that many of the assumptions and values underlying corporate law are no longer valid. Merely 'patching up' the existing model is insufficient. What is needed is a complete re-evaluation of the corporation and its place in our society.

The thesis will begin by examining the corporation as a political entity. Rousseau's political theory will then be contrasted with those of Hobbes and Locke in order to reveal the different values and assumptions that underlie these theories. I shall then examine the way in which contemporary company law is based upon the values and assumptions of liberalism, before examining both the internal and external governance of corporations in order to identify the problems of regulation and the application of Rousseau's theory to those problems.



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## CHAPTER 1

### THE CORPORATION AS A POLITICAL ENTITY

#### Introduction

The company is a creature of law. The act of incorporation creates a new entity which is subject to legal rights and duties. A company is also an association of persons pursuing a common interest (ordinarily the pursuit of profit). This association functions within the wider association of the State. The proper governance of the corporation is thus a matter of legal, economic, social and political importance. The purpose of this study is to consider a new model of corporate governance, both internal (that is, between the members and the management of the corporation) and external (that is, between the corporation and the state). This model is based upon the theory of contractual rights and obligations proposed by Jean Jacques Rousseau<sup>1</sup> in his *Social Contract*.<sup>2</sup> The value of this model is that it recognises and seeks to reconcile the inherent tension which underlies all associations (be they family, state or corporation): that of individual self-interest on the one hand and the collective good on the other.

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<sup>1</sup> The literature on Rousseau's life and work is voluminous. For critical discussions of his philosophy, see, for instance, NJH Dent, *Rousseau: An Introduction to his Psychological, Social and Political Theory* (Oxford: Blackwell, 1989); Hilail Gildin, *Rousseau's Social Contract: The design of the argument* (Chicago: University of Chicago Press, 1983); Richard Fralin, *Rousseau and representation: a study of the development of his concept of political institutions* (New York: Columbia University Press, 1978); John Charvet, *The social problem in the philosophy of Rousseau* (Cambridge: Cambridge University Press, 1974); Guy Dodge, *Jean-Jacques Rousseau: authoritarian libertarian* (Lexington, Mass: Heath, 1971); Judith N Shklar, *Men and citizens: A study of Rousseau's social theory* (London: Cambridge University Press, 1969); Mario Einaudi, *The Early Rousseau* (New York: Cornell University Press, 1967); Frederick Charles Green, *Jean Jacques Rousseau: A critical study of his life and writings* (Cambridge: Cambridge University Press, 1955). Recent articles include: Patrick Riley, 'Rousseau's general will: freedom of a particular kind' (1991) 39 *Political Studies* 55; Leonard Sorenson, 'Natural Inequality and Rousseau's political philosophy in his Discourse on inequality' (1990) 43 *Western Pol Q* 763; Asher Horowitz, '"Laws and customs thrust us back into infancy": Rousseau's historical anthropology', (1990) 52 *Rev of Pol* 215; Peter Breiner, 'Democratic autonomy, political ethics and moral luck' (1989) 17 *Pol Theory* 550; Robert Shaver, 'Rousseau and recognition' (1989) 15 *Social Theory and Practice* 261; ME Brint, 'Echoes of Narcisse' (1988) 16 *Pol Theory* 617; Bernad Grofman and Scott L Feld, 'Rousseau's general will: a Condorcetian perspective' (1988) 82 *Am Pol Sci R* 567. For biographical information, see Maurice Cranston, *Jean-Jacques: the early life and work of Jean Jacques Rousseau 1712-1754* (London: Allen Lane, 1983); Ronald Grimsley, *Jean Jacques Rousseau* (Brighton, Sussex: Harvester Press, 1983).

<sup>2</sup> The translation of the *Social Contract* used in this thesis is that of Hopkins in E Barker, *Social Contract: essays by Locke, Hume and Rousseau* (London: Oxford University Press, 1960).

The use of a political model to determine rights and obligations within a corporation is not new. Many political principles were originally formulated by medieval jurists who sought to delineate the proper governance of ecclesiastical corporations.<sup>3</sup> In recent years, theorists have sought to apply political principles to commercial corporations. Most existing models, however, fail to distinguish corporate purpose from corporate structure. This distinction must be made if the bounds of corporate legitimacy are to be determined. Before examining these models, it is necessary to outline the background to some of the problems faced by corporate regulators.

### **Background: The Current Problem**

The nature of the corporation, the proper role of the State in its regulation, the objectives and conduct of the corporation and the role of management within the corporation have been persistent issues in corporate law.<sup>4</sup> These issues came to the fore once again in Australia following the collapse of the stock market in 1987. There can be no doubt that Australia is experiencing 'a period of unprecedented corporate upheaval'<sup>5</sup> in which the issue of the proper regulation of companies has assumed a new urgency.

Company law in Australia must perform a number of functions. It must provide facilities for incorporation; supplement the general law on relations between members of the corporation *inter se*; enable a registered company to have legal relations with other persons; provide a procedure for the dissolution of the corporation; and protect the investing public.<sup>6</sup> However, there has been considerable criticism of the Australian

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<sup>3</sup> See further, K Pennington, 'Law, legislative authority and theories of government, 1150-1300', and JP Canning, 'Law, sovereignty and corporation theory 1300-1450', in *The Cambridge History of Medieval Political Thought c. 350-c.1450* (Cambridge: Cambridge University Press, 1988) 443; WR Cornish and G de N Clark, *Law and Society in England 1750-1950* (London: Sweet and Maxwell, 1989).

<sup>4</sup> Such issues have been analysed over many years. See, for example, the nineteenth century discussion of Ernst Freund, *The Legal Nature of Corporations* (New York: Burt Franklin, 1897) and more recently, Geof Stapledon, 'The Corporate Governance debate in the United Kingdom', (1993) 11 *CSLJ* 62; James Frayne, 'Corporate Governance: the issues', (1993) 107 *Aus Banker* 151; Roman Tomasic and Steve Bottomley, 'Corporate governance and the impact of legal obligations on decision making in corporate Australia', (1992) 1 *AJCL* 55; PJ Dunstan, 'The corporate governance agenda: crucial issues for directors in the 1990s', (1991) 1 *AJCL* 145; Ian R McEwin, 'Public versus shareholder control of directors', (1992) 10 *CSLJ* 182; Henry N Butler and Larry E Ribstein, 'Opting out of Fiduciary Duties: A Response to the Anti-Contractarians', (1990) 65 *Wash LR* 1; Neil Martin-Kaye 'The Theoretical Basis of Modern Company Law', (1976) 4 *JBL* 235; Tom Hadden, *Company Law and Capitalism* (London: Weidenfeld and Nicolson, 1972).

<sup>5</sup> Justice Andrew Rogers, 'Avalanche Threatens', (1990) *Aus Law News*, at 16.

<sup>6</sup> HAJ Ford, *Principles of Company Law* (4th ed) (Sydney: Butterworths, 1986), at 3.

regulatory scheme in the performance of these functions. Since the introduction of the state companies legislation in the early 1960s, the legislation governing corporations has increased some 450%. The bulk of this increase occurred in the last twenty years.<sup>7</sup> Despite this torrent of legislation, a judge of the NSW Supreme Court stated that, '...the improvements in the justice system, both legislative and curial, ... are so marginal as to be unnoticeable and ineffective';<sup>8</sup> A practitioner noted that the costs of justice have increased without a corresponding increase in the chances of justice;<sup>9</sup> A legal academic wrote that '[A] major regret of corporate law writers, jurists, lawyers and business people is that company law is unnecessarily complex and voluminous. Rules are not always clearly thought out or concisely and clearly expressed.'<sup>10</sup> Even the Australian Securities Commission recognised that:

Company law is becoming excessively complicated and there is a risk that people will turn away from companies altogether. We have seen a spectacular loss of confidence in the capital generation context. There is a real risk of a similar loss of confidence in the utility of company law in the operating business context.<sup>11</sup>

It must be acknowledged, of course, that Australia is not alone in its struggle to regulate the corporate form. Since its inception, the unscrupulous used the corporate form to abuse trust and evade legal obligations. In general, efforts of the state to control this abuse have had limited success.<sup>12</sup>

I suggest that there are two reasons why the corporate form has been difficult to regulate: Firstly, a scheme of regulation based largely upon principles derived from the company law<sup>13</sup> of the nineteenth century is increasingly inadequate to control the modern

<sup>7</sup> John M Green, "Fuzzy Law"-A Better Way to Stop "Snouts in the Trough"?, (1991) *CSLJ* 146. Green notes that this figure does not include legislation affecting the operation of companies such as the *Trade Practices Act*, 1974 (Cth).

<sup>8</sup> Justice Rogers, commenting on the period of fifteen years following the collapse of the Cambridge Credit Corporation, above, note 5, at 16.

<sup>9</sup> Green, above, note 7, at 146.

<sup>10</sup> JF Corkery, *Directors Powers and Duties* (Melbourne: Longman, 1987), xxv.

<sup>11</sup> P Cranswick, 'Background to the Corporations Law and Australian Securities Commission- the ASC's Philosophy', paper presented at A.S.C. Seminar, Hobart, March 1991.

<sup>12</sup> The infamous South Sea Bubble incident, discussed at greater length in Chapter 3, is a good example of this. For a more detailed examination of the South Sea Bubble incident, see Paula Baron, 'Bringing Back the Bubble? Regulation of corporate abuse by an action in public nuisance', (1992) 11 *UTLR* 149.

<sup>13</sup> The development of the modern law of companies is largely the result of piecemeal reform of nineteenth-century legislation. See further, Ch 3.

corporation: Secondly, incorporation creates a rich and complex web of relationships and protecting the interests of all parties concerned is very difficult. These arguments will be discussed in turn.

### **The Inadequacy of the Nineteenth-Century Model**

Australia's corporate regulatory scheme has evolved largely from the piecemeal reform of the nineteenth century companies legislation of England. This scheme has proved to be increasingly inadequate to govern the twentieth-century corporation. This is because both the character of the corporation and the circumstances in which the corporation functions have changed considerably. In the nineteenth century, society generally accepted that the corporation should conform to the economic model. Under such a model, the primary purpose of the commercial corporation was profit maximisation. The role of the state one of neutrality. Under the doctrine of laissez-faire, the market was to be free and autonomous.<sup>14</sup> Once the liberal state was instituted, economic and social inequalities which existed were considered to be beyond the scope of state activity.<sup>15</sup> Under this economic model, internal company relations were also based upon the notion of profit maximisation. The duties of management were owed only to shareholders. These shareholders had very limited rights of action against directors provided that the actions of the directors were directed toward company profit.

The character of the corporation, however, no longer conforms to the stereotype of the nineteenth-century company. Corporate law must govern a variety of corporate models ranging from the quasi-partnership through to conglomerates and multinationals.<sup>16</sup> Further, the rise in institutional investment has led to a depersonalisation of the company, so that many companies are perceived to be aggregations of property, rather than associations of people.<sup>17</sup>

Just as the character of corporations has changed, so have the circumstances in which corporations operate. Today, many people argue that commercial corporations should

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<sup>14</sup> See further, P Baron, 'Shells of steel and bodies of pulp: Commercial man, commercial morality', (1993) 11 *Law in Context* 3.

<sup>15</sup> Frances E Olsen, 'The Family and the Market: A Study of Ideology and Legal Reform', (1983) 96 *Harv LR* 1502.

<sup>16</sup> LS Sealy, '"Bona Fides" and "Proper Purposes" in Corporate Decisions', (1989) 15 *Monash LR* 265.

<sup>17</sup> A characteristic which has become increasingly common since its recognition in the 1930s by Berle and Means. See AA Berle, and GC Means, *The Modern Corporation and Private Property*, (rev ed) (New York: Harcourt, Brace and World, 1968). See also Max Radin, *Handbook of Anglo-American Legal History* (St Paul, Minn: West Publishing Co, 1936), at 485.



promote wider social interests. They should operate so as to further non-financial objectives such as environmental awareness, non-discrimination, consumer and employment protection. The largely untrammelled individualism of the nineteenth century, which gave rise to a reluctance by legislature and judiciary to enter into the internal relationships of the company (just as there was a reluctance to enter into the private sphere of the family) has been eroded.<sup>18</sup> There is greater acceptance of the intervention of the state in the internal affairs of the company in order to alleviate injustice.

### **The Complexity of Relationships Created by Incorporation**

The second argument underlying this thesis is that the difficulties of regulation of the corporate form, in more general terms, stem from the act of incorporation itself. This act creates a rich and complex web of relationships and a multiplicity of legal, moral and social interests. Incorporation creates a distinct legal entity, the rights and obligations of which may be distinguished from those who compose it. In turn, the interests of both the company and its shareholders may be distinguished from those who create and/or manage that company. Further, creditors, employees and other third parties, such as consumers, have an interest in the operation of the company. Where the company forms part of a group, other companies have an interest in its operation. Finally, because the company operates in the wider social and economic environment, the State, and increasingly, the international community, have interests in the operation of the company. The dilemma faced by the legislature and the judiciary then, is to regulate the corporation in the face of three imperatives which arise from this multiplicity of interests. These are: the need to preserve the ability of the company to function effectively in the commercial context; the need to ensure that the individual, as an interested party, is treated justly; and the need to ensure that wider social concerns are recognised and upheld.

Traditionally, however, the law has been limited in its regulation of the corporation. This is because, at law, the corporation is merely a fictitious legal entity. This fiction largely ignores the complexity of relationships and obligations underlying incorporation. The legal fiction of the corporation is adopted because to hold otherwise would be to assume

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<sup>18</sup> A parallel may also be drawn with contract law, where there has been a considerable erosion of the nineteenth century concept of a will-based theory of contract to a theory based upon substantive justice. The enactment of the oppression provision in the *Corporations Law* may be seen to be paralleled by the growth of unconscionability in contract law. See, for instance, *Louth v Diprose* (1991) 110 ALR 1; *National Australia Bank Ltd v Nobile* [1988] ATPR 49; *European Asian v Kurland* (1985) 8 NSWLR 192; *Commercial Bank of Australia Ltd v Amadio & Anor* (1983) 57 ALJR 358; and *Trade Practices Act 1974* (Cth) ss 51AA and 51 AB; the corresponding provisions in the state Fair Trading Acts; and *Contracts Review Act 1980* (NSW) s 9.

that the aggregate is something more than the sum of its parts.<sup>19</sup> This is not the only possible legal view of a corporation, however.

The application of Rousseau's theory assumes that the corporation is an organic,<sup>20</sup> and not merely a fictitious entity. The corporate entity has an existence and a will of its own, so corporate rights and obligations must be distinguished from individual rights and obligations. Before proceeding to consider the application of Rousseau's theory to corporations, it is necessary to outline some alternative theoretical models of corporations.

### **Theoretical Models of Corporate Governance**

The dissatisfaction with the existing model of the corporation is reflected in the number of alternative models proposed by theorists in the twentieth-century. Although a complete and comprehensive analysis of these models is beyond the scope of this thesis, it is necessary to outline briefly some of the more influential of these models in order to provide a basis for comparison with Rousseau's model.

#### *The company as legal fiction*

The traditional model of the corporation is, (as discussed above) that of a fictitious legal entity, the sole purpose of which is ordinarily the pursuit of profit. Attempts have been made to construct a new variant of this traditional economic model that can accommodate such contemporary values as corporate social responsibility and shareholder democracy. One exponent of this model, Eisenberg,<sup>21</sup> claims that the corporation derives its moral legitimacy as an empirical matter from widespread popular acceptance of the desirable economic outcomes it produces. Corporate legitimacy flows primarily from the efficient utilisation of economic resources and secondarily from ethical notions regarding the sanctity of private property. As in the traditional economic model, the corporation has a single objective—that of conducting business activities in order to make a profit. As the company is also a social institution, however, the pursuit of this goal 'must be constrained by social imperatives and may be qualified by social needs'.<sup>22</sup> The model does not adequately determine the extent to which the pursuit of

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<sup>19</sup> Freund, note 4, at 10-12.

<sup>20</sup> Indeed, Rousseau frequently used the analogy of a human body to describe the workings of associations.

<sup>21</sup> Melvin Eisenberg, 'Corporate Legitimacy, Conduct and Governance—Two models of the Corporation' (1983) 17 *Creighton LR* 1.

<sup>22</sup> *Id.*, at 6.

profit may be qualified by these other needs and imperatives. Thus, the model in has been criticised in the following terms:

...Professor Eisenberg does not advocate the adoption of a true economic model that would prohibit legal, ethical and humanitarian conduct unrelated to corporate profit and shareholder gain. Instead, he offers a revised 'restatement' complete with anomalies and unexplained limitations. [in this model] the intuitive legitimacy of specific applications override the authority of the conceptual paradigms. The paradigms are supposed to decide difficult cases, not give way in difficult areas.<sup>23</sup>

#### *The contractual model*

The contractual model is aligned to the traditional economic model. Under this model, the rights and responsibilities within a corporation are considered to be a matter of private contract. Shareholders create the corporate form by free agreement. They collectively own the corporation as private property, and consent to restrict their immediate control of their investment capital in return for certain rights: the right to democratically elect the board; to make extraordinary business decisions; and the right to receive dividends. The board's obligation is to pursue the legitimate commercial expectations of the investors.<sup>24</sup> The emphasis here is clearly upon the internal relations of the corporation. In America, however, such a view has constitutional implications in that, if the company is perceived to be a private contract, the role of the State in determining rights and obligations is limited. Historically, the transition from incorporation by special legislation to general incorporation in the United States is said to confirm the contractual view, and provide justification for the notion that duties are owed primarily to the shareholders, rather than to the general public.<sup>25</sup>

Some analysts claim that the contractual model is best justified by reference to ethical, rather than historical analysis. Pilon, for instance, refers to the natural law tradition 'when freedom of contract was rather more highly regarded'.<sup>26</sup> 'From a normative perspective the corporation is justified under a Nozickian variant of this tradition because

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<sup>23</sup> R Collin Mangrum, 'In Search of a Paradigm of Corporate Responsibility', (1983) 17 *Creighton LR* 21, at 26.

<sup>24</sup> *Id.*, at 27.

<sup>25</sup> R Hessen, 'A New Concept of Corporations: A Contractual and Private Property Model', (1979) 30 *Hastings LJ* 1327; R Hessen, *In Defense of the Corporation* (Stanford, Calif: Hoover Institution Press, Stanford University, 1979).

<sup>26</sup> Roger Pilon, 'Corporations and Rights: On Treating Corporate People Justly', (1979) 13 *Ga L R* 1245, at 1251-52.

it might arise by a process that violates no one's rights...'<sup>27</sup> This contract model makes two claims: The first is that the law recognises the right of shareholders to demand that management be constrained strictly by profit motivation; and the second is that ideas of private property and contract rights should be respected even if they run counter to the public interest.

Either variation of the contract model assumes that the competitive market controls the operations of the company. State regulation is, therefore, largely unnecessary. This view, however, can be criticised as outdated. In recent years, there has been a shift in ethical reasoning. Nineteenth-century notions of laissez-faire and freedom of contract have given way to a more paternalistic view of the role of the state and a greater emphasis on the public interest. This is reflected in America by the Tentative Draft No. 1 of the American Law Institute's Principles of Corporate Governance and Structure, s. 2.01, which provides:

[T]he objective of the business corporation is to conduct business activities with a view to corporate profit and shareholder gain except than, even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business

(a) is obliged to the same extent as a natural person, to act within the boundaries set by law.

(b) may properly take into account ethical principles that are generally recognised as relevant to the conduct of business and

(c) may devote resources, within reasonable limits, to public welfare, humanitarian, educational and philanthropic purposes.

#### *The concessional model*

Some critics of the contractual model propose the concessional model of the corporation. This model is based upon the idea that the corporation was originally a public, rather than a private institution. In medieval times, royal assent was necessary for a grant of corporate identity. Further, many joint stock companies which were granted corporate identity were involved with essentially public operations, such as building and operating railways. As Stokes<sup>28</sup> points out, in the eighteenth and nineteenth centuries, this theory found doctrinal expression in the *ultra vires* rule, that is, that corporate bodies should operate within narrowly defined powers which were granted to them by the statute or charter which conferred corporate identity upon them. From these origins of the corporate form, it can be argued that the corporation was essentially a public body, rather than a matter of private property. This model, however, can be criticised on the basis

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<sup>27</sup> Id, at 1262.

<sup>28</sup> Mary Stokes, 'Company law and legal theory', in W Twining (ed) *Legal Theory and Common Law* (Oxford: Basil Blackwell, 1986), 135 at 162.

that it rests upon an historical, rather than a contemporary understanding, of corporations. Corporate identity is freely available upon compliance with certain basic formalities. It can hardly be seen as a privilege.

#### *The political model*

Political models of the corporation are based upon the idea that the company is a real, rather than a fictional, entity, which exists separately from its shareholders. Dahl's form of this model relies on ideas of democratic pluralism:<sup>29</sup> that, is, in a rational society, every institution ought to be controlled by those groups affected by it. Consumers, employees, shareholders and the general public are each affected by corporate power, and therefore, each ought to have some input into the governance of the company. The corporation, in effect, has a moral responsibility to these various constituents which has not, traditionally, been recognised by the law. In order that these interests be recognised, the law should be reformed so that the board of a corporation operates on a democratic basis, comprising representatives from each group and owing fiduciary duties to all its affected constituents. This is an express rejection of the traditional corporate model whereby such duties are owed only to shareholders.<sup>30</sup> There is some concern, however, that a diffusion of management responsibility would result in the disappearance of investment capital and the dilution of any meaningful accountability on the part of management.

#### *The public interest model*

An alternative paradigm is offered by the public interest model. This model originated as early as 1920's and 1930's, when 'idealised notions of democracy, property and contract rights received continuous haranguing by...political scientists who insisted that society ought to focus on the public interest rather than legal abstractions'. The empirical findings of *The Modern Corporation and Private Property*<sup>31</sup> were that the increase in numbers of shareholders resulted in a corresponding diminution of their control over corporate policy. It was suggested, therefore, that administrative elites controlled economic power in corporate America just as they controlled politics in democratic America.<sup>32</sup> In response, Berle, in searching for a corporate model, retained the contract model, but adjusted it: Whilst individual shareholders had little or no control over the

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<sup>29</sup> Robert Dahl, *After the Revolution?: authority in a good society* (New Haven: Yale University Press, 1970), at 7.

<sup>30</sup> Mangrum, note 23, at 21.

<sup>31</sup> Berle and Means, note 17.

<sup>32</sup> Mangrum, note 23, at 33.

corporation, management was obliged to serve the shareholders' investment interests.<sup>33</sup> Dodd, on the other hand, maintained that, as the public corporation existed as a separate entity from its shareholders, it had social responsibilities of its own. Management 'should concern themselves with the interests of employers, consumers and the general public, as well as of stockholders...'.<sup>34</sup>

This public interest view was interpreted in different ways. For instance, some writers such as John Kenneth Galbraith, claimed that management's profit obligation demanded only fair or normal return on investment capital. Public interest demands more emphasis on economic growth than on shareholder profit.<sup>35</sup> Other public interest theorists, such as Ralph Nader, maintained that as the law creates and protects those rights called property or the corporation, this same law can rearrange those bundle of rights if it is in the public interest.<sup>36</sup> Although the public interest view coincides with the changing legislative and judicial view of the corporation, it leaves unanswered the practical difficulties of reconciling the conflict of interests inherent in the internal operation of corporations.

The inherent difficulty with these various models is that they confuse corporate structure and corporate purpose, failing thereby to distinguish clearly between the rights and obligations of the state and the rights and obligations of the corporation. The internal structure of the corporation is contractual; as an organisation, it will act in its own interests; and those interests are, fundamentally, based on notions of property and the pursuit of profit. Yet, the company must operate within the wider context of the state. It cannot, then, in the pursuit of its interests, function above or outside contemporary moral and legal norms. Rousseau's model of contractual obligations identifies and seeks to accommodate these inherent tensions.

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33 'All powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears'. A Berle 'Corporate Powers as Powers in Trust', (1931) 44 *Harv LR* 1049, at 1052.

34 E Merrick Dodd, 'For Whom are Corporate Managers Trustees?', (1932) 45 *Harv LR* 1145.

35 John Kenneth Galbraith, *The New Industrial State* (London: H Hamilton, 1967), at 166-178.

36 R Nader, M Green and J Selizman, *Taming the Giant Corporation* (New York: Norton, 1976), 15, 33-35 and 63. See also R Nader and M Green, *Corporate Power in America* (New York: Grossman Publishers, 1973).

## The Application of Rousseau's Theory to the Corporation

Rousseau's theory is particularly suited to the study of the regulation of corporations for a number of reasons: First, Rousseau considered associations to be a natural and inevitable occurrence. His theory, therefore, is primarily concerned with an analysis of the rights and liabilities arising from an associative structure, both *inter se* and as between individual members and the group as a distinct moral entity. Second, the corporation is essentially contractual in nature.<sup>37</sup> A theory of justice based upon contractual principles is therefore appropriate. Third, Rousseau's theory places particular emphasis on the importance of reciprocity of obligations in the relationships which are created by associations. This is a principle which is of considerable importance in company law. Fourth, the theory stresses the importance of distinguishing between the interests of the association as a distinct moral entity and the particular or individual interests of the members of that association. This can provide a valuable guide to the judiciary in its determination of the elusive concept of the 'best interests of the company'.<sup>38</sup> Fifth, flowing from the concept of the objective good of the company, the theory can provide guidance as to the proper regulation of the company by identifying the inherent tendency within associations toward totalitarianism (both individual and majoritarian) on the one hand, and atomisation of the association on the other. Sixth, Rousseau's theory emphasised the importance of property as a basis of associations. This is particularly apt in a consideration of commercial corporations. Last, the theory recognises that the objective good of an association is separate and distinct from the good of the state. In turn, the good of the state is to be distinguished from the good of the international community. This may provide a guide to the regulation of companies on both the national and international level.

Although social contract theory in general has met with considerable criticism,<sup>39</sup> many of these criticisms are inapplicable if the theory is applied to corporations rather than to

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<sup>37</sup> See, for example, Henry N Butler and Larry E Ribstein, 'The Contract Clause and the Corporation', (1989) 55 *Brooklyn LR* 767; Henry N Butler, 'The Contractual Theory of the Corporation', (1989) 11 *Geo Mason LR* 99.

<sup>38</sup> This term has been considered in a number of cases. See, for example, *Henry v Great Northern Railway* (1857) 44 ER 858; *Re W & M Roith* [1967] 1 WLR 432; *Dodge v Ford Motor Co* (1919) 170 NW 668; *Walker v Winborne* (1976) 137 CLR 1; *Permakraft (NZ) Ltd (in liq) v Nicholson* (1982) 1 ACLC 488; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 ACLC 215; *Grove v Flavel* (1986) 4 ACLC 654.

<sup>39</sup> The classic essay criticising social contract theory is that of David Hume, 'Of the Original Contract' reproduced in Barker, note 2. For discussions of the theory of social contract generally, see Deborah Baumgold, 'Pacifying politics: resistance, violence, and accountability in seventeenth-century contract theory', (1993) 21 *Pol Theory* 6; Michael Davis, 'The Moral Legislature: contractualism without an Archimedean Point', (1992) 102 *Ethics* 303; Denis Collins, 'Adam Smith's Social Contract: the proper role of

nation states. This is because: firstly, in a corporation, there is an actual, as opposed to a hypothetical, contract of association; secondly, this contract of association of the company can be made precise, unlike the hypothetical contract of association of the state; thirdly, subsequent members of the company voluntarily and knowingly assume the obligations of that association. There are, however, certain difficulties in the application of Rousseau's particular theory to companies. Primary among these is that, although Rousseau saw the tendency to form partial associations within the state as inevitable,<sup>40</sup> he considered such associations as inimical to true democracy:

Partial associations and intriguing groups disadvantage the whole. There should be no subsidiary groups within the whole if the general will is to be expressed. If such groups do exist, they should be as large as possible and of equal power to one another.<sup>41</sup>

Although Rousseau was writing here with specific reference to voting power, it is possible to extend this statement to the more general conflict of interests created by any group within the State. The implications of this paradox for both internal governance of corporations and for the proper regulation of the company by the State will be canvassed where appropriate. It is also acknowledged that Rousseau's theory was never intended to be applied to a nation state. On the one hand, this facilitates the application of the theory to the regulation of companies, as it is possible for the corporate association to be self-governing in the sense used by Rousseau. This aspect of Rousseau's theory, however, presents some difficulties in a discussion of the proper role of the state in the regulation of the company. This is acknowledged in the discussion of the relationship between the company and the State in Chapter 12. Finally, it is also recognised that Rousseau's practical conclusions have been considered to be irrelevant, if not dangerous.<sup>42</sup> It is

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individual liberty and government intervention in 18th century society', (1988) 7 *Bus and Prof Ethics* 119; Paul Hodapp, 'Can there be a social contract with business?', (1990) 9 *J Bus Ethics* 133; Thomas J Lewis, 'On using the concept of hypothetical consent', (1989) 22 *Can J Pol Sci* 793; Louis Dupre and William O'Neill, 'Social Structures and structural ethics', (1989) 51 *Rev of Pol* 327; Carl G. Hedmen, 'Making the social contract relevant', (1987) 13 *Soc Theory and Prac* 327; EA Goerner, 'Letter and Spirit: the political ethics of the rule of law versus the political ethics of the rule of the virtuous', (1983) 45 *Rev Pol* 553. The new order in Eastern Europe has also given rise to a body of literature examining the social contract in the context of post-communism. See, for example, Zbigniew Rau, 'The state of enslavement: the East European substitute for the state of nature' (1991) 39 *Pol Studies* 253; Zbigniew Rau, 'Some thoughts on civil society in Eastern Europe and the Lockean contractarian approach' (1987) 35 *Pol Studies* 573.

<sup>40</sup> Jean-Jacques Rousseau, 'The Discourse on Political Economy', in *The Social Contract and Discourses* (London: JM Dent, 1993), at 133.

<sup>41</sup> *Social Contract* (referred to hereafter as SC) II:iii.

<sup>42</sup> Roger D Masters, *The Political Philosophy of Rousseau* (Princeton: Princeton University Press, 1968), at 421.



appreciated that Rousseau's attempts to reconcile liberty and authority, and the pursuit of the individual self interest with the good of the collective are, in many ways, unacceptable. However, his theory is valuable in this regard for two reasons: firstly, because the theory acknowledged the existence of such issues; and secondly, for the fact that Rousseau's practical solutions reveal the inherent danger of atomisation of the association on the one hand, and injustice on the other.

There are three limitations upon the scope of this thesis: Firstly, this thesis is concerned primarily with the Anglo-Australian model of company law. The law of other jurisdictions will only be considered where appropriate by way of comparison; secondly, the focus of this study is on commercial companies, rather than non-profit organisations; thirdly, the thesis is not intended to provide a complete account of company law in Australia. Rather, it is concerned with the principles of governance of the corporation, both internal and external as these are derived from the traditional economic model of the corporation. Finally, the law is stated as at December 31, 1994.

Chapters 1 to 3 of this thesis are concerned with introductory material: Rousseau's theory, and its connections with, and differences to, earlier contract theorists will be considered. The history of the corporation will then be examined in order to explain the origin of the theories of governance which underlie corporate law. Chapters 4 to 8 of the thesis are concerned with the internal dynamics of the company: that is, the division of power between shareholders and directors. Chapters 9 and 10 of the thesis are concerned with the relationship of the company and the wider society in which it operates. In each section, the traditional model of corporate governance will be described, and this model will be compared with the Rousseau's model. This method is adopted in order to achieve two objectives. The first objective is to consider the extent to which our accepted model of corporate order may be said to be just,<sup>43</sup> democratic and efficient. The second objective is to examine the extent to which Rousseau's theory may be applied to corporate law in order to reconcile the demands of individual self-interest and the common good.

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<sup>43</sup> This is not to ignore that fact, of course, that a law may be criticised as unjust, but be defended upon such grounds as ease of administration, the maintenance of law and order or the attainment of other political goods. This point is discussed more fully in JR Lucas, *The Principles of Politics* (Oxford: Clarendon Press, 1985), at 233 ff.

## CHAPTER 2

### THE VALUES AND ASSUMPTIONS OF ROUSSEAU'S THEORY

At the heart of all political philosophy are certain questions: What is this creature we call a human being? Why do people enter into societies? What is the purpose of these societies? Is power inevitable? If so, how should it be exercised and to what ends? I suggest that these questions are as fundamental to an analysis of the corporation as they are to an analysis of the nation state. The use of political principles to determine rights and obligations within a corporation is not new. Many of the political principles that we now apply to nation states were originally formulated by medieval jurists who sought to delineate the proper governance of ecclesiastical corporations.<sup>1</sup> In this chapter, I shall compare Rousseau's answers to these fundamental questions of political philosophy to those of Locke and Hobbes.<sup>2</sup>

#### Human nature and the rationale for association

All political philosophies are based upon particular views of human nature. Rousseau, Hobbes and Locke based their views of human nature upon a consideration of the pre-political man, that is, man in the 'state of nature'.

Locke claimed:

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<sup>1</sup> See further, K Pennington, 'Law, legislative authority and theories of government, 1150-1300', and JP Canning, 'Law, sovereignty and corporation theory 1300-1450', in *The Cambridge History of Medieval Political Thought c 350-c 1450* (Cambridge: Cambridge University Press, 1988); WR Cornish and G de N Clark, *Law and Society in England 1750-1950* (London: Sweet and Maxwell, 1989).

<sup>2</sup> There is a considerable body of literature comparing Rousseau's philosophy to the work of other philosophers. See, for instance, FM Barnard, *Self-direction and political legitimacy: Rousseau and Herder* (Oxford: Clarendon Press, 1988); David Marshall, *The Surprising Effects of Sympathy: Marivaux, Diderot, Rousseau and Mary Shelley* (Chicago: University of Chicago Press, 1988); Andrzej Rapaczynski, *Nature and Politics: liberalism in the philosophies of Hobbes, Locke and Rousseau* (Ithaca: Cornell University Press, 1987); Jules Steinberg, *Locke, Rousseau and the idea of consent: an inquiry into the liberal-democratic theory of political obligation* (Westport, Conn: Greenwood Press, 1978); Jose Guilherme, *Rousseau and Weber: two studies in the theory of legitimacy* (London: Routledge and Kegan Paul, 1980); Maurice Cranston, *Hobbes and Rousseau: a collection of critical essays* (New York: Anchor Books, 1972); David Cameron, *The Social Thought of Rousseau and Burke* (London: Weidenfeld and Nicolson, 1973); Emile Durkheim, *Montesquieu and Rousseau: forerunners of sociology* (Michigan: University of Michigan Press, 1960); Patrick Neal, 'In the shadow of the general will: Rawls, Kant and Rousseau on the problem of political right', (1987) 49 *Rev of Pol* 389; ME Brint, 'Jean-Jacques Rousseau and Benjamin Constant: a dialogue on freedom and tyranny', (1985) 47 *Rev Pol* 323.

To understand political power aright, and derive it from its original, we must consider, what state all men are naturally in, and that is, a state of perfect freedom to order their actions, and dispose of their possessions and persons, as they think fit, within the bounds of the law of nature, without asking leave or depending upon the will of any other man.

A state also of equality, wherein all the power and jurisdiction is reciprocal, no one having more than another; there being nothing more evident, than that creatures of the same species and rank, promiscuously born to all the same advantages of nature and the use of the same faculties, should also be equal one amongst another without subordination or subjection, unless the lord and master of them all should, by any manifest declaration of his will, set one above another, and confer on him, by an evident and clear appointment, an undoubted right to dominion and slavery.<sup>3</sup>

To Locke, this state of nature is not merely a hypothetical device, but an historical fact:

Tis often asked as a mighty objection, where are, or ever were there any men in such a state of nature? To which it may suffice as an answer at present, that since all princes and rulers of independent governments all through the world are in a state of nature, 'tis plain the world never was, nor never will be, without numbers of men in that state.<sup>4</sup>

Locke considered natural man to be both self-interested and subject to ill-nature and partiality. Despite this, the state of nature, was a state of 'peace, goodwill, mutual assistance and preservation'.<sup>5</sup> All persons were free and equal: free in the sense of freedom from the violence and subjugation of another person; and equal in the sense that each individual had an equal right to this freedom. This state of nature was governed by the law of nature: as all men are the property of God, no man should harm another in the enjoyment of his life, liberty and estate. Hence, people have two natural duties: firstly, the duty of self preservation and (only provided one's self preservation is not at risk) the duty to preserve the rest of mankind. In this state of nature, however, the execution of the law of nature is in the hands of all. Each person may punish another, either as victim of a crime, or as defender of others. This power of punishment is thus open to abuse because of human fallibility. Individuals cannot then enjoy their natural rights, in particular, their right to private property, because they cannot be free of the violence and subjugation of others. This being the case, individuals must unite in a community, rendering the power of punishment to the government. Protection of property and want of a common judge ensured that humans entered society.

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<sup>3</sup> John Locke, 'True End of Civil Government', in E Barker, *Social Contract: Essays by Locke, Hume and Rousseau* (London: Oxford University Press), at II: 4.

<sup>4</sup> Id, at II:14.

<sup>5</sup> Id, at III:19.

[I]n the state of nature every one has the executive power of the law of nature, I doubt not but it will be objected, that is unreasonable for men to be judges in their own cases, that self-love will make men partial to themselves and their friends: and on the other side, ill-nature, passion and revenge will carry them too far in punishing others; and hence nothing but confusion and disorder will follow; and that therefore God hath certainly appointed government to restrain the partiality and violence of men. I easily grant that civil government is the proper remedy for the inconveniences of the state of nature, which must certainly be great where men may be judges in their own case, since 'tis easy to be imagined, that he who was so unjust as to do his brother an injury, will scarce be so just as to condemn himself for it;...<sup>6</sup>

Rousseau, however, disagreed with Locke:

If an individual, says Grotius, can alienate his liberty and become the slave of a master, why should not a whole people be able to alienate theirs, and become subject to a king?...To alienate is to give or sell...why does a nation sell itself? So far from a king supplying his subjects with their subsistence, he draws his from them; and according to Rabelais, a king does not live on a little. Do subjects, then, give up their persons on condition that their property also shall be taken? I do not see what is left for them to keep.<sup>7</sup>

Hobbes had a different view of the pre-associative state. In his theory, the state of nature was the state of war:

So that in the nature of man, we find three principall causes of quarrell. First, Competition; Secondly, Diffidence; Thirdly. Glory.

The first, maketh men invade for Gain; the second, for Safety; and the third, for Reputation. The first use Violence, to make themselves Masters of other men's persons, wives, children, and cattell; the second, to defend them; the third, for trifles, as a word, a smile, a different opinion, and any other signe of undervalue, either direct in their Persons, or by reflexion in their Kindred, their Friends, their Nation, their Profession, or their name.

Hereby it is manifest, that during the time men live without a common Power to keep them all in awe, they are in that condition which is called Warre; and such a warre, as is of every man, against every man.<sup>8</sup>

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<sup>6</sup> Id, at II:13.

<sup>7</sup> SC I:iv.

<sup>8</sup> Thomas Hobbes, *Leviathan*, (Harmondsworth: Penguin, 1981), at I:xiii.

To Hobbes, like Locke, this state of nature was an observable fact:

It may peradventure be thought, there was never such a time, nor condition of warre as this; and I believe it was never generally so, over all the world: but there are many places, where they live so now. For the savage people in many places of *America*, except the government of small Families, the concord where of dependeth on naturall lust, have no government at all; and live at this day in that brutish manner, ...<sup>9</sup>

Hobbes assumed that individuals are naturally bad and, indeed, antisocial. Associations, therefore, are artificial. They only exist so that the individual can escape the inevitably 'nasty, brutish and short' life in the state of nature. Upon association, the individual must surrender all rights to government. This was the only way of ensuring order. On Hobbes's conception of human nature, people enter societies to gain peace.

The finall Cause, End, or Designe of men, (who naturally love Liberty, and Dominion over others,) in the introduction of that restraint upon themselves, (in which we see them live in Common-wealths) is the foresight of their own preservation, and of a more contented life thereby; that is to say, of getting themselves out from that miserable condition of Warre, which is necessarily consequent (as hath been shewn) to the naturall Passions of men, when there is no visible Power to keep them in awe, and tye them by feare of punishment to the performance of their Covenants, and observation of those Lawes of Nature...<sup>10</sup>

And in him consisteth the Essence of the Common-wealth; which (to define it,) is One Person, of whose Acts a great Multitude by mutuall Covenants one with another, have made themselves every one the Author, to the end he may use the strength and means of them all, as he shall think expedient, for their Peace and Common Defence.<sup>11</sup>

Rousseau's view of the 'natural man' was quite different. In the *Social Contract*, Rousseau argued that humans were naturally good. All humans have a common essence. Each individual is born with the potential to develop into a free person. This natural capacity emanated from the common sense of self-preservation in the state of nature:

This common liberty is a consequence of man's nature. His first law is to attend to his own preservation, his first cares are those which he owes to himself; and as soon as he comes to years of discretion, being sole judge of the means adapted for his own preservation, he becomes his own master.<sup>12</sup>

In an earlier work, Rousseau maintained that man's nature was also marked by a common sense of compassion. Rousseau defined compassion as 'a natural repugnance at seeing

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<sup>9</sup> Ibid.

<sup>10</sup> Id, at II:xvii.

<sup>11</sup> Ibid.

<sup>12</sup> SC I:ii.

any other sentient being, and particularly any of our own species, suffer pain or death'.<sup>13</sup>

The result of this was that:

So long as man does not resist the internal impulse of compassion, he will never hurt any other man, nor even any sentient being except on those lawful occasions on which his own preservation is concerned and he is obliged to give himself preference...<sup>14</sup>

Humans form political associations, then, for two reasons. Firstly, people enter associations generally to ensure their self-preservation. Associations are, at some point, natural and inevitable. The family is evidence of this.

[T]heir situation, as a result of this contract, is in reality preferable to what it was before: instead of any alienation, they have only made an advantageous exchange of an uncertain and precarious mode of existence of a better and more assured one, of natural independence for liberty, of the power to injure others for their own safety, and of their strength, which others might overcome, for a right which the social union renders inviolable. Their lives, also, which they have devoted to the State, are continually protected by it; and in exposing their lives for its defense, what do they do but restore what they have received from it? What do they do but what they would do more frequently and with more risk in the state of nature, when, engaging in inevitable struggles, they would defend at the peril of their lives their means of preservation?<sup>15</sup>

Secondly, people enter civil society because it confers upon individuals a better life than that which can be lived in the pre-political state.

Rousseau believed, however, that contemporary societies frustrated people's innate goodness. In Rousseau's view, 'Man is born free but everywhere he is in chains'<sup>16</sup>

Debased societies, then, and not human nature, were responsible for social conflict:

Men are not naturally enemies, if only for the reason that, living in their primitive independence, they have no mutual relations sufficiently durable to constitute a state of peace or a state of war. It is the relation of things and not of men which constitutes war; and the state of war cannot arise from simple personal relations, but only from real relations; private war - war between man and man - cannot exist either in the state of nature, where there is no settled ownership, or in the social state, where everything is under the authority of the laws.<sup>17</sup>

This was a direct refutation of Hobbes. Rousseau disagreed with Hobbes's view that the rationale for association was peace:

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<sup>13</sup> 'Discourse on Inequality', 171-2.

<sup>14</sup> 'Discourse on Inequality', 172.

<sup>15</sup> SC II:iv.

<sup>16</sup> SC I:i.

<sup>17</sup> SC I:iv.

It will be said that the despot secures to his subjects civil peace. Be it so; but what do they gain by that, if the wars which his ambition brings upon them, together with his insatiable greed and the vexations of his administration, harass them more than their own dissensions would? What do they gain if this tranquillity itself is one of their miseries? One lives tranquilly also in dungeons; is that enough to make them good?<sup>18</sup>

In summary, then, Hobbes, saw natural man as bad. Associations were artificial but necessary in order to control conflict. Locke saw natural man as prone to certain vices. These vices meant that man could not enjoy his natural rights unless he formed civil society in order to provide a common judge to protect those rights. Rousseau, however, saw natural man as good and associations as natural and inevitable. Existing societies, however, were debased and corrupted man's natural goodness.

### **The purpose of societies: conflict management v. moral development**

These different assumptions as to human nature and the reasons for association also engendered different conclusions as to the ultimate potential of society. Hobbes believed that people could not overcome human disunity. They could only seek to moderate it. Therefore, the most that could be achieved from the 'good' society was order. Locke's theory implied that the best that people could hope for was a common form of dispute resolution to resolve human conflict and to protect natural rights. Rousseau believed, however, that the good society provided the potential for the full moral development of individuals. This belief in the moralising potential of society was far-reaching. Only within a community could people discover their true humanity:

This passage from the state of nature to the civil state produces in man a very remarkable change, by substituting in his conduct justice for instinct, and by giving his actions the morality that they previously lacked. It is only when the voice of duty succeeds physical impulse, and law succeeds appetite, that man, who till then had regarded only himself, sees that he is obliged to act on other principles, and to consult his reason before listening to his inclinations. Although, in this state, he is deprived of many advantages that he derives from nature, he acquires equally great ones in return; his faculties are exercised and developed; his ideas are expanded; his feelings are ennobled; his whole soul is exalted to such a degree that, if the abuses of his new condition did not often degrade him below that from which he has emerged he ought to bless without ceasing the happy moment that released him from it for ever, and transformed him from a stupid and ignorant animal into an intelligent being and a man.<sup>19</sup>

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<sup>18</sup> SC I:iv.

<sup>19</sup> SC I:viii.

This last sentence is the key to Rousseau's view of the transformative power of association. Rousseau believed that pre-political individuals, despite their innate goodness, were instinctive, indeed, proto-human because they lacked language and reason.<sup>20</sup> Societies, according to Rousseau, potentially transformed the beast into a man. Existing societies, however, changed the man back into a beast, albeit a different type of beast to natural man. This is both a physical and a social development. Frayling and Wokler relate this idea to Rousseau's interest in the figure of the vampire:

For every one of us, 'le vampire, c'est les autres'. Anatomical evidence of our teeth and intestinal tract shows that we must originally have been frugivores like the horse, sheep and rabbit, but civilisation has made us carnivores with an appetite for conquest and blood in addition to food. There have been two causes of this development, Rousseau believed: on the one hand, the artificial cultivation of the soil, which slowly depleted the natural resources of the earth and unavoidably brought men into conflict over the vegetation that remained, and, on the other, the institution of private property, which turned strangers into enemies and made each of us a predator, not just of the diminishing produce of the soil but of the degraded humanity of our neighbours too. With the birth of property and the growth of agriculture we have transfigured ourselves into masters and slaves in turn, everyone moved by contempt for the person and lust for the goods of the next man, so that we have finally become a species of animal which in its totality is self-destructive.<sup>21</sup>

The analysis of Frayling and Wokler identifies Rousseau's conception of the stages of beast/human/beast created by corrupt societies. The proto-human being is a beast in the sense of a brute or an animal; the individual corrupted by social institutions is a monstrosity.

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<sup>20</sup> Christopher Frayling and Robert Wokler, 'From the orang-utan to the vampire' in RA Leigh (ed), *Rousseau After Two Hundred Years* (Cambridge: Cambridge University Press, 1982), at 109, considered Rousseau's inquiry into the nature of pre-political man to be a major advance in anthropology:

Rousseau, nevertheless, was the first enlightenment figure, in our view, to suppose that there might be a temporal and sequential relation between particular species in the natural chain, and the first, moreover, to conceive that the last link in the chain - that is, the relation between apes and men - might be one of genetic continuity.

...Rousseau's portrait of the orang-utan as a kind of savage in the state of nature was drawn with greater accuracy than any description of the animal's behaviour for a further two hundred years or so - a fact all the more remarkable because there is no reason to suppose that he actually saw one.

<sup>21</sup> Id, at 118.



A further consequence of Rousseau's belief that the pre-political being was proto-human, was that natural rights could not be brought into the society.<sup>22</sup> This is in strong contrast to Locke. Rights, in Locke's view, arose prior to society. Natural laws delineated the role of government in relation to those rights:

Man...hath by nature a power not only to preserve his property, that is, his life, liberty, and estate, against the injuries and attempts of other men, but to judge of and punish the breaches of that law in others...But because no political society can be, nor subsist, without having in itself the power to preserve the property, and in order therunto punish the offences of all those of that society: there, and there only, is political society, where every one of the members hath quitted this natural power, resigned it up into the hands of the community ...the community comes to be umpire, by settled standing rules; indifferent, and the same to all parties.<sup>23</sup>

Rousseau's philosophy is also notable for the belief that the potential moral transformation of humans in a good society could be realised without divine intervention. Union with, or divinity achieved through a transcendent being had long been a feature of political philosophy. Both Hobbes and Locke retained considerable theological overtones in their work. Rousseau rejected the idea that the good life could only be experienced in the after life:

It is this which in all ages has constrained the founders of nations to resort to the intervention of heaven, and to give the Gods the credit for their own wisdom, in order that the peoples, submitting to the laws of the State as to those of nature, and recognizing the same power in the formation of man and in that of the State, might obey willingly, and bear submissively the yoke of the public felicity.<sup>24</sup>

Rousseau was not denying the value of religion to the individual. Religion could provide a significant moralising force. His caution lay with the potentially divisive effect of religion which could hinder the development of the good society:

There is a third and more extravagant kind of Religion, which, giving to men two sets of laws, two chiefs, two countries, imposes on them contradictory duties, and prevents them from being at once devout and Citizens...[This] is so evidently bad that it would be a waste of time to amuse oneself by demonstrating it. Whatever destroys social unity is good for nothing; all institutions which put a man in contradiction with himself are worthless.<sup>25</sup>

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<sup>22</sup> See, however, an argument to the contrary, in John Noone, *Rousseau's Social Contract, A Conceptual Analysis* (Athens: University of Georgia Press, 1980), at 164-172.

<sup>23</sup> Locke, note 3, at vii: 87.

<sup>24</sup> SC II:vii.

<sup>25</sup> SC IV:viii.

Although he advocated a 'civil religion', Rousseau maintained that the individual's religious opinions were not of relevance to the State:

The right which the social pact gives to the Sovereign over the subjects does not, as I have said, pass the limits of public utility. Subjects, then, owe no account of their opinions to the Sovereign except so far as those opinions are of moment to the community. Now it is very important for the State that every Citizen should have a Religion which may make him delight in his duties; but the dogmas of this Religion concern neither the State nor its members, except so far as they affect morality and the duties which he who professes it is bound to perform towards others. Each may have, in addition, such opinions as he pleases, without its being the business of the Sovereign to know them. For, as it has no jurisdiction in the other world, the destiny of its subjects in the life to come, whatever it may be, is not its affair, provided they are good citizens in this life.<sup>26</sup>

Despite his optimistic views of human nature, the possibility of the 'good' society, and moral development, Rousseau's final belief about associations was pessimistic. He maintained that all associations were, like human beings, destined to die:

If we wish to form a durable constitution, let us, then, not dream of making it eternal. In order to succeed we must not attempt the impossible, nor flatter ourselves that we are giving to the work of men a stability which human things do not admit of.

The body politic, as well as the human body, begins to die from its birth, and bears in itself the causes of its own destruction.<sup>27</sup>

The best that can be achieved, then, is to encourage the conditions for a stable, enduring association, whilst recognising that such association will, in time end. This was one of the tasks of good government.

## **The problems of power**

The aim of Rousseau's social contract was to establish the association upon a durable foundation.<sup>28</sup> A particular fault of existing institutions, in Rousseau's view, was that they allowed, or even encouraged, inequalities amongst people. Rousseau argued that there are two types of inequality: natural or physical; and moral or political. The latter, he argued, depended upon 'a kind of convention' established, or at the least authorised, by the consent of men. This type of inequality consisted of different privileges which some

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<sup>26</sup> SC IV:viii.

<sup>27</sup> SC III:xi.

<sup>28</sup> SC IV: ix.

enjoyed to the prejudice of others, such as wealth or power.<sup>29</sup> Such inequality could only create disunity:

With regard to equality, we must not understand by this word that the degrees of power and wealth should be absolutely the same; but that, as to power, it should fall short of all violence, and never be exercised except by virtue of station and of the laws; with regard to wealth, no citizen should be rich enough to be able to buy another, and none poor enough to be forced to sell himself, which supposes, on the part of the Great, moderation in property and influence, and, on the part of ordinary citizens, repression of avarice and covetousness.<sup>30</sup>

This is an important distinction from Hobbes and Locke. All three philosophers assume that man is, at least part of the time, covetous and avaricious. Hobbes and Locke assume this to be an inherent and unchangeable fact of man's nature. Hobbes sees this as a vice, which necessitates strong government. Locke sees it as a vice only if unregulated. Where covetousness and avarice are controlled, this egoism may contribute to the good of all. Indeed, Locke maintained that civil society was instituted in order to preserve natural inequality. Although all men held the earth in common, they made part of the earth their own through their labour. Once in the political state, individuals consented to inequality of wealth:

But since gold and silver, being little useful to the life of man, in proportion to food, raiment, and carriage, has its value only from the consent of men, whereof labour yet makes in great part the measure, it is plain that the consent of men have agreed to a disproportionate and unequal possession of the earth, I mean out of the bounds of society and compact; for in governments the laws regulate it; they having, by consent, found out and agreed in a way how a man may rightfully, and without injury, possess more than he himself can make use of by receiving gold and silver, which may continue long in a man's possession without decaying for the overplus, and agreeing those metals should have a value.<sup>31</sup>

Government, in Locke's view, served to protect that right to private wealth:

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<sup>29</sup> 'Discourse on Inequality', at 174. Rousseau's opposition to the rich and powerful was deeply personal as well as political. Paul Johnson, 'Jean-Jacques Rousseau: An Interesting Madman', in *Intellectuals* (London: Weidenfeld and Nicolson, 1988), at 23 recounts some of Rousseau's more bitter diatribes against the rich and powerful: 'I hate the great, I hate their rank, their harshness, their prejudices, their pettiness, all their vice.' Rousseau wrote to one aristocratic woman: 'It is the wealthy class, your class, that steals from mine the bread of my children,' and he admitted to a 'certain resentment against the rich and successful, as if their wealth and happiness had been gained at my expense'. The rich were 'hungry wolves who, once having tasted human flesh, refuse any other nourishment'.

<sup>30</sup> SC III:i.

<sup>31</sup> Locke, note 3, at V: 50.

Political power, then, I take to be a right of making laws with penalties of death, and consequently all less penalties, for the regulating and preserving of property, and of employing the force of the community, in the execution of such laws, and in the defence of the commonwealth from foreign injury; and all this only for the common good.<sup>32</sup>

And later:

The great and chief end therefore, of men's uniting into commonwealths, and putting themselves under government, is the preservation of their property; to which in the state of nature there are many things wanting.<sup>33</sup>

Rousseau, on the other hand, assumed avarice and covetousness to be evil, artificial and remedial. He contended that the primary purpose of government was to abolish gross inequalities of wealth:

It is said that this equality is a chimera of speculation which cannot exist in practical affairs. But if the abuse is inevitable, does it follow that it is unnecessary even to regulate it? It is precisely because the force of circumstances is ever tending to destroy equality that the force of legislation should always tend to maintain it.<sup>34</sup>

Controlling inequality of wealth, however, was only one step in remedying corrupt societies. Should prevailing inequalities created by the concentration of wealth be abolished, however, inequality of power would remain. There would still be a class of people with power and a class without; the ruler and the ruled.<sup>35</sup> Rousseau's solution to this was to vest power in all the people:

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<sup>32</sup> Id, at I:3.

<sup>33</sup> Id, at IX:124.

<sup>34</sup> SC II:xi.

<sup>35</sup> Rousseau's condemnation of slavery, by implication, is a condemnation of the inequalities of wealth and power created by social institutions:

Aristotle...had...said that men are not naturally equal, but that some are born for slavery and others for dominion.

Aristotle was right, but he mistook the effect for the cause. Every man born in slavery is born for slavery; nothing is more certain. Slaves lose everything in their bonds, even the desire to escape from them; they love their servitude as the companions of Ulysses loved their brutishness. If, then, there are slaves by nature, it is because there have been slaves contrary to nature. The first slaves were made such by force; their cowardice kept them in bondage.

The classes of the powerful and the powerless, the rich and the poor, are not natural. They seem to be natural, simply because people come to accept them. (SC I:ii)

[The clauses of the social contract]...are reducible to one only, viz., the total alienation to the whole community of each associate with all his rights. For, in the first place, since each gives himself up entirely, the condition is equal for all; and the condition being equal for all, no one has any interest in making it burdensome for others.

Further, the alienation being made without reserve, the union is as perfect as it can be, and no individual associate has anything more to claim. For, if any rights were left to individuals, since there would be no common superior who could judge between them and the public...the association would necessarily become tyrannical or useless.

Finally, each giving himself to all, gives himself to nobody; and as there is not one associate over whom we do not acquire the same rights which we concede to him over ourselves, we gain the equivalent of all that we lose, and more power to preserve what we have.<sup>36</sup>

Direct democracy eliminated the distinction between ruler and ruled.<sup>37</sup> It also presented a solution to the vexed problem of reconciling political obligation and liberty. As each individual made the law and was simultaneously bound by the law, the individual was logically free (in the sense of being subject only to the self) and equal (in the sense of not being subject to anyone else):

[The whole basis of the social contract] is that instead of destroying natural equality, the fundamental pact, on the contrary, substitutes for the physical inequality which nature imposed upon men, an equality that is moral and legitimate, so that, although unequal in strength or intellect, they all become equal by convention and legal right.<sup>38</sup>

All legitimate acts and decisions of the sovereign people, however, had to be an expression of the general will, that is, an expression of the objective good of the association as a whole. The sum of particular wills<sup>39</sup> was to be carefully distinguished from the general will:

There is often a great deal of difference between the will of all and the general will; the latter regards only the common interest, while the former has regard to private interests, and is merely a sum of particular wills; but take away from these same wills the pluses and minuses which cancel one another, and the general will remains as the sum of the differences.<sup>40</sup>

This general will must, in turn, be distinguished from the sovereign itself. Thus, individuals can be in a dissenting minority but still be forced to submit to the majority

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<sup>36</sup> SC I:vi.

<sup>37</sup> On this point, see the parallels with Hannah Arendt discussed by Margaret Canovan, 'Arendt, Rousseau and Human Plurality in Politics', in RA Leigh (ed), *Rousseau After Two Hundred Years* (Cambridge: Cambridge University Press, 1982), at 286.

<sup>38</sup> SC I:ix.

<sup>39</sup> A point Noone, takes up, note 22, at 187.

<sup>40</sup> SC II:iii.

will and still, paradoxically, obeying themselves. This is because they have agreed to submit to the vote of the majority (provided that vote is in accordance with the general will). This idea of the general will and the individual's submission to the community have lead to accusations of Rousseau's totalitarianism:

Rousseau's state is not merely authoritarian: it is also totalitarian, since it orders every aspect of human activity, thought included. Under the social contract, the individual was obliged to 'alienate himself, with all his rights to the whole of the community' (ie the State).<sup>41</sup>

Certainly, on Rousseau's assumptions as to the nature of rights, it would not be possible for such rights to be partially alienated:

For if the individual retained certain rights, each, in the absence of any common superior capable of judging between him and the public, would be his own judge in certain matters, and would soon claim to be so in all; the state of nature would continue and the association would necessarily become tyrannical or meaningless.<sup>42</sup>

Noone points out, however, that whether Rousseau is a totalitarian,

[I]n a nonperjorative sense is not clear. He specifically states that a well-governed state needs very few laws (SC 4.1) But if you extend the idea of law to cover customs, tradition, and public opinion, the scope of the state is considerably enlarged. From a theoretical point of view the scope of the state cannot go beyond the area of common concerns. ....Given Rousseau's specialised concept of law, 'totalitarian', or for that matter 'non-totalitarian' simply makes no sense when applied to him.<sup>43</sup>

This is, I believe, an important point. Accusations of totalitarianism are inappropriate because Rousseau's ideas stand outside the traditional liberal viewpoint from which totalitarianism, in the perjorative or even the non-perjorative sense, is judged.

Further, Rousseau's sovereign was not entirely unlimited. Firstly, as discussed above, the sovereign was limited by the general will. Power could only be exercised for the common good.

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<sup>41</sup> Johnson, note 29, at 25.

<sup>42</sup> SC I:vi.

<sup>43</sup> Noone, note 22, at 174.

If the State or City is only a moral person, whose life consists in the union of its members, and if the most important of its cares is that of self-preservation, it needs a universal and compulsive force to move and dispose every part in the manner most expedient for the whole. As nature gives each man an absolute power over all his limbs, the social pact gives the body politic an absolute power over all its members; and it is this same power which, directed by the general will, bears, as I said, the name of sovereignty.<sup>44</sup>

A second limitation Rousseau imposed upon the sovereign is that the general will must be general in object as well as in interest. Therefore, the sovereign cannot execute particular acts:

[J]ust as a particular will cannot represent the general will, the general will in turn changes its nature when it has a particular end, and cannot, as general, decide about either a person or a fact.<sup>45</sup>

The execution of particular acts required, on Rousseau's theory, an executive. Although legislative power was to be vested in the people as a whole, Rousseau envisaged that administration would be carried out by the few in the majority of cases. These few, however, would operate merely as agents of the people and could be removed at any of the proposed regular meetings:

What, then, is the Government? An intermediate body established between the subjects and the Sovereign for their mutual correspondence, charged with the execution of the laws and with the maintenance of liberty both civil and political.<sup>46</sup>

The natural conclusion of this notion was that there could be no contract of government:<sup>47</sup>

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<sup>44</sup> SC II:iv. Noone, note 22, at 17, takes exception to Rousseau's creation of a distinct moral entity:

At one moment we are presented with an aggregate of particular, self-regarding wills. A second later an unexplained general will comes into being and everybody promises to obey it. Presto! we have a moral community and the problem of legitimacy is solved. The fact is that there is a lot more work to be done.

Yet this is, perhaps, too harsh and too literal. Rousseau's point is that, in the 'good' community, the interests of the group as a whole, as a distinct moral entity, must take precedence over the interests of its individuals. Further, Rousseau seeks to make clear the relationship between moral obligation and responsibility. In order for an individual to act morally, Rousseau reasons, they must have a choice of action. A large part of Rousseau's unhappiness with existing institutions was that such institutions removed political responsibility from the people.

<sup>45</sup> SC II:iv.

<sup>46</sup> SC III:i.

<sup>47</sup> Contract of government maintained that members of an association instituted political authority and placed themselves under its rule in order to achieve a perceived common good. This theory had gained widespread acceptance during the middle ages

Those therefore who maintain that the act by which a people submits to its chiefs is not a contract are quite right. It is absolutely nothing but a commission, an employment, in which, as simple officers of the Sovereign, they exercise in its name the power of which it has made them depositaries, and which it can limit, modify, and resume when it pleases. The alienation of such a right, being incompatible with the nature of the social body, is contrary to the object of the association.<sup>48</sup>

Hobbes may be contrasted with Rousseau on this point. Hobbes also maintained there was a natural equality among men (because of their common subjection to human limits, desires and death). He concluded, however, that all power should be retained by government. The question of who should hold power was unimportant. All men were equally self-interested and it was in the interest of whoever held power to maintain order:

This is more than Consent, or Concord; it is a reall Unitie of them all, in one and the same Person, made by Covenant of every man with every man, in such manner, as if every man should say to every man, *I Authorise and give up my Right of Governing my selfe, to this Man, or to this Assembly of men, on this condition, that thou give up thy Right to him, and Authorise all his Actions in like manner.* This done, the Multitude so united in one Person, is called a COMMON-WEALTH, in latine CIVITAS. This is the Generation of that great LEVIATHAN, or rather (to speake more reverently) of that *Mortall God*, to which wee owe under the *Immortall god*, our peace and defence. For by this Authoritie, given him by every particular man in the Common-Wealth, he hath the use of so much Power and Strength conferred on him, that by terror thereof, he is inabled to forme the wills of them all, to Peace at home, and mutuall ayd against their enemies abroad.<sup>49</sup>

Locke had a different view of government. Although Locke believed that an absolute monarchy was wrong, he was not opposed to an aristocracy, provided that government power was both limited and divided:

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but fell out of favour as social contract theory gained acceptance in the sixteenth and seventeenth centuries. See further, PH Partridge, *Consent and Consensus* (London: Pall Mall, 1971), 9 ff.

<sup>48</sup> SC III:i. That the many should rule, although to the modern western mind, a familiar concept, was a strange idea to many philosophers. After some discussion by ancient Greek philosophers, democracy fell out of favour, particularly after the conquests of Alexander the Great. Perhaps the most obvious reasons for the doubts in the practicality or wisdom of democracy had to do with the class bias of philosophers (traditionally members of the aristocratic class) or the difficulties posed by lack of effective communication. See further, Glenn Tinder, *Political Thinking* (2nd ed) (Boston: Little Brown and Co, 1974), at 52.

<sup>49</sup> Hobbes, note 8, at IIL:xviii.



And hence it is evident that absolute monarchy, which by some men is counted for the only government in the world, is indeed inconsistent with civil society, and so can be no form of civil government at all. For the end of civil society being to avoid and remedy those inconveniences of the state of nature which necessarily follow from every man's being judge in his own case, by setting up a known authority, to which every one of that society may appeal...wherever any person are who have not such an authority to appeal to, for the decision of any difference between them there, those persons are still in the state of nature. And so is every absolute prince in respect of those who are under this *dominion*.<sup>50</sup>

Rousseau considered that different forms of government - monarchy, aristocracy or democracy were all legitimate in different circumstances. These forms of government were distinct from the sovereign. Thus, government could be run by few officials (aristocracy) or many (democracy). In Rousseau's view, the best form of society, the truly democratic society where individuals were both sovereign and magistrate, required certain preconditions before it could function successfully.

First, a very small State, in which the people may be readily assembled, and in which each citizen can easily know all the rest; secondly, great simplicity of manners, which prevents a multiplicity of affairs and thorny discussions; next, considerable equality in rank and fortune, without which equality in rights and authority could not long subsist; lastly, little or no luxury, for luxury is either the effect of wealth or renders it necessary; it corrupts both the rich and the poor, the former by possession, the latter by covetousness; it betrays the country to effeminacy and vanity; it deprives the State of all its citizens in order to subject them one to another, and all to opinion.<sup>51</sup>

Some writers have seen Rousseau's concern for substantive equality as an attempt to eliminate diversity among people. In particular, Canovan links this elimination of diversity to rationality:

[H]e was emphatic that a General Will is possible only among men whose unity is not threatened by any serious source of diversity. They must know neither riches nor poverty, lest differences over material interests set them at odds; they must share the same Civil Religion, lest confessional hostilities break their unity; they must not form groups or factions, lest these groups develop interests hostile to those shared by the citizens as a whole. Even then, since it is precisely opposition to all private wills that holds the General Will together, it is essential that citizenship should take precedence over private life and intensive schooling in public spirit is necessary.

She then proceeds to point out that Rousseau failed to realise that his theory rested on 'a crucial simplifying assumption':

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<sup>50</sup> Id, at vii:90.

<sup>51</sup> SC III:iv.

...any citizen thinking rationally about these shared interests must come to the same conclusion as any other. Just as 10,000 men simultaneously working out an arithmetical problem must all come to the same conclusion (unless some of them have got it wrong), so citizens deliberating about a matter of general interest (provided that they are neither stupid nor corrupt) must come to the same conclusion because reason allows of no diversity.<sup>52</sup>

It is easy to see how such an interpretation can arise. Certainly, Rousseau was against inequality in wealth and power. He was also highly suspicious of the influence of religion upon the state. Yet, the process of determining the general will may also be seen to assume and encourage, diversity of *individual* opinion. His rejection of partial associations may likewise not be interpreted as a rejection of individual diversity. Rather, it is an affirmation of that diversity. Out of the diversity of individual opinion must come, ultimately, a rational choice as to the common good, and thus the best interests of the association. On this interpretation, Rousseau's point is not that he wishes to 'render ineffective the fact that there are more of us than one and that we are all unique'.<sup>53</sup> Rather, it is that, at some point, out of diversity must come unity in order for the community to continue.

Rousseau's theory, however, assumes that men will, so far as possible, recognise and seek to put into effect, the general will. It further assumes that this general will can emerge from individual debate in the public assemblies. Although Rousseau assumed that people will be guided by reason, he maintained some scepticism as to the utility of reason as the ultimate source of enlightenment. Reason must be supplemented by feeling, insight and intuition. This is borne out by the fact that the general will could be unconscious and hence beyond reason. The people could be mistaken as to the general will yet 'forced to be free'. Rousseau's recognition of this fact that, despite good intentions, people's reasoning could be fallible led him to postulate the existence of a 'legislator':

Of themselves, the people always desire what is good, but do not always discern it. The general will is always right, but the judgment which guides it is not always enlightened....Individuals see the good which they reject; the public desires the good which it does not see. All alike have need of guides. The former must be compelled to conform their wills to their reason; the people must be taught to know what they require. Then from the public enlightenment results the union of the understanding and the will in the social body; and from that the close cooperation of the parts, and lastly, the maximum power of the whole. Hence arises the need of a Legislator.<sup>54</sup>

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<sup>52</sup> Canovan, note 37, at 292-3.

<sup>53</sup> Ibid.

<sup>54</sup> SC II: vi.

The Legislator is a man of:

superior intelligence...who could see all the passions of men without experiencing any of them; who would have no affinity with our nature and yet know it thoroughly; whose happiness would not depend on us, and who would nevertheless be quite willing to interest himself in ours; and, lastly, who, storing up for himself with the progress of time a distant glory, could labour in one age and enjoy it in another. It would require gods to give laws to men.<sup>55</sup>

This man is neither magistrate nor sovereign, who can employ neither force nor reasoning 'he must have recourse to an authority of a different order, which can compel without violence and persuade without convincing'.<sup>56</sup> This figure is reminiscent of Plato's philosopher-king and comes dangerously close to being a transcendent being (although, as discussed, Rousseau explicitly denied the need for unity with the transcendent). At its most minimal interpretation, the Legislator can be interpreted as an individual (or a body) who stands outside the association, yet has its best interests at heart. It is certainly unclear as to how such a being could arise or exist and Rousseau supplies few details.

## Conclusion

In summary, then, the important values and assumptions underlying Rousseau's version of the social contract were the beliefs that natural man is good, that associations are natural and that the good society has a potentially transformative effect upon men. The good society is one in which power resides in all the people, where government is merely a delegation of authority and where gross inequalities of wealth and power have been eliminated. To some, Rousseau's values and assumptions mark him as inherently anti-liberal. To others, he stands completely outside the liberal tradition: Noone, for example, takes the view that it is meaningless, in Rousseau's terms, to oppose the individual and society because the individual is formed by society:

The universe is the one bequeathed to us by Hobbes and Locke, and in it we debate the proper proportions of law and individual freedom. But this is not the universe in which the *Social Contract* is located, and therefore it is misleading to label Rousseau as either an individualist or a conformist.<sup>57</sup>

Certainly, much of the *Social Contract* was written as an explicit rejection of Locke and Hobbes and, at least in this literal sense, can be said to be anti-liberal. With this in mind, I turn now to examine the way in which the liberal tradition, as it was shaped by the ideas of Locke and Hobbes, informed company law.

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<sup>55</sup> SC II: vii.

<sup>56</sup> SC II: vii.

<sup>57</sup> Noone, note 22, at 181.

## CHAPTER 3

### COMPANY LAW AND THE LIBERAL TRADITION

#### Introduction

My aim in this chapter is to provide some historical background to the development of company law. I do not intend to give a complete account of that development. Rather, I shall argue that the modern corporate form, in general terms, is the product of specific economic, political and social developments that culminated in the nineteenth century. Further, I shall argue that these developments are derived from, or were justified by,<sup>1</sup> the ideas of Locke and Hobbes.

Before proceeding, it is important to note that the terms 'liberalism' and 'liberal tradition' are used in the thesis in the sense recognised by Williams.<sup>2</sup> After identifying the historical derivation of the term 'liberalism' and its association with ideas of freedom, he goes on to note that:

[L]iberalism is a doctrine based on individualist theories of man and society and is thus in fundamental conflict not only with socialist but with most strictly social theories. The further observation, that liberalism is the highest form of thought developed within bourgeois society and in terms of capitalism is also relevant, for when liberal is not being used as a loose swear-word, it is to this mixture of liberating and limiting ideas that it is intended to refer. Liberalism is then a doctrine of certain necessary kinds of freedom but also, and essentially, a doctrine of possessive individualism.

#### The essential features of company law

The formative developments in modern company law took place between 1844 and 1897, in the heyday of English laissez-faire liberalism. Cooke<sup>3</sup> identifies six pieces of legislation which created the corporate form as we know it. These were the *Railways*

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<sup>1</sup> The relationship between liberal values and the work of Hobbes and Locke is not necessarily straightforward. For instance, CB McPherson demonstrated that the work of these philosophers had the effect of justifying the fundamental characteristics of liberalism. He did this by showing, however, that their values and assumptions conformed to the liberal model, rather than by showing that they had any conception of possessive market societies. See CB McPherson, *The Political Theory of Possessive Individualism* (London: Oxford University Press, 1962), at 53.

<sup>2</sup> Raymond Williams, *Keywords* (Glasgow: Fontana, 1976), at 150.

<sup>3</sup> CA Cooke, *Corporation, Trust and Company* (Manchester: Manchester University Press, 1950), at 135.

*Regulation Act 1844*; the *Joint Stock Companies Act 1844*; *Companies' Winding Up Act, 1844*; the *Joint Stock Banks Act*; *Companies Clauses Act, 1845*; and the *Joint Stock Companies Act 1847*. The existing law on companies was then largely consolidated by the massive *Companies Act 1862*.<sup>4</sup> To these legislative developments may be added the decisions in *Foss v. Harbottle* (1843) 2 Hare 461 and *Saloman v. Saloman & Co. Ltd* (1897) AC 22 (discussed below).

Briefly, the import of these developments was as follows: The *Railways Regulation Act 1844* established the principle that railway companies were a class of company formed under special parliamentary sanction to carry on a public undertaking. It was reasoned that, as such companies had special powers they should be subject to control by the State in the public interest. This created a distinction between private and public companies. The *Joint Stock Companies Act 1844* established the framework of later company law and granted the privileges of incorporation to the equitable company. The *Companies' Winding Up Act 1844* interposed the body of the company between members and company creditors. The *Joint Stock Banks Act 1844* drew a distinction between unincorporated and incorporated firms by reference to size and provided that deeds of settlement should be in the form prescribed. The *Companies Clauses Act, 1845* had two effects: firstly, it provided that the Board of Trade could provide a licence to a company which wished to purchase, hold or take on lease or hold on mortgage, any land beyond that of its business premises. Prior to this legislation, the Mortmain rule<sup>5</sup> provided that a company could only hold without licence enough land for occupation as a place of business. The legislation did not abolish this rule but removed doubts as to the extent of the Board of Trade's licensing powers. Secondly, this legislation relaxed the procedures relating to promoters.<sup>6</sup> The *Companies Act 1862*, was primarily a consolidating act, but it also transferred jurisdiction over winding-up from the Court of Bankruptcy to the Court of Chancery; replaced the creditors' representative of the earlier winding-up Acts with the liquidator; included insurance and banking companies in its provisions; and introduced companies limited by guarantee. *Foss v. Harbottle* (1843) 2 Hare 461

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<sup>4</sup> Tom Hadden notes that these legislative developments were a consequence of periods of intense activity in company flotation in the periods 1824-5 and 1834-6 which were followed by a large number of failures and consequential losses by investors. A new outbreak of insurance and annuity frauds in the early 1840s led directly to the appointment of the first comprehensive company law reform committee. See Tom Hadden, *Company Law and Capitalism* (London: Weidenfeld and Nicolson, 1972), at 14.

<sup>5</sup> This was an ancient rule framed by the Crown to preclude the alienation of lands to corporate bodies by which the benefits of the incidents of tenure were lost. It was directed originally to religious societies.

<sup>6</sup> Discussed at greater length in Chapter 4, below.

established both the 'proper plaintiff' and the 'indoor management' rules and *Saloman v. Saloman & Co. Ltd* (1897) AC 22 entrenched the separate entity doctrine.

Together, these legislative and judicial developments established or consolidated the salient features of the modern corporation. These features may be identified as: a contractual division of power between management and the general meeting; a contractual determination of rights and obligations *inter se*; freely transferable shares; the share as personal property; voting rights attaching to shares; the separate entity doctrine; and limited liability. I shall discuss each of these features in turn, identifying their origins, their relationship to the theories of Locke and Hobbes, and discussing their implications for corporate regulation.

### **Contractual determination of obligation**

Both the rights and obligations of the members *inter se* and the division of power between management and the general meeting are determined by the contract of association.

Historically, the contractual resolution of rights and obligations *inter se* derives from the *Joint Stock Companies Act* 1856, and is a reflection of the fact that the company was a statutory form of the earlier deed of settlement company. Prior to this legislation, associative rights and obligations were established by the deed of settlement, a device that was used extensively from the eighteenth century. The deed of settlement arose because, at common law, an unincorporated group of people could not own property as a group. Chancery, however, avoided this rule by holding that property could be held in trust for such an unincorporated group. This was accomplished by mutual covenants between the members of the company and the trustees they selected. A deed of settlement was drafted in which these covenants were set out and every member of the group was deemed to assent to those terms. The trustees covenanted to observe the terms of the deed and to apply the fund settled on them for the purpose specified. This form of association flourished in the period 1825-52. In 1834, this equitable company was given legislative recognition by the *Trading Companies Act*<sup>7</sup> and later, the passing of the *Joint Stock Companies Act* 1844.

Historically, the contractual division of power between the board and the general meeting derives from late nineteenth-century case law. At the time of the case of *Foss v.*

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<sup>7</sup> This Act began with a recitation that companies were being formed which it would be inexpedient to incorporate at common law, but which had claims to be endowed with some of the privileges of incorporation. The Act empowered the Crown to grant by Letters Patent to trading and other companies, the privileges which could be conferred by charter of incorporation.

*Harbottle* (1843) 2 Hare 461, the prevailing view was that directors were merely delegates of the general meeting and therefore subject to its ultimate control. The rationale for this decision was that, as a share gives right to a proprietary ownership in the company, the body of corporators in the general meeting are the proprietors of the company. Hence, they retain control, although they may delegate the day to day management of the company.

In *Automatic Self-Cleansing v. Cuninghame* [1906] 2 Ch 34, it was held that the contract in the articles entitled the directors to manage the company, and the court would not allow the general meeting to interfere with the board in the exercise of its powers under the contract. In this case, the articles contained a parallel provision to Art. 66 of Table A. The general meeting resolved to sell a company undertaking after the board refused to do so. Collins M.R. stated:

I cannot see anything in principle to justify the contention that the directors are bound to comply with the votes or the resolutions of a simple majority at an ordinary meeting of the shareholders. I do not think it true to say that the directors are agents. I think it is more nearly true to say that they are in the position of managing partners appointed to fill that post by a mutual arrangement between all the shareholders. (at 45)

On this view, the only effective control that a general meeting may exercise over the board is the threat of removal from office (and even this may be weakened by articles which entrench the directors in power).<sup>8</sup> This was the ultimate step in the separation of management and ownership within the company.

Philosophically, both the contractual determination of rights and obligations *inter se* and the contractual division of power may be linked to important ideas of Locke and Hobbes: specifically, the significance of enforcement of voluntary obligations; the value of individualism; and the idea of the limited state. Although I shall discuss each of these ideas in turn, it is important to note that these assumptions were interdependent.

### **Individualism**

Individualism was central to the theories of both Locke and Hobbes. Williams notes the extraordinary development of the term 'individual' from its original medieval meaning of 'indivisible'. He writes:

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<sup>8</sup> Delegation theory did not die away completely, however. See for instance, *Marshall's Valve Co v Manning Wardle* [1909] 1 Ch 267 and *Dowse v Marks* (1913) 13 SR (NSW) 332. Delegation theory is discussed in more detail in Chapter 6.

The emergence of notions of individuality, in the modern sense, can be related to the break-up of the medieval social, economic and religious order. In the general movement against feudalism there was a new stress on a man's personal existence over and above his place or function in a rigid hierarchical society. There was a related stress, in Protestantism, in a man's direct and individual relation to God, as opposed to this relation mediated by the Church. But it was not until C17 and C18 that a new mode of analysis, in logic and mathematics, postulated the individual as the substantial entity...from which other categories and especially collective categories were derived. The political thought of the Enlightenment mainly followed this pattern. Argument began from individuals, who had an initial and primary existence, and laws and forms of society were derived from them.<sup>9</sup>

It was fundamental to Hobbes's theory that political rights and obligations arose from the interest and will of dissociated individuals.<sup>10</sup> He assumed man's nature to be inherently acquisitive: 'Life itself...can never be without desire' and 'the felicity of this life' is only 'continual success in obtaining those things which a man from time to time desireth'.<sup>11</sup> Man desires, but also reasons, so is necessarily preoccupied with ways of fulfilling his desires. He is the rational maximiser of his own interests: 'the power of a man ... is his present means to obtain some future apparent good'. Hence, society is, by nature, competitive as men desire scarce resources: 'And therefore if any two men desire the same thing, which nevertheless they cannot both enjoy, they become enemies'.<sup>12</sup>

Locke considered that, as each man's primary motivation was to protect his 'life, liberty and estate' his main obligation was to protect himself and only if this self-preservation was not at risk was there a secondary duty to protect the rest of mankind. It was thus the charge of each individual to act in his own interest and, further, this self-preservation was necessary to promote the common good.

### Consent

The implications of this belief in individualism were numerous. In particular, Shapiro notes that the view of rights which developed from the seventeenth century contract theorists was one that:

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<sup>9</sup> Williams, note 2, at 135-6.

<sup>10</sup> Macpherson, note 1, at 1.

<sup>11</sup> Thomas Hobbes, *Leviathan* (Harmondsworth: Penguin, 1981), I:vii.

<sup>12</sup> Id, at i:xiii.



...assumes that the individual will is the cause of all actions, individual and collective; it ascribes decisive epistemic and hence moral authority to the individual over his actions, on the grounds that he has privileged access to the contents of his own mind. For this reason individual consent becomes vital to the whole idea of political activity.<sup>13</sup>

The idea of individual consent led to an increasing emphasis upon contractual theories of obligation. As cottage or farm-based production gave way to factory-based production, there was an attendant growth of urbanisation. The nexus of mutual rights and obligations created and maintained by the feudal structure was progressively destroyed. New guidelines were needed to determine obligation in this bewildering new world. Contractual theories of obligation were particularly appropriate. In the nineteenth century, in particular, the performance of one's contracts was an important feature of legal and economic life. Each individual had sole proprietorship of his own person and thus the right (even the duty) to further his own advantage by means of the contract. In contract law, this belief may be seen in the idea of freedom of contract - that is, the freedom to make, but not to break, contracts.<sup>14</sup> In company law, this could be seen in the rigid and formalistic interpretation of the company constitution.

Individualism and the enforcement of contractual obligations were to lead courts to uphold the decisions of management despite opposition from shareholders. After all, only the individual can know his own interests. As managers were the guiding will of the company, only they could determine the company's good. The fundamental flaw with this argument, of course, was that it identified company interests only with management. Coupled with the idea of the limited state, this view was to condone, or at least to turn a blind eye, to abuses within the corporate structure.

### **The limited state**

The limited state is the idea that there is a 'public' sphere in which it is proper for government to intervene; and a 'private' sphere in which government has no role. In the nineteenth century, many people considered that government should interfere as little as

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<sup>13</sup> Ian Shapiro, *The Evolution of Rights in Liberal Theory* (Cambridge: Cambridge University Press, 1986), at 275.

<sup>14</sup> See, for instance, the classic formulation of the rule in *Printing and Numerical Registering Co v Sampson* (1875) LR 19 Eq 462, 465:

It must not be forgotten that you are not to extend arbitrarily those rules which say that a given contract is void as being against public policy, because if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that the contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by courts of justice. Therefore, you have this paramount public policy to consider-that you are not lightly to interfere with this freedom of contract.

possible in such areas as the family and the market place.<sup>15</sup> Non-interference in the market place was to be of particular importance in the development of corporate regulation.

The limited state was advocated by both Hobbes and Locke. Despite Hobbes's political absolutism, Shapiro points out that Hobbes was an advocate of economic minimalism:

Despite the state's absolute power, its actions are conceived of as indirect and regulative, as revealed in the discussions of unemployment and taxation; it is supportive of the institution of the market, revealed in the account of contract and individual freedom; and it is limited, revealed in the discussion of the limits to public property as well as by the fact that Hobbes does not ascribe any further economic roles to the state.<sup>16</sup>

Locke, too, maintained the importance of a limited state. On Locke's interpretation of the social contract, government was instituted to protect natural rights and, correspondingly, its power was circumscribed by the individual's natural freedom. Just as no man should harm another in the enjoyment of his life, liberty and estate, government should similarly refrain from interfering with the individual's enjoyment of these rights. Should government fail to so refrain, its legitimacy could be called into question.<sup>17</sup>

The values of individualism and the limited state, as propounded by Locke and Hobbes, were reinforced and expanded, as Williams suggests, by classical economics, theology and Darwinism. For instance, in the century after Locke, Adam Smith's *Wealth of Nations* laid the foundations of classical economics:

...it is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.<sup>18</sup>

The pursuit of self-interest was, in Smith's view, not only a 'natural' characteristic of man, it was demanded by the good of all:<sup>19</sup>

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<sup>15</sup> See Francis E Olsen, 'The Family and the Market: An study of ideology and legal reform', 96 *Harv LR* 1497.

<sup>16</sup> Shapiro, note 14, at 34.

<sup>17</sup> The power of government was that of '...making laws with penalties...for the regulating and preserving of property and of employing the force of the community in the execution of such laws...and all this only for the public good': Locke, 'True End of Civil Government', in E Barker, *Social Contract: Essays by Locke, Hume and Rousseau* (London: Oxford University Press, 1960), IX:131.

<sup>18</sup> Adam Smith, *Wealth of Nations* (New York: Modern Library, 1937), at 14.

<sup>19</sup> Similarly, Mandeville's *Fable of the Bees* justified the pursuit of self-interest in terms of the common good. The familiar moral of the *Fable of the Bees* was that, although

He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it.. he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was not part of his intention...By pursuing his own interest he frequently promotes that of the society more effectively than when he really intends to promote it.<sup>20</sup>

The implications of this passage seemed clear. The profit motive, each man's pursuit of his self-interest, automatically controlled prices. The free-market was self-regulating and should not, indeed could not, tolerate the interference of the State. The individual pursuit of material gain, unhindered by state interference, would further the common good.

Utilitarianism, which was introduced by Jeremy Bentham in the latter eighteenth century, reinforced the ideal of furthering the common good by pursuing self-interest.<sup>21</sup> Utilitarianism justified egoism by the 'greatest good for the greatest number'. This principle was considered to be the only rational guide to private morals and to public policy. The 'felicific calculus' or 'moral arithmetic' determined the greatest good. The assumption that self-interest motivates all human conduct was the basis for this principle.

From a scientific perspective, the principles of Charles Darwin also offered support to the beliefs of social contract and classical economics. If a struggle for existence within a hostile environment determined who would survive in the natural world, then, by analogy, competition in civil society was 'natural' and survival of the fittest was a 'natural' law. Indeed, Herbert Spencer used the biological principles of Darwin to promote 'Social Darwinism', which was, in essence, 'extreme laissez-faire endowed with a (supposed) biological sanction'.<sup>22</sup>

Whilst philosophy, economics and biology justified egoism, Protestantism furnished its theological justification. One of the great phenomena of the nineteenth century was the rise to power of the middle class. Manufacturers, financiers, providers of consumer goods and services and commodity brokers gained strength as the economy shifted from land and cottage to the factory. Correspondingly, the influence of the landed gentry declined and wage earners, for most of the nineteenth-century, had not attained political self-consciousness or effective organisation.<sup>23</sup> This middle class was mainly Protestant.

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avarice and selfishness should be condemned in private life, they were to be encouraged in the market because they optimised the well-being of the community. Within the beehive, 'every part was full of vice/Yet the whole an earthly paradise'.

<sup>20</sup> Smith, note 19, at 423.

<sup>21</sup> RD Altick, *Victorian People and Ideas* (New York: WW Norton and Co, 1973), at 116.

<sup>22</sup> Id, at 232.

<sup>23</sup> Ibid. The rise in power of the middle class was not, of course, an overnight event. It had been growing since the Elizabethan era and had been at the core of both the Protestant

The Dissenters in England directed their energies primarily to 'trade' from around the seventeenth century. This was largely because they were somewhat removed from the mainstream of English society. Until the repeal of the *Corporation and Test Acts* in 1828, a Dissenter could not hold public office without requiring a dispensation through an annual Act of Indemnity. Until 1854 to 1856, Dissenters could not take degrees at Oxford or Cambridge and so could not join the traditional professions.<sup>24</sup>

Protestantism stressed personal salvation through the conduct of one's daily life and the importance of private conscience over theological dogma. The moral code of Protestantism valued frugality, self-denial, dedication to one's calling and the value of hard work. Its ethics were those of sobriety, thrift, cleanliness of person, tidiness of home, good manners, respect for law, honesty in business affairs, chastity and seriousness.<sup>25</sup> Self-help and self-reliance were the keys both to eternal life and to material success:

[Prevailing religious thought] was the natural counterpart of a social philosophy which repudiated teleology and which substituted the analogy of a self-regulating mechanism, moved by weights and pulleys of economic motives, for the theory which had regarded society as an organism composed of different classes untied by their common subordination to a spiritual purpose.<sup>26</sup>

These ideas of individualism and the limited state brought about a marked change of thinking as to the role of government and the conduct of commercial matters. In the middle ages, for instance, a great number of statutes dealt with the conduct of specific trades.<sup>27</sup> Laws were made to ensure that a commodity was not only honestly manufactured, but that it was fairly and reasonably priced, that an adequate amount of skill went into its manufacture; and that there was fair treatment of labourers.<sup>28</sup> Indeed, Holdsworth notes that the burden of proof was on those who denied the right of the state

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Reformation and the Puritan Revolution. For a comprehensive discussion of this rise in power, see RH Tawney, *Religion and the Rise of Capitalism* (Harmondsworth: Penguin, 1938).

<sup>24</sup> Id, at 32.

<sup>25</sup> George H Sabine, *A History of Political Theory* (3rd ed) (London: George H Harrap and Co Ltd, 1954), at 175.

<sup>26</sup> Tawney, note 24, at 194.

<sup>27</sup> Victuallers, 31 Edward III c 10; 12 Edward IV c 8; fishermen, 35 Edward III c 1; wool, silk, worsted and broadcloth manufacturers 33 Henry VI c 5; chandlers 11 Henry VI c 12; shoemakers 4 Edward IV c 7; boyers, 12 Edward IV c 1; tilers 17 Edward IV cc 4, 5; fullers 22 Edward IV c 5; horners 4 Edward IV c 8

<sup>28</sup> See, for instance, 22 Edward IV c 5, against the use of fulling mills to make caps as these threw men out of work and did the work to an inferior standard.

to interfere.<sup>29</sup> In contrast, Shapiro notes the effect of the adoption of the idea of a limited state:

This negative libertarian view of social life in general and of the production, exchange, and consumption of wealth in particular, was also of great importance in the subsequent history of the liberal ideology of individual rights. Indispensable as it obviously is to the functioning of a capitalist market, it became deeply embedded in the emerging social system. Hobbes did not intend to justify such a system nor had he any very clear idea of what it was. His negative libertarianism survived and achieved the preeminent status it did in the dominant ideology because of its affinity with these emerging economic and social relations. It provided the conceptual tools for the construction of an ideology that could legitimate these relations.<sup>30</sup>

This is supported by Cooke who, with specific reference to company law, comments on the theoretical direction of the law engendered by the belief in individualism:

[T]he English law of corporations, trusts and companies has been concerned much more with the rules governing the conduct of individuals than with logical classification of groups. It has not, perhaps always been clear that the transactions of groups are the transactions of individuals and that it is individuals who carry on the affairs of corporations...Once within the legal machine the law is concerned with the behaviour of the individuals who compose, act for, or transact business on behalf of the corporation.<sup>31</sup>

The individualistic view had a considerable impact upon business ethics. After all, if one's primary duty is self-preservation, then one's ethical duties to others do not come into play unless self-preservation is not at stake - and one can argue that one's self-preservation in business is always an issue. Thus, one's duty to others was limited, in essence, to the duty of honesty. Ethically, there was no requirement of, for instance, fair dealing, or a duty of care to one's shareholders or one's creditors.

One of the more influential expressions of the belief in limited government and individualism in company law is to be found in the case of *Foss v. Harbottle* (1843) 2 Hare 461; 67 ER 189. In this case, promoters (also directors of the company) sold the company plots of land at allegedly exorbitant prices. The Court refused to allow two minority shareholders to maintain an action on behalf of the company. The Court held that the company itself was the proper plaintiff in the action because it was for the company to determine whether or not proceedings should be taken. It was not for the Court to interfere with the decision of the company. Together, there are two aspects of what came to be known as 'the rule in *Foss v. Harbottle*'. These were the 'proper

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<sup>29</sup> WS Holdsworth, *A History of English Law* (6th ed) (London: Methuen, 1966), II: 467-8.

<sup>30</sup> Shapiro, note 14, at 63.

<sup>31</sup> Cooke, note 3, at 188-189.

plaintiff' rule and the 'indoor management' or 'business judgment' rule. Together, these rules contributed to the separation of management and ownership of the corporation. The indoor management rule, coupled with the contractual division of power within the corporation, lead to a situation whereby courts were reluctant to question the management decisions of the board. The proper plaintiff rule was to restrict the rights of shareholders to rectify improper decisions by the board. This was to create considerable problems for corporate regulation. It lead, in particular, to abuses of power within the company, such as oppression and unfair dealing, that the courts were reluctant to rectify.

### **The share**

The altered nature of the share may also be linked to ideas of Locke and Hobbes. Modern corporate law is centred around three important ideas relating to the share. These are: The idea of the share as personal property; the idea of freely transferable shares; and the idea of voting rights attaching to shares. These ideas evolved from around the seventeenth century.

The conception of a share as personal property derived from the difference between capital and the business itself. Subscribed capital is a liability, whilst the land, buildings, stock, cash goodwill and balance of profit are assets.<sup>32</sup> Hence, the idea of a shares as personal property is the result of the rise of the capital fund and the development of accounting practice.<sup>33</sup>

It would appear that a share in a joint stock was considered to be a saleable asset from the outset of the joint stock system. The transferability of shares on paper seems to have begun with the East India Company which kept books in which the transfer of stock was recorded.<sup>34</sup> In time, it became common for statutes incorporating joint stock companies to provide that shares could be assigned by entry in the transfer book.<sup>35</sup> It was, of course, possible to transfer shares by using the trust but Gower notes that:

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<sup>32</sup> On the conception of a share as personal property see *Bligh v Brent* (1836) 2 Y and C Ex 281 and *R v Dock Coy of Hull* (1786) 1 TR 219.

<sup>33</sup> *Drybutter v Bartholomew* (1723) 2 P Wms 127; *Townsend v Ash* (1745) 3 Atk 336; *Stafford v Buckley* (1750) 2 Ves Sen 171; *Swayne v Fawkener* (1696) Show PC 207; *Sandys v Sibthorpe* (1778) Dick 545; but see *Howse v Chapman* (1799) 4 Ves 542 where a share in the Bath Navigation was held to be real estate.

<sup>34</sup> See *Johnson v East India Co* (1679) Finch Rep Temp 430.

<sup>35</sup> 4 and 5 Wm and M, c 17 s 24 (Greenland Co 1692); 5 & 6 Wm & M, c 20, s 25 (Bank of England 1694); 7 & 8 Wm & M c 31 s 17 (National Land Bank 1695) See also *Bank of England v Moffatt* (1791) 3 Bro CC 260; *Cock v Goodfellow* (1721) 10 Mod 489, 498.

[I]ncorporation, with the resulting separation of the business from its members, greatly facilitates the transfer of the members' interests, although even without formal incorporation much the same end was achieved through the device of the trust coupled with an agreement for transferability in the deed of settlement. But this end could only be approximately attained since the member, even after transfer, would remain liable for the firm's debts incurred during the time when he was a member. Moreover, in the absence of limited liability, his opportunities of transfer would in practice be much restricted.<sup>36</sup>

By the middle of the seventeenth century the ownership of a share was associated with financial, rather than personal, participation in a company. By the end of that century, there was a market in London for shares in major companies.<sup>37</sup>

Attaching suffrage to shares was a later development. In the early corporation, each member had a right to vote in corporate affairs but the individual had one vote only. This was the case, for instance, in the East India Company. There was no necessary connection between suffrage and stock held. As corporate membership evolved to that of shares in a capital fund accumulated for trading purposes, suffrage became progressively restricted: first to those members who held shares, and then to those members who held shares of a defined value. For instance, in the statute that founded the Greenland company,<sup>38</sup> it was provided that each subscriber of 500 pounds should have one vote but each subscriber of 1000 pounds or more shall have two votes. In the eighteenth century, in the absence of a specific provision, all shareholders had one vote each but this rule could be avoided by splitting a stock holding and assigning part of it. This practice was condemned in 7 Geo. III c. 48, 1767, which provided that no member of a joint stock company who held shares for less than six months could exercise a vote.<sup>39</sup> In addition, there was no general right to vote by proxy. Indeed, it was prohibited at common law<sup>40</sup> but could be given to a company by special grant.<sup>41</sup>

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<sup>36</sup> LCB Gower, *Principles of Modern Company Law* (4th ed) (London: Stevens and Sons, 1979), at 106. It is also interesting to note that, for a time, freely transferable shares constituted a public nuisance under the *Bubble Act*. This is discussed below.

<sup>37</sup> Hadden, note 4, at 8.

<sup>38</sup> 4 & 5 Wm & M, c 17, 1692.

<sup>39</sup> Cooke, note 3, at 73-4. See also *Companies Act* 1862 and *Moffatt v Farquhar* (1878) 7 Ch d 591 and the cases cited therein.

<sup>40</sup> *Harben v Phillips* (1882) 23 Ch D 14.

<sup>41</sup> Cooke, note 3, at 74. See the *Mines Adventurers* 9 Anne c 24 (1710) and the *Northumberland Fishery Society* 29 Geo III c 25 (1789).

It may be argued that, although these developments did not necessarily derive directly from Hobbes and Locke, they reflect very similar assumptions and values. Specifically, they may be linked to the following: the belief that the underlying rationale for the institution of society is the protection of private property; an inherently mathematical conception of society and the 'good' (discussed below); and the belief that inequalities of wealth or power are to be condoned.

The implications of these developments were numerous. First, by attaching voting rights to the shares themselves, the democratic nature of the corporation declined. The potential for abuse within the company, particularly when coupled with the idea of limited government, was increased dramatically. Second, by the transference of shares on paper, the company was increasingly seen to be an abstract entity, defined not in terms of people, but in terms of numbers (discussed below); Hadden notes a further development in the disconnection of enterprise and investor:

Through the joint stock company it was now possible to raise large sums of capital for any profit-making enterprise from persons who could not in any way be regarded as having any direct connection with the enterprise. Capitalism of this kind was the base upon which our modern commercial society has been founded.<sup>42</sup>

The third implication was that the share became an important, and volatile, source of wealth as the South Sea Bubble incident (also discussed below) was to reveal.

### **The separate entity doctrine**

In law, a corporation is a separate legal entity from its members. It can thus enjoy rights and be subject to duties distinct to those of the members of the association. The obvious application of this idea is in such areas as the company's rights to own property or to make contracts but the idea of corporate personality has been taken much further.

The full implications of the separate entity doctrine became known with the seminal decision of *Saloman v. Saloman & Co. Ltd* (1897) AC 22. In this case, Mr. Saloman was the owner of a boot business. He formed a company under the *Companies Act* 1862 with capital of 40,000 pounds. He sold his business to the company for 30,000 pounds. The company paid for the business by issuing Saloman with 20,000 fully paid shares and 10,000 pounds in debentures. Saloman thus owned 20,000 shares in the company. Six other members of his family owned one share each. The company had a short life and when it went into liquidation its assets were 6000 pounds and its liabilities were 10,000 pounds owed to Saloman under the debentures and 7000 to other unsecured creditors. Saloman claimed all the assets as the secured creditor of the company. The liquidator



sued Saloman on the basis that the company was effectively Saloman himself and the issue of debentures by him to himself was a fraud on the company.

At first instance, Vaughan Williams J. held that the company was merely an agent for Saloman. He was then obliged to indemnify the company by paying the creditors. The Court of Appeal also found against Saloman. Lindley J. claimed the debentures to be a device to defraud creditors ('one substantial man and six mere dummies do not make a company'). The House of Lords, however, found for Saloman. The latter had merely 'availed himself to the full of the advantages offered by the *Companies Act*'. Lord Macnaghten claimed 'I cannot understand how a body corporate made "capable" by statute can lose its individuality by issuing the bulk of its capital to one person...The company is at law a different person altogether from the subscribers to the memorandum'. (at 51) As all the members of the company knew the true state of affairs, there could be no fraud on the company and the creditors understood that they were dealing with a limited company. The agency argument was also rejected. If the company were not a legal person it could not be an agent; and if it were a legal person, it acted for itself.

The case of *Saloman* shows, I believe, the abstraction of the corporate form which took place in the nineteenth century. Two factors, in particular, contributed to this abstraction: The first is the development of accounting practice, in particular, the development of 'double entry' accounting.<sup>43</sup> This led to an abstraction of the share and ultimately the company itself. The corporation became a profit and loss account, an agglomeration of capital, rather than a collection of individuals. Cooke notes this development as follows:

[T]he concept of a common stock or a common fund of capital (whether in goods or money) began to be of importance. Losses were lessened to an individual who spread his risks over a number of ventures and outlets for the investment of profits were multiplied. In this development, the rise of accounting was a necessary factor, promoted mainly by Italian ingenuity in assessing the results of voyages on the great trade routes across the Mediterranean. The importance of the double entry system of keeping books lies not in its arithmetic, but in its metaphysics...The business men created the financial entity of the business, a fund separate and distinct from its subscribers, linked with them by debits and credits.<sup>44</sup>

Cooke goes on to note that, whether the individual was a member of a chartered corporation operating a joint stock fund or the shareholder of a trust operating a joint stock fund:

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<sup>43</sup> Discussed at greater length by Hadden, note 4, at 65-69.

<sup>44</sup> Cooke, note 3, at 185.

...he had a claim or an obligation; a claim to a share of profits or an obligation to subscribe to the fund and to meet the fund's losses. And in either instance he had something which could be sold, whether it was the stock of an incorporated company or the share of and in a trust.<sup>45</sup>

This faith in numbers may be linked to Hobbes whose theory was inherently mathematical in the sense that he believed that society could be explained in terms of addition of 'desires' and subtraction of 'aversions'.

These small beginnings of Motion, within the body of Man, before they appear in walking, speaking, striking, and other visible actions, are commonly called ENDEAVOUR.

This Endeavour, when it is toward something which causes it, is called APPETITE, or DESIRE;...and when the Endeavour is fromward something, it is generally called AVERSION.<sup>46</sup>

This mathematical model was taken up in the early nineteenth century by utilitarianism which was based upon the principle of 'the greatest good for the greatest number'. This 'felicific calculus' or 'moral arithmetic' determined the greatest 'good' by mathematical calculations of units of pleasure and pain. The 'good' was inherently material in nature: bank deposits, lucrative investments and the ownership of land. It made no allowances for 'the promptings of conscience' nor for such intangibles as 'generosity, mercy, compassion, self-sacrifice or love'.<sup>47</sup> It is easy to see how such a theory would facilitate the abstraction of the company which was no longer perceived as a group of individuals but as an account.

In addition to this abstraction, the separate entity doctrine was aided by legal positivism. Positivism maintains that 'law is a system of rules which can be identified through their pedigree and that the judge is bound to apply it in some straightforward way'.<sup>48</sup> Thus, the role of the judge is merely to enforce the *existing* rules. What the law *ought* to be is a political question for the legislature. The decision in *Saloman* was a rigidly formalistic interpretation of the 1862 legislation and one which was blind to its own consequences.

The decision in *Saloman* was to have important implications for company law. First, it established the legality of the one-man company, a seemingly unusual development given that the legislature had recently rejected the legitimacy of the limited partnership form. It also meant that traders could limit their liability not only to the money which

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<sup>45</sup> Id, at 186.

<sup>46</sup> Hobbes, note 11, at I:6.

<sup>47</sup> Altick, note 21, at 116, 117, 133-4.

<sup>48</sup> S Berns, *Concise Jurisprudence* (Sydney: Federation Press, 1992), at 21.

they put into the venture, but to avoid serious risk to the major portion of that by subscribing to debentures rather than shares. It opened up the availability of the company as a means of realising taxation advantages and escaping some legal obligations. It allowed entrepreneurs to abuse the corporate form by amassing debts in the company name, and then escaping unscathed after a company collapse to pursue new ventures.

### **Limited liability**

The problems of the separate entity doctrine were exacerbated by the development of limited liability. As the corporation is a separate legal person, its members are not liable personally for its debts in the absence of any express provision to the contrary. Where a company is limited by shares, members' liability is limited to the unpaid nominal value of their shares (and in practice, shares are fully paid up, so there is no further liability). In this case, liability of members is limited without restriction on their role in management.

Until the nineteenth century, limited liability was looked upon with some degree of suspicion. The principle was recognised with regard to non-trading corporations as early as the fifteenth century. It was seen primarily, however, as avoiding the risk of the company's property being seized in the payment of the members' separate debts. It was not widely perceived to be a method of enabling members to escape liability for the company's debts. This was because the constitution of a company could expressly or impliedly confer upon the company a power on call on its members for contributions (leviations). Creditors could then claim payment indirectly from members by applying to court for an order compelling the company to raise a leviation.<sup>49</sup> Consequently, it became common for the liability of shareholders to be limited to the subscribed amount and large unincorporated companies in the early nineteenth century often petitioned for special rights in this regard. Even in the eighteenth century, limited liability was limited to the legal separation of the corporation from its members. Members could still be indirectly liable for company debts.<sup>50</sup>

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<sup>49</sup> This rule was established in *Salmon v Hamborough Company* (1671) 1 Ch Cas 204.

The company, the Merchant Adventurers of England, incorporated by letters patent, had been raising large loans by contract under its common seal. The plaintiff lent the company 2000 pounds but when he sought to recover in 1656 it was objected that the company had no common stock and those in control refused to levy actions on its members to meet the obligation. The Lords finally agreed to order the company to make such a leviation upon every members as shall be sufficient to satisfy the said sum.

<sup>50</sup> See, for instance, *Naylor v Brown* (1673) Rep temp Finch 83; *Edmunds v Brown* (1668) 1 Lev 237(78).

As late as 1844, the *Joint Stock Companies Act* defined the joint stock company as a kind of partnership with more than 25 members or with shares transferable by a partner without consent of his co-partners.<sup>51</sup> Members were all liable personally, though this personal liability came after the liability of the company itself. There was, however, some separation of members' liability from that of the company in the concession that a company could become bankrupt as a company and thus the corporate bankruptcy did not imply the bankruptcy of members in their personal capacities.<sup>52</sup>

The *Companies Winding Up Act* 1844 provided that the Bankruptcy Court could direct the creditors' assignees in bankruptcy to apply to the Chancery Court for directions 'to compel a just contribution' for all members of the company towards the full payment of all the debts and liabilities of the company, including the costs of winding up. In 1848 the *Winding-Up Act* provided that shareholders could wind up the company themselves before the creditors. Shareholders thus had some chance of settling the affairs of the company and so limiting their liability.

At this time, it was possible to establish a joint stock company with limited liability with the express consent of Parliament or the Crown. Existing companies formed under the *Joint Stock Companies Act* 1844 (except insurance companies) or companies formed under private acts, could obtain limited liability subject to certain conditions. In such cases, the Board of Trade would issue the company in its new name a certificate of registration with limited liability. Under such procedures, limited liability, however, was a privilege, granted ordinarily to the rich and powerful. Increasingly, there were calls for the democratisation of limited liability. The response to this call was the *Limited Liability Act* 1855. This allowed that the extent of a shareholder's liability (after execution against the company) was to the amount not paid up on his or her shares.<sup>53</sup> A shareholder who was fully paid up was free of further liabilities provided that certain conditions were adhered to (set out in ss 1 and 2 of the Act).

Within 12 months, however, the *Limited Liability Act* was repealed. Formoy notes that, although this did not give much time to observe the workings of the Act, its defects were obvious:

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<sup>51</sup> 7 & 8 Vict c 110, s 2.

<sup>52</sup> 7 & 8 Vict c 111, s 2.

<sup>53</sup> 18 & 19 Vict c 133 s 8.

Limited liability only applied after complete registration, and the promoters, therefore, of a company only provisionally registered were still liable without limit for all expenses incurred previous to complete registration. By section 17 of the Act the provisions of the Winding-up Acts 1848 and 1849, were extended to companies with limited liability, and the effect of limiting the liability of shareholders was to make the winding-up not nearly such a prize as it had been formerly in the days of unlimited liability, when many of the cases of winding-up had been a speculative bid for costs, and the Judges had had to exercise their power of referring unopposed petitions to the master to institute a preliminary enquiry as to whether it was expedient that the company be wound up.<sup>54</sup>

However, in 1856, the *Joint Stock Companies Act* provided that any company which complied with the terms of the Companies Act in adding the word 'limited' to its formal title as a warning to those who dealt with it was entitled to limit its liability and that of its members, to the amount of the subscribed capital. In support of this development, it was argued that:

The principle we should adopt is this, not to throw the slightest obstacle in the way of limited companies being formed... and when difficulties arise to arm the courts of justice with sufficient powers to check extravagance or roguery... That is the only way the legislature should interfere, with the single exception of giving the greatest publicity to the affairs of such companies that everyone may know on what grounds he is dealing.<sup>55</sup>

The Act provided that incorporation occurred on the registration of the Memorandum and Articles and:

The Subscribers of the Memorandum of Association, together with such other Persons as may from Time to Time become Shareholders in the Company, shall thereupon be a Body Corporate by the Name prescribed in the Memorandum of Association, having a perpetual Succession and a Common Seal, with Power to hold Lands; but with such pecuniary Liability on the Part of the Shareholders as is herein-after mentioned.<sup>56</sup>

For limited companies, liability extended only to the amount, if any, due on unpaid shares.<sup>57</sup>

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<sup>54</sup> RR Formoy, *The Historical Foundations of Modern Company Law* (London: Sweet & Maxwell, 1923), at 122.

<sup>55</sup> Robert Lowe, in introducing the *Companies Act*, Parl Deb, 1856, Vol 140, col 131, cited in Hadden, note 4, at 17.

<sup>56</sup> 19 & 20 Vict c 47, s 13.

<sup>57</sup> 19 & 20 Vict c 47, ss 61, 63, 66.

The limitation of liability may, I believe, be linked directly to the Locke's view that duties within civil society are restricted. Ethically, the individual has a first duty of self preservation and a secondary duty to look to the preservation of others (which only arises if there is no threat to the self). Hence, in an inherently hostile commercial world, the first duty of the merchant was to guard his own preservation. This was best done by ensuring his economic survival even in the face of the demise of the company itself. Additionally, the legacy of Locke and Hobbes was to be seen in the fact that liability was as determined by the contract of association. Liability was thus an inherently private matter. In addition, the idea that publicity was sufficient to protect third parties, derives from the idea of individualism and self-help: the business-man should protect his own interests. Should he fail to do so, he must bear the consequences.

Limited liability, coupled with a strict interpretation of the separate entity doctrine, were to have considerable impact upon corporate regulation. In particular, these features would serve to limit the social responsibilities of companies. Third parties were taken to be put on notice that they were dealing with a limited company, and the liability of shareholders was accordingly restricted. Losses third parties then experienced were, effectively, 'their own fault'.

### **Public purpose, private advantage**

An important aspect of the increasing abstraction of the company, and the developments outlined above, was the rise in tension between the company and the state. Over time, the company became the preferred money-making entity. Faceless, without conscience, with 'no soul to damn and no body to kick', it would pursue its individual good to the detriment, in many cases of the public welfare. Yet, this was certainly not always the case. It can be argued that the associative form was adopted originally to serve a public, rather than a private, purpose. In the twelfth and thirteenth centuries, for instance, the precursors of the commercial company, the gilds and the boroughs, primarily were instituted to serve a collective interest. Boroughs were municipal associations which sought release from feudal control under their particular charters. The merchant gild at this time was often the means by which municipal self-government and municipal charters were gained. A gild was a body of citizens which possessed the exclusive right to trade within the borough free of tolls. The quest for a borough charter was often financed by town trade and the prominent gild members were often the representatives and councillors of the new corporation. Gild members did not form an association which pursued a joint venture, but they did pursue a common purpose and there were occasional examples of common action.<sup>58</sup> The gild's primary function was to maintain and protect

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Holdsworth, note 29, at II: 385.

the immunity from toll conceded by the borough charters. Importantly, in both borough and gild, considerations of social welfare and social good took precedence over the interests of members of the corporation.

By the late sixteenth century, the gilds had broken down as a means of regulating particular industries and the chartered corporation came to be the primary form by which trade was regulated. For the next hundred years, corporations were still formed ostensibly, however, to serve public purposes: 'the advantage of the public' or 'the advancement of religion, of learning, and of commerce'.<sup>59</sup> With the rise of the capital fund, however, it is interesting to note the tension between the public purpose and private interest reflected both in the *Bubble Act* (6 Geo 1, c. 18) and in such cases as *Buck v. Buck* (1808) 1 Campb. 547; 170 ER 105, and *The King v. Webb* 14 East 406; 104 ER 658, decided under it.<sup>60</sup>

After the disastrous collapse of the South Sea Company, the *Bubble Act* was passed. Interestingly, this Act declared certain acts, such as opening books for public subscription; presuming to act as if a corporate body; pretending to make stocks transferable; and pretending to act under an obsolete charter, illegal, such acts constituting a public nuisance. There were, however, few prosecutions under the Act. One reason for this is that the Act was badly drafted; but can also be argued that the years after the passing of the Act were transitional, in which there was a growing acceptance of individualism and the ideas of Locke and Hobbes.

In *Buck v. Buck*, the defendant was employed by the plaintiff to purchase, on his behalf, shares in the British Ale Brewery. The highest premiums on shares in the company were then five pounds each, but the defendant charged and received 50 pounds each as the premium upon the shares so purchased. It was alleged that the excess on the original premium was money had and received to the plaintiff's use. The Court held that no action was available, however, as the company was a public company, neither incorporated by charter nor Act of Parliament and its stock was raised by public subscription and its shares transferable. The plaintiff argued that the company was outside the Act because the 'object of the British Ale Brewery was to carry on a lawful trade in a lawful manner, and to furnish to the public at a cheap rate, and of a good quality, an article of the first necessity. It was a public benefit, therefore, instead of a public nuisance. The Act did not apply because it was only intended to prohibit

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<sup>59</sup> W Blackstone, *Commentaries on the Laws of England* (New York: Garland, 1978) I, xviii, 127.

<sup>60</sup> The Act and the cases decided under it are discussed in some detail in P Baron, 'Bringing back the Bubble? Regulation of Corporate Abuse by an Action in Public Nuisance', (1992) 11 *UTLR* 149.

companies which tended to the common grievance, prejudice or inconvenience of the public. This argument was rejected by the court which held that the company was within the prohibitions of the *Bubble Act* and the parties *in pari delicto*.

In *The King v. Webb*, the defendants were prosecuted for having covenanted by a deed of co-partnership to raise 20,000 pounds by subscriptions of 1 pound per share for the purpose of making and selling bread. Each member was obliged to buy a weekly quantity of bread not exceeding a shilling in value per share. The jury considered that the Company was originally created for altruistic motives which were beneficial to the townsfolk, but the scheme was 'prejudicial to the bakers and millers of the town and neighbourhood in their trades'. Lord Ellenborough held that the facts did not bring the defendants within the prohibitions of the Act because the purpose for which the capital was raised was not 'manifestly tending to the common grievance, and being in this case expressly found to have been beneficial', it did not fall within the *Bubble Act*.

The *Bubble Act* was repealed in 1825.<sup>61</sup> With the rise of capital, and an increasing faith in ethical egoism, public interests became confused with, and ultimately subordinated by, the pursuit of private gain.

## Conclusion

Liberalism's preference for private interests over public ones, its belief in limited government and its enthusiasm for the pursuit of material gain would serve to restrict the scope of social responsibilities of companies and the opportunity for court intervention where the corporate form was used to abuse the trust of shareholders or third parties. Today, many of the assumptions and values of Locke and Hobbes have been rejected. We are unlikely to hold that the unbridled pursuit of self-interest must inevitably lead to the good of all or that the state has no business regulating the affairs of company or family. Yet, our modern corporate scheme of regulation is still largely based upon a nineteenth century model that derives from those assumptions and values. I turn now to look at the traditional model in some detail, comparing it with a model based upon the ideas of Rousseau. I shall start with the determination of pre-incorporation rights and duties.

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<sup>61</sup> By 6 Geo IV c 91. Hadden, note 4, at 13 claims that this was probably as a result of the 'official embarrassment caused by a sudden spate of new unincorporated flotations'.



## CHAPTER 4

# ‘FRAUDULENT CONTRIVANCE AND MISCHIEVOUS DECEPTION’: PRE- INCORPORATION RIGHTS AND DUTIES

### Introduction

So far, I have examined the assumptions and values of Hobbes and Locke and contrasted these with Rousseau. I have sought to show that the essential features of the modern company were the result of specific historical developments that culminated in nineteenth century law and that these features may be linked to the ideas of Hobbes and Locke. I turn now to examine the transition from the non-associative to the associative form, that is, the law of promoters and pre-incorporation rights and duties.

The law relating to promoters and pre-contractual rights and obligations has often appeared inconsistent and ineffective. I suggest that there are a number of possible reasons for this: Firstly, liberalism did not supply a coherent philosophical model on which to base rights and obligations in the pre-associative state; secondly, there was a fundamental confusion of private and public interests that dominated much economic and social thought subsequent to Locke and Hobbes; and thirdly, there were considerable logical difficulties posed by the separate entity doctrine. I shall discuss each of these problems in turn.

### Lack of a coherent philosophical model

Neither the theory of Locke nor Hobbes provided a model upon which to base pre-associative rights and obligations. This is despite the fact that both theorists sought to explain political obligation by reference to the pre-political state. Their rationales for association, however, could not be used to explain the creation of a commercial company. Members of the corporation do not associate because they are in a state of war with each other and desire order, as suggested by Hobbes, nor do they associate because of want of a common judge, as Locke argued.

In fact, Rousseau came closer than Locke or Hobbes to articulating the rationale for the formation of the corporation. As discussed in Chapter 2, Rousseau, like Locke and Hobbes started from the state of nature. In this state, he argued, people were both naturally free (in the sense that they could do as they pleased) and naturally equal (in the sense that they were not subject to another's power). This natural freedom and equality were directed to the individual's self-preservation. At some point in time, however, it became necessary for individuals to unite in order to better achieve that self-preservation. This is more analogous to the creation of a corporation, whereby individuals unite in

order to pursue their common commercial interest or to ensure their better economic survival:

I suppose that men have reached a point at which the obstacles that endanger their preservation in the state of nature overcome by their resistance the forces which each individual can exert with a view to maintaining himself in that state. Then this primitive condition can no longer subsist, and the human race would perish unless it changed its manner of being.

Now, as men cannot create any new forces, but only combine and direct those that exist, they have no other means of self-preservation than to form by aggregation a sum of forces which may overcome the resistance, to put them in action by a single motive power, and to make them work in concert.<sup>1</sup>

In addition to the lack of a coherent philosophical model, Hobbes and Locke provide no figure analogous to a promoter. A promoter, in the case of the commercial company, must perform certain formal tasks: she must select the form that the company will use; prepare the company constitution, pay legal expenses and registration fees, select directors, obtain members and, in some circumstances, prepare a prospectus. In the case of liberal theories of the associative state, however, the agreement amongst individuals institutes the political state: there is no process whereby an individual or a few individuals prepare the form of the association or invite others to join the group.

Rousseau does provide the figure of the legislator who, in some ways may be seen to be an analogous figure to a promoter, but, significantly, his legislator acts only in the public interest:

In order to discover the rules of association that are most suitable to nations, a superior intelligence would be necessary who could see all the passions of men without experiencing any of them; who would have no affinity with our nature and yet know it thoroughly; whose happiness would not depend on us, and who would nevertheless be quite willing to interest himself in ours; and, lastly, one who, storing up for himself with the progress of time a distant glory, could labor in one age and enjoy another. It would require gods to give laws to men.

As shall be discussed, promoters did not, nor were they expected to, act for the good of others.

### **The problems of ethical egoism**

As discussed in the previous chapter, the work of Hobbes, Locke and the classical economists led to a fundamental confusion between private and public interests. Many people believed that the pursuit of individual self-interest would inevitably contribute to the good of all. The practical effect of this confusion was that entrepreneurs were to be encouraged in their pursuit of profit because this would lead inevitably to the common good.

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<sup>1</sup> SC I:iv.

Yet it became clear at a relatively early stage in the development of modern company law that the private interests of promoters and the interests of the public did not necessarily co-incide. This is evident in the evolution of statutory provisions relating to promoters. For instance, under the *Joint Stock Companies Act* (UK) 1844,<sup>2</sup> a company was required to file a copy of 'every prospectus or circular addressed to the public' before provisional registration, although the Act did not specify the contents of the prospectus or circular. The Act of 1847<sup>3</sup> relaxed this provision. It recited that the registration of prospectuses and advertisements with the Registrar of Joint Stock Companies under the 1844 Act 'has been found to be very burdensome to the Promoters of such Companies' and proceeded to the repeal of that provision. Yet, this moderation of the law was followed by a series of frauds perpetrated by promoters in the years 1860-1920.<sup>4</sup> It was, for instance, common practice for promoters to acquire property with the object of making such property over to a newly promoted public company at an advantageous price, paid for either in cash or shares in the new company. The promoter would then sell the company in the market. In the period 1856-65, 36% of companies formed ceased to exist within five years of registration and after 10 years, some 54% no longer existed. One explanation for this was that:

[M]any companies were deliberately set up in order that after a short fictitious existence they might pass into the winding up process, with birth and burial expenses accruing to their creators. It would be arranged that the first charge on the capital received from investors should be the preliminary promoting and vendor charges, which satisfied the first of the trio, and a preferential charge on the assets in winding up was (and is) the legal expenses, which satisfied the other two. Companies, it must be remembered, were then free from having to state either promoting expenses or vendor contracts or to state the minimum capital on which business could be commenced; therefore, when capital sufficient to pay the above expenses had been collected, the company would pretend to start business, fulfil its promoting agreements-and fail.<sup>5</sup>

The relaxation of the 1847 provision was a precursor to a shift in government policy which occurred in the period 1856-62. Concern for investor protection gave way, at this time, to a policy of laissez-faire. Thus, Robert Lowe, introducing the *Joint Stock Companies Bill* 1856 into the House of Commons, said:

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<sup>2</sup> 7 & 8 Vict, c 110, s 4.

<sup>3</sup> 10 & 11 Vict., c 110, s 4.

<sup>4</sup> CA Cooke, *Corporation, Trust and Company* (Manchester: Manchester University Press, 1950), at 145.

<sup>5</sup> HA Shannon, 'The First Five Thousand Limited Companies and their Duration', (1932) 7 *Economic History* 396, at 418-419.

We entirely repudiate as the basis of legislation the principle upon which the present *Joint Stock Companies Act* is founded - that it is in the power of the government to prevent the institution of fraudulent companies...[T]he principle we should adopt in this - not to throw the slightest obstacle in the way of limited companies being formed - because the effect of that would be to arrest 99 good schemes in order that the bad 100th might be prevented.<sup>6</sup>

It soon became clear, however, that the policy of encouraging the pursuit of private interests by promoters did not always promote the public good. The frauds that followed the relaxation of the law prompted both legislative and judicial action. In 1867, after a parliamentary committee had noted evidence of abuse in company promotions, the *Companies Act* (30 and 31 Vict. c. 131 s. 38) provided that disclosure in a prospectus of details of every contract made by a company, its promoters, directors or trustees was required. If such disclosure was not made, then the prospectus was deemed to be fraudulent. The courts, however construed this obligation as applying only to material contracts and the provision could be evaded if subscribers provided a waiver. Due to the high level of abuse, the *Companies Act* 1900 (UK) reimposed the requirement of the 1844 act that prospectuses be registered before issue and prescribed their contents in detail.

Redress for an aggrieved shareholder was also the subject of legislative reform.<sup>7</sup> In *Derry v. Peek* (1889) 14 AC 337, directors of a tramway company issued a prospectus. They stated in this that the company had the right to use mechanical motive power instead of horses. The company's special Act of Parliament, however, made that right conditional on the consent of the Board of Trade. The Board refused its consent. The plaintiff subscribed for shares in reliance on the prospectus. After the company went into liquidation, he sued the directors for damages for deceit. Because the directors, however, had honestly but mistakenly believed that the granting of consent was a mere formality, they were held not liable. This decision led to the *Directors Liability Act* (UK) 1890, 53 & 54 Vict, c. 64. This made promoters and directors liable to persons induced to subscribe by false statements in a prospectus, unless the representor had reasonable grounds to believe the statement true. The regulators reasoned that, as company securities, unlike goods, do not lend themselves to examination by the buyer without

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<sup>6</sup> Hansard, 3rd series CXL (1856) 124, 131.

<sup>7</sup> A further restriction was imposed by the rule in *Houldsworth v City of Glasgow Bank* (1880) 5 AC 317. This is that, should a person be induced to subscribe for shares by a fraudulent misrepresentation of an organ of the company, such as the board of directors, or an agent of the company, and choose to remain a member of the company, the company itself cannot be sued. The rationale for this was that the contract between the shareholder and the company, and between the shareholder and his fellow members, which he was not rescinding, impliedly restricted the use of company property to the achievement of the company's objects. Those objects would not include the payment of damages to a member who had been induced by fraud to become a member.

assistance from the seller, certain matters should be disclosed whenever the public is invited to subscribe for securities.<sup>8</sup>

It must be generally acknowledged that a person who is invited to subscribe to a new undertaking has practically no opportunity of making any independent inquiry before coming to a decision. Indeed, the time usually allowed between the issue of the prospectus and the making of an application does not permit of any real investigation. The maxim of Caveat Emptor has in the opinion of your committee but a limited application in such cases.<sup>9</sup>

Thus, this approach established minimum standards of disclosure of facts likely to be of relevance to the investor. Such disclosure has remained a fundamental principle of the regulation of prospectus. The problem with this is that this principle was originally based upon the idea of self reliance: the assumption is that a person will be able to tell a good proposition from a bad one once certain basic information has been provided. This assumes a degree of business knowledge which many member of the public lack.

The courts' response to the problem of abuse of the corporate form by promoters was to apply the doctrine of fiduciary duties to promoters:

The relief afforded by equity to companies against promoters, who have sought improperly to make concealed profits out of the promotion, is only an instance of the more general principles upon which equity prevents the abuse of undue influence and of fiduciary relations. The term promoter is a term not of law, but of business, usefully summing up in a single word a number of business operations familiar to the commercial world by which a company is generally brought into existence. In every case the relief granted must depend on the establishment of such relations between the promoter and the birth, formation and floating of the company, as render it contrary to good faith that the promoter should derive a secret profit from the promotion.<sup>10</sup>

This doctrine of fiduciary duties was a recognised exception to the general rule of ethical egoism. In business dealings, in the absence of fraud, duress or one of the other circumscribed exceptions to the general rule, a man could ruthlessly pursue his self-interest in contractual dealings. If, on the other hand, he made himself another's fiduciary, he was obliged to act loyally in another's interest to the exclusion of his own: 'In short, the law in essence condoned selfish behaviour save where it demanded self-less behaviour. Moral action was, in the main, a matter of individual propensity; moral delinquency a

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<sup>8</sup> The links between consumerism and the prospectus are to be seen in the adoption of s. 52 of the *Trade Practices Act* 1974 (Cth) as the model for liability for the misleading prospectus in CL 996. Under this provision, promoters may be liable for loss or damage caused by a prospectus which offers securities for subscription and contains a false or misleading statement, or omits a material matter.

<sup>9</sup> Lord Davey, Report of the Departmental Committee, quoted in Paul Redmond, *Companies and Securities Law* (Sydney: LBC, 1988), at 27.

<sup>10</sup> *Whaley Bridge Calico Printing Co v Green* (1879) 5 QBD 109, 111 per Bowen J. In *Gluckstein v Barnes* [1910] AC 240, the House of Lords held that disclosure to a board of directors comprised of other members of the syndicate formed for the object of making profit was not a sufficient disclosure.

matter of social censure'.<sup>11</sup> The promoter was thus required to act honestly and in good faith for the benefit of the company to be promoted. He was under an obligation to disclose all relevant information in regard to his interests and any potential conflicts of interests with the company; he could not compete with the company and he could not receive secret profits.

The distinction between a free agent and a fiduciary was discussed in *Ladywell Mining Co. v. Brookes* (1887) 35 Ch D 400. In this case, five men leased a mine with the intention of reselling the lease to a company to be formed. After the purchase, they entered into a provisional contract with a trustee for an intended company for the sale. The company was formed and its principle object as stated in the company constitution was the purchase of the mine. Four of the five men were company directors. The contract was not disclosed to the company. The five men received 18,000 pounds for the purchase of the mine. Some years later the company was wound up and the facts made known. An action was brought for recovery of secret profits. It was held that there was no evidence that the directors were promoters of the company, nor in a fiduciary relationship to the company. Even if there had been such a duty, it was too late to rescind by the time the action was brought. Cotton L.J., noting that he disliked 'the use of the term promoter', said at 413:

...the contract was absolute, and not in any way contingent on the company being formed. The money was all paid by Palin and his friends and in my opinion they bought for themselves, and without putting themselves into such a position as to entitle the company when formed to say, 'You were acting for us; you were in a fiduciary position as regards this property, and now, therefore, as you have purported to sell this to us, we are entitled to take it at the price you originally gave for it.' That is an obvious equity. If a man is instructed as agent for another to buy property, whatever price he buys it for he must hand it over at that price to his principal, and he cannot as between himself and his principal, when he has bought at a lower price add to it by pretending to sell to his principal that which he has already bought for his principal.

Lord O'Hagan, in *Erlanger v. New Sombrero Phosphate Co.* (1898) 3 AC 1218, noted that the duties of a fiduciary extended beyond honesty:

The promoters, who so forgot their duty to the company they formed, as to give it a directorate without independence of position or vigilance and caution in caring for its interest, must take the consequences. And this without the necessary imputation of evil purpose or conscious fraud. The fiduciary obligation may be violated though there may be no intention to do injustice. If the protection, proper and needful for a person standing at disadvantage in relation to his guardian or his solicitor, or to the promoters of a company, be withheld, the guardian, the solicitor or the promoters, cannot sustain a contract equitably invalidated by the want of it, merely because it may be impossible to prove that he is impeachable with indirect or improper motives. (at 1257)

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<sup>11</sup> P Finn, 'Commerce, the common law and morality' (1989-90) 17 (1) *MULR*, 87, at 91.

The extracts from *Ladywell* and *Whaleybridge* discussed above also evidence the *ad hoc* manner in which the law developed. For instance, these decisions reveal that the term 'promoter' did not have a comprehensive legislative or judicial definition.<sup>12</sup> 'Promoter' is a business, rather than a legal term.<sup>13</sup> Despite the somewhat narrow interpretation of the term in *Ladywell*, it is clear that the term can refer to a wide range of persons; 'A promoter...is one who undertakes to form a company with reference to a given project and to set it going, and who takes the necessary steps to accomplish that purpose.'<sup>14</sup> The term thus refers to individuals who take part in such activities as preparation of the memorandum and articles of association; the seeking out of persons who may become subscribers to shares in the company and the raising of funds from others who may wish

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<sup>12</sup> This lack of definition could pose some problems for an aggrieved shareholder. This was raised by Lord Lindley in *Ladywell Mining Company v Brookes* (1887) 35 Ch D 400, 414:

Having considered the whole correspondence, and having examined the evidence with care, I am not surprised at the shareholders being desirous of upsetting this transaction or getting relief if they can. But the evidence is not sufficient to enable them to succeed. It is not proved that when Palin bought...he bought for the company which was ultimately formed nor that when he bought the company was so far formed as to entitle it or its members to claim the benefit of the purchase on any theory of trusteeship; nor is it proved that the new company was buying from the old company. It is plain that the new company did not, in fact, find the money with which the vendors were paid.

<sup>13</sup> The *Joint Stock Companies Act* 1844 (UK), s. 3, defined a promoter as 'every person acting by whatever name in the forming and establishing of a company at any period prior to the company obtaining a certificate of complete registration'. However, this definition was omitted from subsequent legislation. Section 9 of the *Corporations Law* provides:

'promoter' in relation to a prospectus issued by or in connection with a corporation, means a promoter of the corporation who was a party to the preparation of the prospectus or of any relevant portion of the prospectus, but does not include a person by reason only of his acting in the proper performance of the functions attaching to his professional capacity or to his business relationship with a promoter of the corporation.

This definition is relevant only for the purposes of the prospectus provisions. See *Australian Securities Commission v Woods & Johnson Developments Pty Ltd* (1991) 6 ACSR 191, 194-5

<sup>14</sup> *Twycross v Grant* (1877) 2 CPD 469, per Cockburn CJ. See also *Wheal Ellen Gold Mining Co NL v Read* (1908) 7 CLR 34: 'A promoter is one who brings a company into existence by taking an active role in forming it or in procuring persons to join it as soon as it is technically formed.' In *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215 at 241, Dixon CJ, Williams and Taylor JJ approved the opinion of Cockburn CJ that the term 'promoter' has no precise meaning. However, it 'involves the idea of exertion for the purpose of getting up and starting a company...and also the idea of some duty towards the company imposed by it or arising from the position which the so-called promoter assumes towards it'. See also, *Emma Silver Mining Co v Lewis &*

to act as creditors to the company.<sup>15</sup> In *Tracey v. Mandelay* (1953) 88 CLR 215, 242, Dixon C.J. went a step further and stated:

It is not only the persons who take an active part in the formation of the company and the raising of the necessary share capital to enable it to carry on business who are promoters....Persons who leave it to others to get up the company upon the understanding that they will profit from the operation may become promoters.

### **The influence of the separate entity doctrine**

The problems created by the confusion of self-interest and the interest of all were exacerbated by the separate entity doctrine. As discussed in the previous chapter, the separate entity doctrine was given legislative recognition by the *Companies Act* (UK) 1862, 25 & 26 Vict., c. 89 and full judicial recognition in *Saloman v. Saloman & Co. Ltd.* (1897) AC 22. The creation of a fiduciary duty, however, in combination with the separate entity doctrine, created a number of logical difficulties. For instance, how could one be a fiduciary for a legal fiction? Lord Cairns explained the duty this way:

[Promoters] stand, in my opinion, undoubtedly in a fiduciary position. They have in their hands the creation and moulding of the company; they have the power of defining how, and when, and in what shape, and under what supervision, it shall start into existence and begin to act as a trading corporation. If they are doing all this in order that the company may, as soon as it starts into life, become, through its managing directors, the purchaser of the property of themselves, the promoters, it is, in my opinion, incumbent upon the promoters to take care that in forming the company they provide it with an executive, that is to say, with a board of directors, who shall both be aware that the property which they are asked to buy is the property of the promoters and who shall be competent and impartial judges as to whether the purchase ought or ought not to be made. I do not say that the owner of property may not promote and form a joint stock

company, and then sell his property to it, but I do say that if he does his is bound to take care that he sells it to the company through the medium of a board of directors who can and do exercise an independent and intelligent judgment on the transaction, and who are not left under the belief that the property belongs, not to the promoter, but to some other person.<sup>16</sup>

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*Son* (1879) 4 CPD 396, 407; *Lydney and Wigpool Iron Ore Co. v Bird* (1886) 33 Ch D 85, 93.

<sup>15</sup> *Tracy v Mandalay Pty Ltd* (1953) 88 CLR 215. Although persons who actively proceed to do what is necessary to incorporate a company are promoters, those acting merely in a professional capacity to incorporate the company on a promoter's behalf are not. Therefore, solicitors and accountants who only carry out the instructions of the individuals seeking incorporation and who take no further part in the company, are excluded. See also *Bagnall v Carlton* (1877) 6 Ch D 371; *Re Great Wheal Polgooth Co Ltd* (1883) 53 LJ CH 42; *Jubilee Cotton Mills Ltd. v Lewis* [1924] AC 958, 965.

<sup>16</sup> *Erlanger v New Sombrero Phosphate Company* (1878) 3 AC 1218, 1236. See also *Tracey v Mandalay Pty Ltd* (1953) 88 CLR 215; *Wheal Ellen Gold Mining Co NL v Read* (1908) 7 CLR 34; *Re Fitzroy Bessemer Steel Co Ltd* (1884) 50 LT 144; *Gluckstein v Barnes* [1900] AC 958.



An independent board, then, is one way in which the courts sought to overcome the logical problems in this area. Some judges, however, treated this power of the creation of an independent board with some scepticism. Lord O'Hagan in *Erlanger* said, at 1255 that:

The original purchase of the island of Sombrero was perfectly legitimate - and it was not less so because the object of the purchasers was to sell it again, and to sell it by forming a company which might afford them a profit on the transaction. The law permitted them to take that course, and provided the machinery by which the transfer of their interest might be equitably and beneficially effected for themselves and those with whom they meant to deal. But the privilege given them for promoting such a company for such an object, involved obligations of a very serious kind. It required, in its exercise, the utmost good faith, the completest truthfulness, and a careful regard to the protection of the future shareholders. The power to nominate a directorate is manifestly capable of great abuse, and may involve, in the misuse of it, very evil consequences to multitudes of people who have little capacity to guard themselves. Such a power may or may not have been wisely permitted to exist. I venture to have doubts upon the point. It tempts too much to fraudulent contrivance and mischievous deception; and, at least, it should be watched with jealousy and restrained from employment in such a way as to mislead the ignorant and unwary. In all such cases the directorate nominated by the promoters should stand between them and the public, with such independence and intelligence, that they may be expected to deal fairly, impartially, and with adequate knowledge in the affairs submitted to their control. If they have not these qualities, they are unworthy of trust. They are the betrayers and not the guardians of the company they govern, and their acts should not receive the sanction of a Court of justice.

A further logical problem created by the separate legal entity doctrine is whether, prior to incorporation, there could be a distinction between the interests of the promoter and the interests of the company. At this point, the company exists only in the mind of the promoter. Could the interests of a non-existent entity conflict with the interests of its creator(s)? The case of *Byron Hall Ltd v. Hamilton* (1930) 45 CLR 37; 4 ALJ 32 suggested not. In this case, three co-venturers arranged to buy land and erect a building upon it. They contributed their services and capital in differing proportions. After commencing this venture, they formed a company, of which two of them were to be the directors. No formalities were observed in regard to this company and, in fact, they did not qualify as directors. No express contract to transfer the land to the company was made. Money was raised, however, in the company's name on overdraft, secured both by personal guarantee and by a mortgage given by them of the land. The money was applied to the erection of the building and construction was executed in the company name. The Court held that there was no obligation to transfer the land to the company either in common law or in equity. The co-venturers were entitled to deal as they chose in relation to the company, to use the credit of the company and to use its name for their own purposes. The company was their creature, and they were at liberty to deal with it as they wished.

The problems posed by the separate entity doctrine were worsened by the fact that the doctrine was applied inconsistently.<sup>17</sup> For instance, failure to provide an independent board did not always render promoters liable. In *Lagunas Nitrate Co. v. Lagunas Syndicate* [1899] 2 Ch. 392, company promoters formed a public company to buy their interest in a nitrate mine. They were the initial directors and the sole shareholders of the new company. Two years later, a newly appointed independent board sought to have the contract set aside on the basis that the mines had been overvalued. The judge held, however, that the promoters had made a sufficient disclosure of their interests as promoters to themselves as directors and the fact that there had not been an independent board from the start was not sufficient to render them liable as promoters.

Another example of an inconsistent application of the doctrine of separate entity is provided by *In re Ambrose Lake Tin and Copper Mining Company* (1880) 14 Ch D 390. In this case, shareholders in a cost-book mine, T and M, assigned the mine to a trustee, then signed an agreement on behalf of an intended company to buy the mine from the trustee for 24,000 pounds to be paid in shares of the new company. The value of the mine at that time was around 6000 pounds. Later, the company was wound up and the liquidator called T and M to account for the difference between the nominal value of their shares and the actual value of the mine. It was held that, although the scheme was intended to defraud the public (investors on the stock exchange), there was no fraud to the company because both the shareholders were parties to the arrangement. Brett L.J. reasoned that if anyone had bought shares their remedy would lie against T and M and not against the company. Therefore, the company suffered no wrong.

### **Pre-incorporation contracts**

There were also logical difficulties in the law relating to pre-incorporation contracts. The law of pre-incorporation contracts is based upon agency. Therefore, until a company has been incorporated, it cannot, logically, contract. This is because, as there is no company, there is no principal whereby the doctrine of agency can operate. Further, under the common law, a company, once incorporated, could not be liable on or entitled under contract purporting to be made prior to incorporation. This is because an entity which did not exist at the time of contracting was incapable of ratification.<sup>18</sup>

In the nineteenth century, however, judges were reluctant to give a decision which would result in there being, in effect, no contract. As discussed in Chapter 3, great stress was

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<sup>17</sup> For a more recent example of a willingness to lift the corporate veil, see *Nurcombe v Nurcombe* [1985] WLR 370.

<sup>18</sup> *Stott Land Development Corp. Ltd. v Dean* [1967] WAR 86; *Summergreene v Parker* (1950) 80 CLR 304. A company can, however, become party to such a contract by accepting a novation of the rights and obligations of one of its parties or by the company entering a new contract on similar terms: *Vickery v Woods* (1952) 85 CLR 336.

placed upon the sanctity of contract. To this end, the judicature would, from time to time, interpret the facts so as to make the individual persons who had contracted on behalf of a company liable themselves on the contract, as in the case of *Kelner v. Baxter* (1866) LR 2 CP 174.<sup>19</sup> In this case, a person who purchased liquor and other provisions on behalf of a company not yet formed was held to be personally liable despite the fact that this was a pre-incorporation contract. This was because the provisions had been consumed and the language of the contract indicated that the incorporators were prepared to undertake personal liability.

The rule that individuals should be liable for pre-incorporation contracts was not, however, applied consistently. Later cases, such as *Newborne v. Sensolid (Great Britain) Ltd*, [1954] 1 QB 45 distinguished *Kelner v. Baxter* on the basis that, where a promoter signs the proposed name of the company, adding his or her own name only to authenticate the contract, the promoter is not liable. Whereas, in *Kelner v. Baxter*, the defendant acted as an agent for a non-existent principle, in *Newborne*, it was held that there was no evidence that the promoter purported to contract either as agent or as principle. In *Black v. Smallwood* (1966) 117 CLR 52, the High Court adopted the traditional contractual formulation for determining the legitimacy of the parties: What was the intention of the parties as ascertained from the terms of the contract? The contract in that case was held to be a nullity because, as Windeyer J. stated at 57:

...The document which the respondents signed does not purport to be a contract made by them as agents for the supposed company. They thought that the company existed and that they were in fact directors. It is therefore impossible to regard them as having used the name of the company as a mere pseudonym or firm name or as having intended to incur a personal liability.

The result of this decision was somewhat absurd. The case established a precedent for the proposition that a third party has a remedy where there is no belief that a company has been formed, but no remedy will lie where it is believed in good faith that the company is in existence.

Obviously, the rule that companies could not contract prior to incorporation, coupled with the principle that promoters could not be liable on such contracts, operated to the prejudice of innocent third parties. This has led to statutory reforms. Yet, the reforms that have taken place in Australia show the danger of merely adapting the existing law in an attempt to overcome abuse.

Under the *Corporations Law*, changes to the common law rule were made so that a company is capable of ratification. The objective of the legislation is to secure the legal position of the third party. However, the status of pre-incorporation contracts is not made

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<sup>19</sup> See further, *Summergreen v Parker* (1950) CLR 304; *Stott Land Development Corporation Ltd v Dean* [1967] WAR 86; *Lomax v Dankel* (1987) 29 SASR 68, 72-73.

certain by this legislation. *Corporations Law* s 183 (1) provides that reference to the formation of a company is to be construed as a reference to the formation of a company that is 'reasonably identifiable' with the company in the name of which the promoter made the contract. What if the original name of the company is scrapped, or the purpose of the company is changed? In such cases a court must look to the name of the company, the identity of the directors, the purpose for which the company is incorporated and the present activities of the corporation in order to determine whether a company is 'reasonably identifiable'.<sup>20</sup> Further, the legislation uses the phrase 'is formed' and may thus exclude the case where the company is assumed to be formed. The legislation may not cover the *Kelner v. Baxter* situation where a promoter contracts as a principal. *Corporations Law* s 183(2) provides that ratification must take place within a 'reasonable time'.<sup>21</sup> Again, this gives rise to some uncertainty.

### **The application of Rousseau's model**

My argument is that the combination of the separate entity doctrine, the confusion of private and public interests and the lack of a coherent philosophical model, had a profound effect on the development of the law in this area. I believe that Rousseau's model clarifies the problems arising prior to incorporation. In particular, the Rousseauan model distinguishes clearly between the interests of outsiders and the interests of members of the group. The interests of a promoter who is also a member of the company must be distinguished from those of a promoter who stands outside the company. Rousseau claimed that:

Each individual ...contracts, so to speak, with himself and has a twofold function. As a member of the sovereign people he owes a duty to each of his neighbours, and, as a Citizen, to the sovereign people as a whole. But we cannot here apply that maxim of Civil Law according to which no man can be held to an undertaking inured into with himself, because there is a great difference between a man's duty to himself and to a whole of which he forms a part.<sup>22</sup>

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<sup>20</sup> See *F Goldsmith (Sicklesmere) Ltd v Baxter* [1970] 1 Ch 85, 92; *Oshkosh B'Gosh Inc v Don Marbel In Ltd* [1989] BCLC 507.

<sup>21</sup> *Watson v Davies* [1931] 1 Ch. 455; *Dibbins v Dibbins* [1896] 2 Ch 348.

<sup>22</sup> SC I:vii.

Each individual may exercise a will at variance with or different from that general will to which as citizen he contributes. His personal interest may dictate a line of action quite other than that demanded by the interest of all. The fact that his own existence as an individual has an absolute value, and that he is, by nature, an independent being, may lead him to conclude that what he owes to the common cause is something that he renders of his own free will; ...Regarding the moral entity constituting the State as a rational abstraction because it is not a man, he might enjoy his rights as a citizen without, at the same time, fulfilling his duties as a subject, and the resultant injustice might grow until it brought ruin upon the whole body politic.<sup>23</sup>

Where the promoter is also a member of the company, his duty to the company, and to each of his fellow members is clear. A promoter's misuse of company profit, information or opportunity constitutes an act which is in the particular interest, and not in accordance with the general will. It is, therefore, illegitimate. This rule, of course, applies not just to promoters but to all members of the association.

What a man loses as a result of the Social Contract is his natural liberty and his unqualified right to lay hands on all that tempts him, provided only that he can compass its possession...we distinguish between natural liberty which the individual enjoys so long as he is strong enough to maintain it, and civil liberty which is curtailed by the general will.<sup>24</sup>

To act in a particular interest is to undermine the association, and in this circumstance, to exclude the promoter from any claim upon the company:

...the positive act which establishes a man's claim to any particular item of property limits him to that and excludes him from all others. His share having been determined, he must confine himself to that, and no longer has any claim on the property of the community.<sup>25</sup>

Rousseau rejected the idea that the pursuit of the private interest leads inevitably to the public good. Where a promoter stands outside the company, he or she stands in a 'state of nature' *vis a vis* the company and is free to act in his own interest. His or her interests will be separate to and probably in conflict with, the interests of the company: 'An individual may conquer half the world, but he is still only an individual. His interests, ...are private to himself'.<sup>26</sup> Any limitations upon the promoter's freedom must be imposed by the state.

Rousseau's model stresses the importance of unanimous and unqualified consent to the original contract. Where the promoter is also a member of the company, and the property in issue forms the basis of association, disclosure to the board would be insufficient. To merely disclose to the board would create potential for abuse. A contract based upon a

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<sup>23</sup> SC I:vii.

<sup>24</sup> SC I:viii.

<sup>25</sup> SC I:ix.

<sup>26</sup> SC I:v.

private interest would be no contract at all. Although Rousseau advocated participatory, as opposed to representative democracy, not all acts required the unanimous consent of the people, nor even the calling of a meeting. However, the original compact does require unanimous consent:

There is one law only which, by its very nature, demands unanimous consent, and that is the social pact. For civil association is, of all acts, the most deliberately willed. Since every man is born free and his own master, none, under any pretext whatsoever, can enslave him without his consent.<sup>27</sup>

A company formed upon a particular interest would call into question the legitimacy of the original compact. Therefore, the association must determine whether the 'general will' is that the company continue or not, and if it is to continue, on what basis (that is, acknowledging and accepting the particular interest or striking it down). Under this model, an illegitimate act by the promoter gives rise to the shareholder's right to dissolve the association: '...should the social compact be violated, each associated individual would at once resume all the rights which once were his, and regain his natural liberty, by the mere fact of losing the agreed liberty for which he renounced it.'<sup>28</sup> Therefore, the individual shareholder, now in a 'state of nature' *vis a vis* the promoter would have standing to bring an action.

Where the promoter stands outside the association, his or her duties would be determined by the wider association of the State. Because he saw associations as natural and, indeed, inevitable, Rousseau recognised the operation of associations within associations. Although the individual stands outside the company, his relationship with the company operates within the context of the association of the state. Thus, using Rousseau's statement above, he or she owes 'a duty to each of his neighbours, and as a Citizen, to the sovereign people as a whole'.<sup>29</sup> The promoter's duties, then, are circumscribed by the doctrines both of neighbourhood and legality. This is a peculiarly modern view. It has been noted, for instance, in the context of Australian contract law, that legal obligation is being asked to match 'the now pervasive concepts of duty to a neighbour and the linking of power with obligations'.<sup>30</sup> The concern of neighbourhood is regard for others<sup>31</sup> and, with specific reference to commercial transactions, 'neighbourhood' imposes a duty of

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<sup>27</sup> SC IV:ii.

<sup>28</sup> SC I:vi.

<sup>29</sup> SC I:vii.

<sup>30</sup> *Nicholson v Permakraft (NZ) Ltd* (1985) 3 ACLR 453, 459, per Sir Robin Cooke.

<sup>31</sup> Finn, note 11, at 92.

good faith and fair dealing.<sup>32</sup> A promoter who stands outside the company, then, would be constrained by these principles.

In regard to pre-contractual obligation, Rousseau's model provides a far stricter basis for liability than the traditional model. Under Rousseau's theory, it is necessary to distinguish between those situations where a group of individuals has decided to associate and, to this end, instructs one or more individuals to act for them. By analogy, one can use Rousseau's writings on the institution of government:

The difficulty is to understand how it is possible to have an act of government before ever a government exists, and how a People, which can only be either sovereign or subject, can, in certain circumstances, become prince or magistrate...This then, is the specific advantage of democratic government, that it can be established in fact as the result of a simple act of the general will. This done, the provisional government thus set up remains in possession, should its form be the one adopted, or proceeds to establish, in the name of the sovereign, the form of government prescribed by law.<sup>33</sup>

Association, then, is merely the act of the general will. Where the will is present, the association is formed even though the formalities of its constitution have not yet been completed. In such a case, the association, whether a formal company or not at this point, would be liable. Where there is no such act of the general will, that is, where the company is the brainchild of the promoter, up to the time of association (that is the formal constitution of the company), the promoter(s) of a company and the company are one and the same. There is no separate entity. Therefore, a promoter would be liable under all contracts formed. After the association is formed, the question of whether a contract should or should not be adopted by a company is a question of the general will. It should not be a question of 'reasonable time' or a 'reasonably identifiable' company. Such expressions only create loopholes capable of exploitation. If the company decides that a contract should not be adopted, then the promoter would be liable. As there would then always be a party liable on the contract, the doctrine of relation back would not operate because the contract would operate as any other contract.

## Conclusion

In this chapter, I have sought to show that the law of pre-contractual obligations was not based upon any coherent philosophical model; that it was complicated by the separate entity doctrine, and that it was based upon assumptions of individualism. Further, our contemporary contract law continues to be largely based upon assumptions and values underlying the traditional model which have not been seriously challenged. Rousseau's model points to the necessity to distinguish clearly the interests of promoters from those of the company and to ensure that the original contract is not based upon fraudulent or

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<sup>32</sup> Kathryn Jane Smith, 'Themes in the Liability of Banks and Lending Institutions', (1990) 64 *ALJ* 331.

<sup>33</sup> SC III:xvii.

misleading information. Once the company is formed, however, the rights and obligations *inter se* are determined by the contract of association. I shall now proceed to explore the contract of association in more detail.



## THE CONTRACT OF ASSOCIATION

### Introduction

After the collapse of the feudal system, few ideas were to be as pervasive in law as that of contract. As discussed in Chapter 3, Contract was to replace status as the primary determinant of legal rights and obligations, be those rights and obligations *inter se* between individuals, or as between the government and the people:

...liberal law tends to characterise social relationships in contractual terms. It sees people as current or potential parties to agreements in which they will derive some form of profit. In a legal contract, something is promised (such as goods or services or property) in exchange for consideration (usually money). The role of the law is to make such transactions possible, to secure the rights of persons to form contracts of their own choosing from which they will derive a benefit. ...[This model] is seen to secure two types of freedom. One is quite simply the right to form contracts with others. The other is the right to use and dispose of our property ...as we see fit.<sup>1</sup>

Although Locke, Hobbes and Rousseau all employed the conception of a contract to determine civil rights and obligations, there was a fundamental difference in the way that the latter perceived the purpose and operation of this contract. Locke and Hobbes predicated their contracts upon the individual as the apex in a hierarchy of social rights and obligations. The contract was the means by which the individual furthers his particular will. This model of contract assumes that individuals are inherently divided and, despite the supposed mutual advantages to be gained by the contractual process, inherently antagonistic. They are also assumed to be theoretically equal. Even if one party is placed at what would appear to be a disadvantage by the agreement, that party must, subjectively, gain more than he has lost - otherwise, there can be no 'rational' explanation for the decision to contract.<sup>2</sup> Thus, because the contract is the primary vehicle for the expression of individual will, there must be freedom to make contracts; and as commercial and social order, in the Hobbesian sense, must rely upon the fulfilment of contractual obligations, 'sanctity' of contract must be upheld. Given these assumptions, any duty of concern for the interests of the other party to the contract is minimised. That other party is, in theory, a self-contained, self-reliant and, above all, separate unit.

Rousseau's contract of association, in contrast, was an attempt to meld classical and medieval ideas of community with a consensual assumption of obligation. In

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<sup>1</sup> Ngaire Naffine, *Law and the Sexes* (Sydney: Allen and Unwin, 1990), at 71.

<sup>2</sup> Frances E Olsen, 'The Family and the Market: A study of ideology and legal reform', (1985) 96 *Harv L R* 1497.

consequence, the group, rather than the individual, is at the apex of the hierarchy of civil rights and duties. Indeed, Rousseau often used the term 'social tie' as an alternative to 'social contract', the implication being that the contract is a binding or unifying social force. Individuals are, in the post-political state, mutually dependent, both on each other and on the continuing, positive existence of the association. Rousseau's stated objectives of 'political right' and durability could only be achieved if the good of the group was given the highest precedence. On this view, the individual's interest must be subverted to the good of all.

In this chapter, I shall argue that the corporate contract, in many ways, conforms to the Rousseauan model but is distorted by liberal ideology. This distortion is the result, in particular, of three liberal assumptions: Firstly, the assumption that individualism is the right and proper scheme of social organisation; secondly, that the acquisition and maintenance of the private possession of property is to be given primacy in the ordering of social 'goods'; and thirdly, in the assumption that the state should only intervene in 'private' contractual arrangements in limited circumstances: primarily, in order to protect this security of property. I shall begin by examining Rousseau's original contract and the ways in which the contract of association conforms to this model. I shall then proceed to consider the ways in which these liberal assumptions affect the corporate form of associative obligation. It should be noted at the outset that the discussion of the corporate contract is split into two chapters. This is because the determination of rights and obligations by the corporate contract operates three ways. The first two ways that this contract functions are as between the members *inter se* and between the individual members and the corporation itself. These aspects of the contract have, traditionally, been 'contractual' in the sense that we use that term to mean a consensual arrangement. They have not, as shall be seen, always been considered to be necessarily 'contractual' in the sense of a legally enforceable agreement. The third way in which the contract of association functions is as a constitutional document, in the sense that it determines the governmental structure of the association. My concern in this chapter is the first two ways in which the corporate contract determines rights and obligations. The operation of the contract of association in relation to management will be discussed in the next chapter.

### **Rousseau and the contract of association**

As outlined above, the apex of the liberal contractual hierarchy is the individual. The motivation and underlying rationale for the contractual process is the individual will. To Rousseau, the individual will is relevant insofar as the necessity of association is concerned. At some point, the individual acknowledges that he must join with others so as to best ensure self-preservation. Individual will provides the initial motivation for entering into the contract. As discussed in Chapter 3, Rousseau agrees with Locke and Hobbes that self-preservation is the primary duty; but only in the pre-political state, and

not in civil society. At a point in time, this first duty of self-preservation necessitates the formation of associations and the individual then exercises their will to associate with others. In stark contrast to Locke and Hobbes, and to the received model of a legal 'contract', after this initial exercise of self-interested will, the individual good was subverted to the good of the collective. This communal good was determined by the initial contract in a number of ways. First, each individual, by the contract, agreed to be bound by acts and decisions of the sovereign or the administration, provided such acts and decisions were in the 'general will', that is, for the objective good of the association.

*'Each of us puts his person and all his power in common under the supreme direction of the general will, and, in our corporate capacity, we receive each member as an indivisible part of the whole.'*

At once, in place of the individual personality of each contracting party, this act of association creates a corporate and collective body, composed of as many members as the assembly contains voters, and receiving from this act its unity, its common identity, its life, and its will.<sup>3</sup>

This theory of the collective good gives rise to Rousseau's controversial statement that the individual can be 'forced to be free'. Rousseau's point here was, that as the original contract sought to ensure that the individual gained civil freedom (that is freedom from the rule of others) he could be forced to abide by a majority decision, provided that decision was made for the objective good of the association:

In order then that the social compact may not be an empty formula, it tacitly includes the undertaking, which alone can give force to the rest, that whoever refuses to obey the general will shall be compelled to do so by the whole body. This means nothing less than that he will be forced to be free; for this is the condition which, by giving each citizen to his country, secures him against all personal dependence.<sup>4</sup>

The second way in which the collective good was ensured by the original contract, was by imposing a twofold classification of duty upon each individual. 'As a member of the sovereign people he owes a duty to each of his neighbours and as a citizen to the sovereign people as a whole.'<sup>5</sup> This is a far wider conception of obligation than the liberal model. In Rousseau's view, the individual's primary obligation within civil society was not self-preservation, but preservation of the collective. Her secondary obligation was to her 'neighbour', a surprisingly modern idea. This twofold classification imposes a nexus of mutual obligations among the individuals comprising the association, and between the individuals and the association itself. Rousseau's reasoning on this point was that the first associations were formed because of the need for mutual assistance. All

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<sup>3</sup> SC I:vi.

<sup>4</sup> SC I:viii.

<sup>5</sup> SC I:vi.

people, therefore, have a 'gross conception of mutual undertakings'.<sup>6</sup> As 'all social obligations were mutual in nature', all members of the association, including the rulers, were bound to abide by the association's laws.<sup>7</sup> 'The undertakings which bind us to the Commonwealth are obligatory only because they are mutual';<sup>8</sup> '.....the social compact establishes between all the citizens of a State a degree of equality such that all undertake to observe the same obligations and to claim the same rights'.<sup>9</sup>

[I]n short, whoso gives himself to all gives himself to none and, since there is no member of the social group over whom we do not acquire precisely the same rights as those over ourselves which we have surrendered to him, it follows that we gain the exact equivalent of what we lose, as well as an added power to conserve what we already have.<sup>10</sup>

Thirdly, the collective good was to be ensured by the tailoring of the association to meet the needs of the people. All associations, Rousseau believed, were doomed to dissolution from the moment of their inception. The best that individuals could achieve was to ensure the durability of the association by choosing the correct form of government:

There has been at all times much dispute concerning the best form of government, without consideration of the fact that each is in some cases the best, and in others the worst.<sup>11</sup>

The question 'What absolutely is the best government?' is unanswerable as well as indeterminate; or rather, there are as many good answers as there are possible combinations in the absolute and relative situations of all nations.<sup>12</sup>

This rule, and the very special sense in which Rousseau used the term 'democracy' are discussed in the next chapter.

Fourthly, and concomitant to the third rule, Rousseau's contract sought to ensure the collective good by its rule that the sovereign people must be free to vary the terms of the original contract according to their needs. Thus, the original contract had to be on alterable terms: 'there is not, nor can be, any fundamental law which is obligatory for the whole of the People, even the social contract itself'.<sup>13</sup> To Rousseau, it is 'against the nature of the body politic that the sovereign should impose upon himself a law which he

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<sup>6</sup> SC II:iv.

<sup>7</sup> 'Discourse on Political Economy', at 106-107.

<sup>8</sup> SC II:iv.

<sup>9</sup> SC II:iv.

<sup>10</sup> SC I:vi.

<sup>11</sup> SC III:iii.

<sup>12</sup> SC III:ix.

<sup>13</sup> SC I:vii.

cannot infringe'.<sup>14</sup> This is because each member of the society can contract with the society, but the society cannot contract with itself: '...there is a great difference between incurring an obligation to yourself and incurring one to a whole of which you are part'.<sup>15</sup>

Rousseau's contract, then, sought to ensure that the collective good was maintained by adherence to these four principles: that all members of the association abide by the majority will; that the contract impose mutual obligations upon the members of the association; that the association must choose an appropriate form of governance; and that the original contract should be alterable. In fact, our received legal model of the corporate contract shares also adopts some of these principles. I turn now to discuss the similarities between Rousseau's contract and that of the corporation.

### **The contract of association**

The first similarity between the Rousseauan model and the contract of association is that the members of the corporation agree to abide by the majority decision. The nature of the contract of association was considered in *Heron v. Port Huon Fruitgrowers Assn.* (1922) 30 CLR 315. In this case, the objects of a fruitgrower's cooperative were directed towards the promotion of the sale of members' fruit. The Articles provided that each shareholder must sell his whole crop to the association and if he failed to do so was liable to pay damages. Shares could only be transferred to *bona fide* orchardists and the association could refuse to register any transfer. The provisions were considered to be void at common law as being in restraint of trade. The Court held that these provisions dealt not with the rights of members as members, but rather were concerned with a relationship analogous to that of employer-employee. Isaacs J. considered the nature of the contract of association, noting that this was a contract:

...which is only indirectly a contract and only so by force of other provisions which empower a majority to impose obligations...We must then recognise that 'deemed' means to say that although there is no true contract in the ordinary sense, which imports the actual consent of all concerned, this regulation shall, and as so changed, from time to time and notwithstanding the absence of consent and even against the will of the minority, be regarded as if they actually consented and so bargained... Having regard to the ambit of the business agency for marketing fruit, it is difficult to see how art.7, in all its far-reaching ramifications, can be said to be confined to a 'regulation for the company'. And it is only such a 'regulation' that can constitute a contract between the company and members as such. (at 340-341)

The statutory contract provides that the memorandum and articles have the effect of a contract between the company and each member. In consequence, the company can act against a member to force him or her to comply with the provisions in the memorandum

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<sup>14</sup> SC I:vii.

<sup>15</sup> SC I:vii.

or articles where that individual is unwilling to do so voluntarily. That member can, in fact, be 'forced to be free'. Thus, in *Hickman v. Kent and Romney Marsh Sheep-Breeders Association* [1915] 1 Ch. 881, Hickman was a member of an incorporated non-profit-making company. Hickman brought an action complaining of irregularities in the association's affairs. Under article 49 of the association, however, it was provided that disputes between the company and its members were to be referred to arbitration. Hickman's case was stayed. It was held by Astbury J. that by virtue of the statutory contract, art. 49 was binding upon Hickman and he was therefore obliged to refer his disputes to arbitration.<sup>16</sup> His Honour noted the importance of finding that the company was a party to the corporate contract:

A company cannot in the ordinary course be bound otherwise than by statute or contract and it is in this section that its obligation must be found. As far as the members are concerned, the section does not say with whom they are to be deemed to have covenanted, but the section cannot mean that the company is not to be bound when it says it is to be bound, ..., nor can the section mean that the members are to be under no obligation to the company under the articles in which their rights and duties as corporators are to be found. Much of the difficulty is removed if the company be regarded, as the framers of the section may very well have so regarded it, as being treated in law as a party to its own memorandum and articles. (at 897)

His Honour also quoted from the decision of Lord Herschell in *Welton v. Saffery* [1897] AC 299:

It is quite true that the articles constitute a contract between each member and the company, and that there is no contract in terms between the individual members of the company; but the articles do not any the less, in my opinion, regulate their rights inter se. Such rights can only be enforced by or against a member through the company, or through the liquidator representing the company; but I think that no member has, as between himself and another member, any right beyond that which the contract with the company gives.

A second similarity between the contract of association and that of Rousseau is in the mutuality of obligation between associative members. The contract of the articles and memorandum, both in the *Corporations Law*, and in case law, binds the members both to the company, and to one another.

The third similarity is in the mutable nature of the original contract. The contract of association is made on alterable terms: The power to alter the articles cannot be excluded although it may be restricted by the memorandum: CL 176(2) and (3). Provided that the alteration is deemed to be made *bona fide* for the benefit of the company as a whole,<sup>17</sup> it binds even those members who vote against the proposal for change. One rationale for

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<sup>16</sup> Note the contrary decision in *Beattie v Beattie Ltd.* [1938] Ch 708 which involved a director *qua* director.

<sup>17</sup> *Allen v Gold Reefs of West Africa* [1900] 1 Ch 656 but for the problems of this approach, see *Peters American Delicacy v Heath* (1939) 61 CLR 457.

the alterability of the articles is that the membership of the company may change: new members should not be irrevocably bound by the decisions of former members. This principle is illustrated by *Shuttleworth v. Cox Bros & Co (Maidenhead) Ltd* [1927] 2 KB 9 where a company's articles provided that the plaintiff and others were to be 'permanent directors'. The plaintiff was suspected of falsifying the accounts, but this was not one of the specified grounds of dismissal in the articles. The EGM added this ground to the Articles and accordingly dismissed the plaintiff. The Court upheld the dismissal, claiming that the alteration need only be *bona fide* for the benefit of the company as a whole in order to be legitimate. Bankes L.J. claimed that:

In the present case it seems impossible to say that the action of these defendants was either incapable of being for the benefit of the company or such that no reasonable man would consider it for the benefit of the company. It is idle to say that their action was directed against the plaintiff, because the more outrageous the conduct of a director, the more certain it is that his removal will be *bona fide* for the benefit of the company, and the more certainly will the effects of the shareholders, acting *bona fide* and for the benefit of the company be directed against him because it is necessary to protect the company against such conduct in the future. (at 19)

Scrutton L.J. said:

Now, when persons honestly endeavouring to decide what will be for the benefit of the company and to act accordingly decide upon a particular course, then, provided there are grounds on which reasonable men could come to some decision, it does not matter whether the Court would or would not come to the same decision or a different decision. It is not the business of the Court to manage the affairs of the company. That is for the shareholders and directors. (at 23)

A fourth feature common to both the Rousseauian model and that of the corporation is that parties are free to choose the rights, obligations and constitutional form of their association:

The articles of association may be drawn to ensure any allocation of power within the company that the parties desire. And given the flexibility of the system in terms of multiple and variable voting rights, special majorities, and provision for casting votes there is virtually no objective in this respect which cannot be achieved by careful drafting.<sup>18</sup>

In the principles of majority rule, mutuality of obligation, freedom to choose the form of the association and the mutability of the original contract, the contract of association is similar to the Rousseauian model. Beyond these principles, however, the contract of association adheres to liberal ideas of contract and liberal assumptions about the contractual process.

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<sup>18</sup> Tom Hadden, *Company Law and Capitalism* (London: Weidenfeld and Nicholson, 1972), at 74.

## The liberal conception of the original contract

The Rousseauan model seeks to ensure the group, as opposed to the individual, interest. I would suggest that the liberal ethos subverted the communal good of the corporation in a number of important ways: Firstly, in the stress placed upon individualism and private property; and secondly in the belief in the limited state. Doctrinally, these ideas are evidenced in the proprietary view of associative rights and the reluctance of courts to intervene in internal company matters.

I claimed in the introduction that the contract of association is contractual in the sense that it is consensual, but not necessarily in the sense that it is a legally binding agreement. This is because of the proprietary view of associative rights that has traditionally been applied to the corporate contract. This proprietary view may be contrasted with a contractual view of associative rights. A proprietary analysis is based upon the idea that share ownership can only grant rights which reflect the nature of a share as an item of property, whilst a contractual analysis suggest that the parties to the contract of association may incorporate (and in turn enforce) any terms which they desire, provided these do not conflict with the general law and the parties are bound by each term.

Traditionally, this proprietary analysis has served to confine the rights and obligations within the corporate structure. Many of the duties set out in the articles are characterised not as duties owed to the individual members of the association, but duties owed to the company itself. The effect of this is to deny a contractual remedy to an individual shareholder where it is possible to characterise the article in question as one which sets out the duties owed to the company by, for example, the directors. Individuals may only bring an action to restrain a breach of the original contract if they can maintain a derivative action under one of the exceptions to *Foss v. Harbottle* (1842) 2 Hare 461; (12843) 67 ER 189. (Discussed at some length in Chapter 7).

The proprietary view resulted in the rule that members could not enforce provisions in the articles which would confer rights upon them in some other capacity than that of member, for instance, as a director or promoter. In *Eley v. Positive Government Security Life Assurance Co* [1875] 1 Ex D 20, for example, the company's articles provided Eley was to be the permanent solicitor of the company and that he could only be dismissed for misconduct. Eley had no separate employment contract but had received an allotment of shares in the company for some work he had done in forming the company. The company ceased to employ him. He brought an action against the company for breach of contract but this failed on the basis that the articles conferred no rights on a member



where the member seeks to enforce a right in a capacity other than that of member. Here, Eley was attempting to assert a right in his capacity as solicitor.<sup>19</sup>

The contract of association was also distorted by the law's view of the voting rights which are concomitant to share ownership. On the proprietary analysis, the right to vote in company meetings is a proprietary right attached to share ownership and the individual may, therefore, vote as he or she wishes. This renders the tension between self-interest and the interest of the association a constant source of litigation. In *Pender v. Lushington* (1887) 6 Ch D 70, 75-76, Jessel M.R., in holding that a shareholder may vote in his or her self interest, claimed that:

[I]f these shareholders have a right of property, then I think all the arguments which have been addressed to me as to the motives which induced them to exercise it are entirely beside the question...There is...no obligation on a shareholder of a company to give his vote merely with a view to what other persons may consider the interests of the company at large. He has a right, if he thinks fit, to give his vote from motives or promptings of what he considers his own individual interest.

The problems caused by this view are well illustrated by *North-West Transportation v. Beatty* [1938] Ch 708, in which a contract made between a company and one of its directors (as vendor) was ratified by the general meeting. The Court found that this ratification was legitimate, despite the fact that the vendor held the majority of votes at the general meeting. Shareholders, unlike directors, were under no fiduciary duty to the company. Further, the court should not involve itself in the internal workings of the company at least where the issue before the court could be characterised as a question of commercial judgment.<sup>20</sup>

Hence, the individual majority shareholder has traditionally had the power to vote in his own interest regardless of the hardship or unfairness that may be inflicted upon other members of the association (provided that the vote did not constitute a fraud on the minority under the exception to the rule in *Foss v. Harbottle*).<sup>21</sup> In *Bushell v. Faith* [1970] AC 1099, three shareholders, two of them directors, held all the shares in a small private company. The articles provided that, in any motion for the removal of a director, the shares held by that director should carry three votes per share (thus allowing him,

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<sup>19</sup> This view was also taken in *Forbes v NSW Trotting Club Ltd* [1977] 2 NSWLR 515 where Forbes, a professional punter, attempted to overturn his exclusion from the defendant's race course on the grounds that in making its decision, the Committee did not comply with procedures in the articles for exclusion. The Court held Forbes could not enforce the procedures because he was not a member of the club. See also *Beattie v Beattie* [1938] Ch 708; *Shindler v Northern Raincoat Co Ltd* [1940] AC 701; and *Read v Astoria Garage* [1960] 2 All ER 239.

<sup>20</sup> Note, however, the decision of Vinelott J in *Prudential Assurance v Newman* (no 2) [1980] 3 WLR 543; reversed [1982] Ch 204.

<sup>21</sup> See further, Chapter 7.

effectively, to outbid the other shareholders). In a dispute concerning the conduct of one of the directors, the other directors sought to remove him. They argued that the article in question was invalid, as it was an attempt to avoid s. 181 of the *Companies Act* (which provided that any director may be removed from office at any time by a simple majority in the general meeting). The House of Lords held that there was nothing to prevent the creation of multiple voting rights for this purpose, any more than the creation of any other form of special voting rights for particular shares. The relevant legislative provision only regulated the majority required in a resolution, not the number of votes per share.

The duties of shareholders, then, have traditionally been seen as quite different to those of directors. The distinction between the duties of directors and those of shareholders is well illustrated by *East Pant Du United Lead Mining Co Ltd v. Merryweather* (1864) 2 H & M 254; 71 ER 460. In that case, a director of the company, Merryweather, along with another director, Whitworth, fraudulently sold mines to the company for cash and an allotment of shares in the company. The company then brought an action against Merryweather. The application was adjourned by the Court to allow a general meeting to take place. This meeting passed a resolution to adopt the proceedings. Whitworth proposed an amendment to say the action and refer the dispute to arbitration. A vote was taken: Of 668 votes cast, 324 were against the stay and 344 in favour. The motion was only passed, however, because of the votes cast by Merryweather and Whitworth. Page Wood V.C. upheld the resolution:

Then comes the question, has the company now sanctioned the suit? To decide that it has done so, would be to discard Mr Merryweather's votes, and to do that would, in effect, be to decide now on this application the question at issue in the suit. But if I assume, as upon this motion I must assume, that Mr Merryweather was entitled to the 600 shares which he actually holds in the company, the further question occurs, has he a right to vote in respect of such shares upon a question in which he is personally interested? Now as to the management of the company by the board, no director is entitled to vote as a director in respect of any contract in which he is interested; but the case is different when he acts as one of the whole body of shareholders. The shareholders of one company may have dealings with interests in other companies, and therefore it would be manifestly unfair to prevent an individual shareholder from voting as a shareholder in the affairs of the company. At a general meeting, therefore, Mr Merryweather's votes must be held to be good, so long as he continues to hold his shares.

This ability to vote in self interest can result in oppressive conduct of minority shareholders within the corporation. In addition to the problems posed by the ability to vote in self-interest, there is some confusion as to what rights may properly be termed as 'proprietary'. The courts have held that the right to have one's vote counted,<sup>22</sup> the right to

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*Pender v Lushington* (1887) 6 Ch D 70.

a cash dividend<sup>23</sup> and the right to have the prescribed procedure for an election followed<sup>24</sup> are proprietary rights. There is, however, no coherent body of declared principle, but an *ad hoc* application to specific factual circumstances.<sup>25</sup>

In recent years, corporate regulation has moved away from the traditional view that members can vote in their own interests. Courts have held that the right to vote should be exercised for a proper corporate purpose<sup>26</sup> and that a resolution may be struck down if it is such that no reasonable member could suppose it to be within the scope of the majority's power having regard to the contemplated objects of the company.<sup>27</sup> The courts have also applied the statutory oppression remedy, holding that the right to vote must not be exercised in such a way as to oppress the minority.<sup>28</sup> In particular, judges are less likely to insist on the formal application of the general rule that a shareholder can vote in his own interests where a company can be characterised as a 'quasi-partnership' or where corporate and family relationships are interconnected. In *Clemens v. Clemens*, [1976] 2 All ER 268, for example, the plaintiff held 45% of the issued capital, whilst her aunt held 55%. Each held 100 preference shares. The plaintiff held 800 of the 1800 ordinary shares, her aunt holding the remainder. The aunt was one of four directors, the plaintiff was not. The directors proposed to issue 1650 voting shares, the directors (other than the aunt) to receive 200 shares and the remainder to be held on trust for the company employees. The practical effect of this would have been to reduce the plaintiff's shareholding to 25% of the issued shares and would prevent the plaintiff from blocking a special resolution. The Court held that the aunt's voting power was not unlimited. It claimed that the proposed alterations:

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<sup>23</sup> *Wood v Odessa Waterworks* (1889) 42 Ch D 636.

<sup>24</sup> *Papaivanoy v Greek Orthodox Community* [1978] 3 ACLR 801.

<sup>25</sup> Note, for example, Gower's discussion that the rights to attend general meetings and to vote on a show of hands are rights attaching to membership whilst rights to a return of capital or payment of a dividend are shareholder rights and the right to vote on a poll is a mix of shareholder and membership rights. LCB Gower, *Principles of Modern Company Law* (4th ed) (London: Stevens and Sons, 1979), at 286.

<sup>26</sup> *Clemens v Clemens Bros Ltd* [1976] 2 All ER 268.

<sup>27</sup> *Prudential Assurance v Newman* (no 2) [1980] 3 WLR 543.

<sup>28</sup> *Re Carratti Holding Co Pty Ltd* (1975) 1 ACLR. Similarly, termination of membership of an association according to the articles will not be upheld if oppression is found: *Gaiman v National Association of Mental Health* [1971] Ch 317; *Thorborn v All Nations Club* (1975) 1 ACLR 127.

...are specifically and carefully designed to ensure not only that the plaintiff can never get control of the company but to deprive her of what has been called her negative control. Whether I say that these proposals are oppressive to the plaintiff or that no one could honestly believe that they are for her benefit matters not. A court of equity will in my judgment regard these considerations as sufficient to prevent the consequences arising from Miss Clemens using her legal right to vote in the way that she has and it would be right for a court of equity to prevent such consequences taking effect. (at 282)

In addition, some courts have used a contractual, rather than a proprietary analysis of rights arising under the associative contract. On a contractual view of the rights arising under the articles, a member should be able to maintain a personal action (as opposed to a derivative action under the exceptions to the rule in *Foss v. Harbottle*) to restrain any breach of the original contract. Certainly, such a view is more in accordance with Rousseau, who maintained that, should the contract of association be violated, each individual would resume all the rights which were his prior to association.<sup>29</sup> This would impose a far wider view of the individual's rights than the three traditional rights acknowledged by company law.

The contractual approach was taken in *Quin & Axtens Ltd v. Salmon* [1909] AC 442.<sup>30</sup> In this case, the company's articles provided that specific transactions required the consent of both managing directors. The company proceeded to enter into a contract and a member who was also one of the managing directors, sought and obtained an injunction restraining the company from entering the contract. This wider view is also given support, albeit on a different basis, by the decision in *Re HR Harmer Ltd* [1959] 1 WLR 62 which provided that a company is entitled to be regulated by its articles. Should it not be so, an action for oppression may lie. In this case, the Board of the company in question consisted of the father, who was the Governing Director for life and Chairman of the Board, and two sons, each of whom was a director for life. The father ran the business in an authoritarian fashion, disregarding decisions of the Board. His actions, however, became capricious and irrational. The Court found that his conduct amounted to oppression and that the members were entitled by the Articles to have company affairs regulated by the Board as specified by the Articles. Romer J. said at 86 that:

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<sup>29</sup> SC I:vi.

<sup>30</sup> A number of decisions in the UK have followed *Quin & Axtens Ltd v Salmon*: these include *Re Richmond Gate Property Co* [1965] 1 WLR 355; *Hogg v Cramphorn* [1967] Ch 254; *Bamford v Bamford* [1970] Ch 212; *Re Sherbourne Park Residents Co Ltd* (1986) 2 BCC 99.528; *Breckland Group Holdings v London and Suffolk Properties* [1989] BCLC 100; *Guinness plc v Saunders* [1990] 2 AC 663 HL.

...the sons agreed that their father should govern the company, and therefore, they must put up with it. I cannot myself believe that the agreement to his appointment as governing director was wholly unconditional on the way he was to govern, and surely they were entitled to assume that their father would exercise his power moderately and reasonably, and give some effect, at least to their own life directorships to which he had agreed.

His Honour was careful to draw the distinction between oppression and submission to the majority:

For a petition to succeed it must be shown that there had been oppression in a real sense of members qua shareholders, and not merely a subordination of their wishes to the power of a voting majority. (at 87)

Insofar as the original contract was concerned, he stressed the importance of the shareholders' expectations:

...shareholders are entitled to have the affairs of a company conducted in the way laid down by the company's constitution. Members are entitled to expect that their board shall perform its functions as a board, and that the proceedings of the directors shall be carried out in a normal and orthodox manner...If the board is browbeaten and either ignored or overruled by one of its number...in reliance on his superior voting power, the proprietary interests of the minority shareholders cannot fail to be affected, and a case of oppression...is made out. (at 87)<sup>31</sup>

This view would also appear to be supported by the *Corporations Law*, which now provides that the articles and memorandum constitute a contract under seal. Section 180(1) of the *Corporations Law* gives contractual effect to the memorandum and articles, providing that:

Subject to this Law, the constitution of a company has the effect of a contract under seal:

- (a) between the company and each member;
- (b) between the company and each eligible officer; and
- (c) between a member and each other member;

under which each of the above-mentioned persons agrees to observe and perform the provisions of the constitution as in force for the time being so far as those provisions are applicable to that person.

An exception to the general rule that a shareholder can vote in his own interests is in regard to alterations made to the articles. Such alterations must be executed, bona fide, for the good of the company as a whole. Many judges have evidenced some confusion,

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<sup>31</sup> *Kraus v JG Lloyd* [1965] VR 232 too, lends some support for the contractual view. In this case, a company director died and his widow complained that she was not given the right granted in the articles to put the appointment of a replacement to the general meeting. The wife of the other director claimed to have been validly appointed as life director by her husband and this took precedence over the articles. The Court upheld the widow's action, holding that her membership rights had been affected.

however, in their determination of what constitutes an act 'bona fide for the good of the company as a whole'. This difficulty has arisen primarily in regard to class rights. On the one hand, it has been held that the fact that an alteration prejudices or diminishes the rights of certain shareholders does not necessarily make an alteration invalid, provided the alteration was for the benefit of the company as a whole.<sup>32</sup> Yet it has been held that an alteration to the articles must not discriminate between the majority shareholders and the minority shareholders so as to give the former an advantage of which the latter have been deprived.<sup>33</sup>

As discussed above, to Rousseau, a power would be exercised bona fide for the good of the company as a whole when it is in accordance with the general will, that is, when it is exercised for the objective good of the company as a distinct entity and not exercised for the benefit of any individual or partial association (class) within the company. If the alteration, then, is for the objective good of the company, it would be irrelevant if that alteration operated to prejudice or diminish the rights of particular individuals or particular classes. This was the view taken in *Peter's American Delicacy Co. Ltd v. Heath* (1939) 61 CLR 451. In this case, the company's articles, as a result of faulty drafting, contained two inconsistent modes of making a bonus issue of shares. The company had been financially prosperous and it was agreed that there should be a bonus issue of shares. Special resolutions were passed to delete one of the original articles which provided that bonus issues should be distributed in proportion to the shares held. This was replaced by a provision that distribution was to be proportional to the amount of capital paid up on the shares. Holders of partly paid shares opposed the resolutions on the basis that those who voted for the change did so in order to benefit the fully paid shareholders to the disadvantage of partly paid shareholders. Latham C.J. stated that:

..where the rights of members of the company depend only upon the articles it is possible to alter the rights of members or of some only of the members by altering the articles. The fact that an alteration prejudices or diminishes some of the rights of the shareholders is not in itself a ground for attacking the validity of an alteration...Any other view would, in effect, make unalterable and permanent any articles of association which conferred rights upon a class of shareholders, or possibly upon any shareholder, if they or he desired that those rights should continue to exist unchanged. It is plainly not the law that the fact that an alteration of articles alters the rights or prejudices the rights of some shareholders is sufficient to prevent the alteration from being made. (at 457)

His Honour also reiterated the view that the Court should not interfere with the internal dynamics of the company:

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<sup>32</sup> *Peters American Delicacy v Heath* (1939) 61 CLR 457.

<sup>33</sup> *Greenhalgh v Aderne Cinemas* [1946] 1 All ER 512, affirming [1945] 2 All ER 719.

It is not for the court to impose upon a company the ideas of the court as to what is for the benefit of the company. It is for the shareholders to determine whether an alteration of the articles is or is not for the benefit of the company, subject to the proviso that the decision is not such as no reasonable man could have reached. (at 452)

Latham CJ also noted that:

Primarily a share in a company is a piece of property conferring rights in relation to distributions of income and of capital. In many respects the proprietary rights are defined by the articles of association, and it is easy to see that a power of alteration might be used for the aggrandisement of a majority at the expense of a minority. ...But reliance upon the general doctrine that powers shall be exercised bona fide and for no bye or sinister purpose brings its own difficulties. The power of alteration is not fiduciary. The shareholders are not trustees for one another, and unlike directors, they occupy no fiduciary position and are under no fiduciary duties. They vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owner's personal advantage. No doubt the exercise of the right affects the interests of others too...(at 454)

Rousseau's view would then accord with decided cases which hold that an alteration to remove a delinquent director is bona fide for the benefit of the company as a whole<sup>34</sup> and an alteration to expropriate the shares of a shareholder who is in competition with the company may be bona fide for the benefit of the company as a whole.<sup>35</sup>

A further exception to the general rule that the individual shareholder may vote in his private interest is that of class meetings. In this case, however, I would argue that this exception serves to undermine the common good. Under CL 197, those voting in class meetings must consider class interests and not their particular interests as individual shareholders. This is in direct conflict with Rousseau's model. He maintained that the formation of particular associations within the wider association should be prevented because of the likelihood of the distortion of the general will. Where such groups did exist, they should be similar in size and power so as to provide some balance against one another.

### **The private/public dichotomy**

I have argued, then, that the common good of the corporation was subverted by the proprietary analysis of rights; by the linkage of suffrage to share ownership; and by the creation of class rights within the corporation. In addition, the general rule that individuals could vote in their private interests was exacerbated by the fact that the internal workings of the company were considered to be 'private'. Hence, in keeping with liberal ideas of the minimalist state, the courts were reluctant to intervene in situations which, although inherently unfair, were company matters. This is illustrated by the decision of *In re Cuthbert Cooper & Sons Ltd* [1937] Ch. 392. In this case, a father established a company in which he and his two elder sons were sole directors and shareholders. The father later died and his shares passed to his three younger sons who

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<sup>34</sup> *Shuttleworth v Cox Bros & Co (Maidenhead)* [1927] 2 KB 9.

<sup>35</sup> *Sidebottom v Kershaw, Leese and Co* [1920] 1 Ch D 154.



were employed in the company but were not shareholders. The elder sons, in their capacities as directors, refused to register the younger sons as shareholders in reliance upon their powers as directors to refuse to register any share transfer without providing a reason. The younger sons argued that it was just and equitable for the company to be wound up. Simonds J. held that intervention was not appropriate:

[My decision] largely depends on what are the contractual rights of the parties as determined by the articles of association in this case. Accordingly, when I come to consider the allegations which are made in the petition, I must be guided by what are the legal rights of the parties as determined by the bargain into which they have entered.<sup>36</sup>

## Conclusion

In this chapter, I have sought to show that many of the features of Rousseau's original contract are paralleled by the corporate contract of association: these include the mutuality of associative rights and obligations; the principle of majority rule; the freedom to tailor the form and governance of the association to the special needs of the group; and the mutability of the original contract. This model of rights and duties is, however, confounded by philosophical ideas of individualism, private property, and the belief in the limited state. These philosophical ideas are adopted doctrinally by the proprietary analysis of associative rights, the link

linkage of suffrage to share ownership, and the reluctance of courts to intervene in internal company matters. In the next chapter, I shall explore the way in which the division of power between management and the membership of the association is determined by the contractual model of obligation.

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Mere internal irregularities will not allow a shareholder to bring an action against the wrongdoers because of the rule in *Foss v Harbottle*. Under the *Corporations Law*, however, a court may invalidate a procedural irregularity which causes substantial injustice: s 1322(2). See *Chew Investments Pty Ltd v General Corp of Australia Ltd* (1988) 6 ACLC 87 where it was held that a rejection of a valid demand for a poll meant that resolutions passed at the meeting could be invalidated under s 539(2) of the Code (upon which CL 1322 is based).

## CHAPTER 6

### THE CORPORATE DIVISION OF POWER

#### Introduction

In the last chapter, I outlined the threefold classification of obligations engendered by the contract of association: as between the members *inter se*; as between the members and the corporation and as between the members and the management of the corporation. I then sought to show the ways in which liberal principles distorted the rights and liabilities delineated by the contract of association in these first two classes of obligation. In this chapter, I shall examine the operation of the contract in the third class: that is, as a constitutional document which determines the governmental structure of the association. I shall use Rousseau's theory in this context to try to give some substance to the judicial notion of the 'business of the company'; to argue for the need for members of the association to 'tailor' their corporate contract to their needs; and to argue for more active shareholder participation. To do this, I shall examine three elements of Rousseau's theory in turn. These are: the distinction between the sovereign and government; the indeterminacy of the 'best' constitutional form; and the role of the individual member of the association.

#### Defining functions: sovereign and government/general meeting and directors

Rousseau's idea of the general will determined the distinction between the sovereign and the government. As discussed in the last chapter, the communal good was achieved by the device of the general will. This general will could only be known, and expressed by, the sum of the members of the association in a legitimate meeting. This expression of the general will was what Rousseau termed 'sovereignty'. As Rousseau reasoned that sovereignty is only the exercise of the general will, it could not be alienated or divided:

But the body politic or the Sovereign, drawing its being wholly from the sanctity of the contract, can never bind itself, even to an outsider, to do anything derogatory to the original act, for instance, to alienate any part of itself, or to submit to another Sovereign. Violation of the act by which it exists would be self-annihilation; and that which is itself nothing can create nothing.<sup>1</sup>

The unique nature of the sovereign, then, excluded the possibility of a contract of government.<sup>2</sup> Members of the governing body of the association would be officers rather than rulers and their duty derived not from any contract but from obedience:

Several have pretended that the instrument in this establishment is a contract between the People and the chiefs whom they give themselves; a contract by which it is stipulated between the two parties on what conditions the one binds itself to rule, the other to obey.<sup>3</sup>

Those therefore who maintain that the act by which a people submits to its chiefs is not a contract are quite right. It is absolutely nothing but a commission, an employment, in which, as simple officers of the Sovereign, they exercise in its name the power of which it has made them depositaries, and which it can limit, modify, and resume when it pleases. The alienation of such a right, being incompatible with the nature of the social body, is contrary to the object of the association.<sup>4</sup>

The Sovereign would create the government by the establishment and execution of law:

By the first, the Sovereign determines that there shall be a body of Government established in such or such a form; and it is clear that this act is a law.

By the second, the People nominate the chiefs who will be entrusted with the Government established. Now, this nomination, being a particular act, is not a second law, but only a consequence of the first and a function of Government.<sup>5</sup>

Government was thus separate in both form and function from the Sovereign. As all members of the association would be, at once, sovereign and citizen: makers of the law and subjects to the law, government must be an intermediary body:

What then, is government? An intermediate body set up between the subject and the Sovereign, to secure their mutual correspondence, charged with the execution of the laws and the maintenance of liberty, both civil and political.<sup>6</sup>

Throughout the *Social Contract*, Rousseau used the analogy of a human body to explain his theory. In relation to the Sovereign and Government, he explained their separate functions in terms of will and physical act:

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<sup>2</sup> The contract of government is that contract between the ruler and the ruled. The theory gained considerable acceptance in the middle ages. See further, Janet Nelson, 'Kingship and Empire' in JH Burns (ed) *The Cambridge History of Medieval Thought* (Cambridge: Cambridge University Press, 1988).

<sup>3</sup> SC III:xvi.

<sup>4</sup> SC III:xvi.

<sup>5</sup> SC III:xvii.

<sup>6</sup> SC III:1.

Every free action is produced by the concurrence of two causes; one moral, ie the will which determines the act; the other physical, ie the power which executes it. When I walk towards an object, it is necessary first that I should will to go there, and in the second place, that my feet should carry me. If a paralytic wills to run and an active man wills not to, they will both stay where they are. The body politic has the same motive powers; here too force and will are distinguished, will under the name of legislative power and force under that of executive power. Without their concurrence, nothing is, or should be, done.<sup>7</sup>

In function, both the Sovereign and the government were limited by the general will. In addition, the Sovereign was limited to general acts; the government to particular ones.

The object of laws was always general and never particular:

When I say that the object of laws is always general, I mean that law considers subjects en masse and actions in the abstract, and never a particular person or action. Thus the law may indeed decree that there shall be privileges, but cannot confer them on anybody by name. It may set up several classes of citizens, and even lay down the qualifications for membership of these classes, but it cannot nominate such and such persons as belonging to them; it may establish a monarchical government and hereditary succession, but it cannot choose a king, or nominate a royal family. In a word, no function which has a particular object belongs to the legislative power.<sup>8</sup>

The division in function between government and the Sovereign was of particular importance to the ongoing stability and order of the association:

If the Sovereign desires to govern, or the magistrate to give laws, or if the subjects refuse to obey, disorder takes the place of regularity, force and will no longer act together, and the State is dissolved and falls into despotism or anarchy.<sup>9</sup>

In order to maintain the sovereign's control over the government, the commission of those holding government was to be called into question at every fixed periodic meeting of the people:

The opening of these assemblies, whose sole object is the maintenance of the social treaty, should always take the form of putting two propositions that may not be suppressed, which should be voted on separately.

The first is: 'Does it please the Sovereign to preserve the present form of government?'

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7 SC III:i.

8 SC II:vi.

9 SC III:i.

The second is: 'Does it please the people to leave its administration in the hands of those who are actually in charge of it?'<sup>10</sup>

If we were to apply Rousseau's model to the company, then the shareholders should make the general rules under which the corporation is to operate: they must select corporate objectives and define corporate policy. Beyond this point, they would consign particular acts, that is, the day to day implementation of corporate policy, to the board. At each fixed meeting, the directors would be held accountable to the shareholders and could be removed.

### **The Corporate Contract: Delegation theory**

In corporate law, however, the division of power between the general meeting and the board has been problematic. Although the internal governance of the corporation is recognised as a form of constitutional law, the law's distribution of decision making power between the board of directors and the shareholders has 'never been well articulated'.<sup>11</sup> The issue that has arisen has been whether the board of directors holds power in its own right or whether it is merely the delegate of the body corporate. To what extent can the shareholders in general meeting control overrule the decisions of directors or prescribe to the board desired courses of action to the board? The issue of control has arisen primarily in relation to the current Table A, Art. 66(1) (and its predecessors) which reads as follows:

66(1) Subject to the Law and to any other provision of these regulations, the business of the company shall be managed by the directors, who may pay all expenses incurred in promoting and forming the company, and may exercise all such powers of the company as are not, by the Law or by these regulations, required to be exercised by the company in general meeting.

This issue of control can be split into two parts: Firstly, in managing the 'business of the company', are directors delegates of the company or coordinate bodies to the general meeting; and secondly, if they are coordinate, autonomous bodies, what functions are included in the words 'business of the company'? I shall discuss each issue in turn.

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<sup>10</sup> SC III:xviii.

<sup>11</sup> MA Eisenberg, 'The Legal Roles of Shareholder and Management in Modern Corporate Decisionmaking' (1969) 57 *Calif LR* 1. Although Eisenberg's comment was directed towards the American scheme whereby decision-making power is conferred upon the directors by statute, I believe that the comment is equally applicable to the Anglo-Australian schemes where the division of power is determined by the company's articles of association. For a comparative analysis of the statutory and contractual schemes as they operate in Canada, see Barry Slutsky, 'The Division of Power Between the Board of Directors and the General Meeting' in JS Ziegel (ed) *Studies in Canadian Company Law* (Vol 2) (Toronto: Butterworths, 1973), at 166.

## Delegation v. contractual theory

There are two theoretical views as to the division of power within the corporation: the delegation theory and the contractual theory. Until the early twentieth century, the law adopted the 'delegation theory' of division of corporate power. This was that the general meeting is the fundamental organ of the company and the directors are its delegates or agents. Thus, the board is subject to the control of the shareholders in the sense that a resolution by the general meeting can override the board's decisions. This was the view expressed in *Foss v. Harbottle* (1842) 2 Hare 461; (1843) 67 ER 189:

The result of these clauses is that the directors are made the governing body, subject to the superior control of the proprietors assembled in general meetings; and, as I understand the Act, the proprietors so assembled have power, due notice being given of the purposes of the meeting, to originate proceedings for any purpose within the scope of the company's powers, as well as to control the directors in any acts which they may have originated. There may possibly be some exceptions to this proposition, but such is the general effect of the provisions of the statute.<sup>12</sup>

This delegation theory originated in the common law corporations of boroughs and guilds which could only execute corporate acts at corporate meetings.<sup>13</sup> The principle of identifying the corporate will with that of a majority of the corporators duly assembled was applied to chartered trading corporations and, after the *Bubble Act*, was commonly expressed in the constitutions of unincorporated joint stock companies and companies incorporated by private statute.<sup>14</sup> By the eighteenth century, the deed of settlement

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<sup>12</sup> (1842) 2 Hare 461, 492-3 per Wigram VC. KA Aikin, however, in 'Division of Power between Directors and General Meetings as a Matter of Law and a Matter of Fact and Policy' (1967) *MULR* 448, at 456 notes that this statement appears odd when placed alongside the provisions of the private act which it referred to. That Act provided as follows:

38. That the business affairs and concerns of the company shall, from time to time, and at all times hereafter, be under the control of five shareholders (to be appointed directors), who shall have the entire ordering, managing and conducting of the company, and of the capital, estates, revenue, effects and affairs, and other the concerns thereof, and who shall also regulate and determine the mode and terms of carrying on and conducting the business and affairs of the company, conformably to the provisions contained in this Act; and no proprietor, not being a director, shall on any account or pretence whatsoever, in any way meddle or interfere in the managing, ordering or conducting the company, or the capital, estates, revenue, effects or other the business, affairs or concerns thereof, but shall fully and entirely commit, entrust, and leave the same to be wholly ordered, managed and conducted by the directors for the time being, and the persons whom they shall appoint, save as hereinafter mentioned.

<sup>13</sup> See *Conservators of the Rive Tone and Ash* (1829) 10 B & C 349, 378-379; 109 ER 479, 490.

<sup>14</sup> *Ibid.*

company operated such that the general meeting was given exclusive consideration of policy or changes of major importance, whilst the day to day conduct of the company's affairs was left to a small group elected by the general meeting and known as 'directors'. Although the precise division of power varied, a common provision was that directors were 'to order, direct, manage and transact all and every the affairs and things of or belonging to the said company except such matters which ought to be ordered in and done by a General Court of the said Company'. The *Joint Stock Companies Act 1844* (UK) also adopted this form of division of power. The company was required to appoint directors 'for the conduct and superintendence of the affairs of the company' and was enjoined from participating in the management of the company 'otherwise than by means of the directors'.<sup>15</sup>

The operation of this principle is illustrated by *Isle of Wight Railway Co. v. Tahourdin* (1884) 25 Ch D 320. In this case, shareholders in the Isle of Wight Railway Company wanted the directors of the company to call a meeting in order to accomplish two aims: the first was to form a committee to inquire into the management of the company; and the second was to remove, if necessary or expedient, any directors and to elect new directors in order to fill the resulting vacancies. Section 90 of the *Companies Clauses Consolidation Act* (the section considered in *Isle of Wight*) provided for the division of power as follows:

The directors shall have the management and superintendence of the affairs of the company and they may lawfully exercise all the powers of the company, except as to such matters as are directed by this or the Special Act to be transacted by a general meeting of the company; but all the powers so to be exercised shall be exercised in accordance with and subject to the provisions of this and the Special Act; and the exercise of all such powers shall be subject also to the control and regulation of any general meeting specially convened for the purpose, but not so as to render invalid any act done by the directors prior to any resolution passed by such general meeting.

The directors issued a notice of the meeting but did not make any mention of the second issue - that of the election of new officers. The shareholders gave notice to the directors that they would not attend the meeting and proceeded to issue notice of their own meeting. The directors sought both a declaration from the court that the notice convening the shareholders' meeting was invalid and an injunction restraining that meeting. That injunction was granted at first instance and the shareholders appealed. The directors argued that they had not failed to call the desired meeting and so it was illegal for the shareholders to do so. Where the company had the power to remove the directors, it had to do so at a properly constituted meeting of the company. The shareholders argued that

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Under CL 27 and Schedule A.

the directors were merely agents of the company and the shareholders could remove them provided they did so in a lawful manner. The Court (Cotton L.J., Lindley L.J. and Fry L.J.) upheld the appeal, Cotton L.J. stating that:

It is a very strange thing indeed to prevent shareholders from holding a meeting of the company, when such a meeting is the only way in which they can interfere, if the majority of them think that the course taken by the directors, in a matter which is *intra vires* of the directors, is not for the benefit of the company. (at 329)

In the Court's view, the rule in *Foss v. Harbottle* meant that the Court would not interfere on behalf of shareholders unless they had attempted to rectify the problem by calling a general meeting. The board, then, could not prohibit the proposed shareholder meeting.

### **The Corporate Contract: Contractual theory**

The contractual theory of the division of power is that the contract of association found in the articles determines the division of power. Thus, if the articles vest power in the directors, and there is no machinery delineated for shareholder control, the general meeting must pass a special resolution to alter the articles before shareholders can interfere. An ordinary resolution of the general meeting cannot overrule a board's decision nor prescribe to the board a particular course of action. As discussed in Chapter 3, the adoption of this theory is generally traced to the decision in *Automatic Self-Cleansing Filter Syndicate Co Ltd v. Cunningham* [1906] 2 Ch 34. The articles of the Automatic Self-Cleansing Filter Syndicate company gave the board the power to manage the company and specifically to deal with company property subject to such regulations as might be made by extraordinary resolution of the general meeting. The company's memorandum gave as one of the company's objects the power to sell its undertaking to another company having similar objects. A shareholder brought a resolution to sell the company property to another company having similar objects and this was passed at a general meeting by a narrow majority (that majority being composed primarily of the proposing shareholder's votes and those of his friends). At first instance, Warrington J. held that the directors were not bound to put the resolution into effect. On appeal, the company argued that the company was the principal or employer and the directors were merely agents or servants and the board was therefore bound to obey the general meeting in the absence of oppression or fraud, the company's powers being concurrent with those of the directors. The board argued that, where the articles gave a particular power to the directors, their control was not to be interfered with by the general meeting unless by extraordinary resolution. It would amount to an alteration of the articles to interfere with the exercise of the directors' power by a simple resolution in the general meeting.



The Court dismissed the appeal, *Collins M.R.* on the bases that to allow the appeal would be unfair to the minority and it would render the article requiring a special resolution to remove the directors otiose. He distinguished the *Isle of Wight* case on the basis that it rested on a different statute. Cozens-Hardy L.J. reasoned that there was no right of the court to interfere in the contract of association short of director misconduct. In a partnership there would be no right for the court to interfere in similar circumstances. This was not a case, in his view, of a master/servant or principal/agent relationship. Rather, directors were managing partners appointed to fill that post 'by mutual arrangement between [sic] all the shareholders: 'You are dealing here, as in the case of a partnership with parties having individual rights as to which there are mutual stipulations for their common benefit...'. (at 45)

Under the contract theory, then, if the articles give a general power of management to the directors, the general meeting retains only statutory powers<sup>16</sup> and residual powers (that is, the power to act where a board is unwilling or unable to act; the power to ratify the acts of directors and the so-called doctrine of unanimous consent).<sup>17</sup>

The adoption of the contractual view has, however, been problematic for corporate law. As outlined above, the practical effect of the contractual view is that a resolution of the general meeting which takes away the directors' power of management or which interferes with the exercise of that power is inconsistent with Table A art. 66(1). At the least, this view is likely to offend our intuitive ideas of democracy.<sup>18</sup> A board may make significant structural change (such as altering company direction or selling the company undertaking) inconsistent with the wishes of the majority.<sup>19</sup> *Cunninghame's case*<sup>20</sup> is an example of an instance of the former problem. In *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] AC 821, 827, Lord Wilberforce stated that:

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<sup>16</sup> Some acts under the *Corporations Law* require general meeting approval. Similarly, ASX listing rule 3J(3) requires such approval. See, for example, *FAI Traders Insurance Co Ltd v ANZ McCaughan Securities* (1990) 3 ASCR 279.

<sup>17</sup> See *Mendes v Commissioner of Probate Duties* (Vic) [1967] ALR 649, 653.

<sup>18</sup> Roman Tomasic, James Jackson and Robin Woellner, *Corporation Law: Principles, Policy and Practice* (2nd ed.) (Sydney: Butterworths, 1992), at 320.

<sup>19</sup> For a more comprehensive discussion of this problem, see Slutsky, note 11, above, at 181-187.

<sup>20</sup> See also *Wilson v Miers* (1861) 142 ER 486; and *In Re HH Vivian and Co Ltd* [1900] 2 Ch 654. Contra two British Columbian decisions: *Picard v Revelstoke Sawmill Co Ltd* (1913) 18 BCR 416 (BCCA) and *Pylypchuk and Ewachniuk v Dell Hotel Ltd* (1958) 15 DLR (2d) 589 (BCSC).

The constitution of a limited company normally provides for directors, with powers of management and shareholders, with defined voting powers having power to appoint the directors, and to take, in general meetings, by majority vote, decisions on matters not reserved for management. ... it is established that directors, within their management powers, may take decisions against the wishes of the majority of shareholders, and indeed that the majority of shareholders cannot control them in the exercise of these powers while they remain in office...

From the contractual viewpoint, it is argued that the shareholders retain ultimate control over the board by their power to alter the articles or to remove the directors but empirically, this is often not the case. The directors, through proxy voting and their ability to vote in self-interest, can often dominate the general meeting.

A further problem is that, despite the development of the contractual theory, the delegation theory did not disappear. Although the contractual view was adopted in *Cunninghame, Gramophone and Typewriter Ltd v. Stanley* [1908] 2 KB 89, *Quin & Axtens v. Salmon* [1909] AC 442, *John Shaw and Sons (Salford) Ltd v. Shaw* [1935] 2 KB 113 and *Scott v. Scott* [1943] 1 All ER 582 *NRMA v. Parker* (1986) 6 NSWLR 517; 11 ACLR 1; and *Stanham v. the National Trust of Australia (NSW)* (1989) 15 ACLR 87, the delegation theory survived for some years. A year after the decision in *Cunninghame*, the court adopted the delegation theory in *Marshall's Valve Gear Co v. Marring Wardle and Co* [1909] 1 Ch 267. In this case, a patentee sold his patents to a company formed for the purpose of taking them over, the consideration for which consisted, in part, of the allotment to him of fully-paid shares. The patentee had a controlling vote in the company, but not such control as would give him a three-fourths majority so he could pass a special resolution. The other three directors then took out a patent similar to the valves developed by the patentee. As the company owned the patent, it was the proper plaintiff in an action against the three directors. Those directors, however, would not, of course, institute an action against themselves. The patentee instituted an action on behalf of the company and the directors sought to stop the action on the ground that it was unauthorised by the company. Neville J., relying on a number of cases prior to the *Cunninghame* case, stated that '...the principle has been acted upon that in the absence of any contract to the contrary the majority of the shareholders in a company have the ultimate control of its affairs, and are entitled to decide whether or not an action in the name of the company shall proceed'. Neville J. distinguished the *Cunninghame* case on the basis that, in the former, the company's articles made the board's management powers subject to 'regulations...made by extraordinary resolution' and, '[I]nasmuch as there was no extraordinary resolution in that case, the court, it seemed to me, could have come to no other conclusion.....'. He did note, however, that:

There are among the observations which fell from one or more of the learned judges who decided that case propositions which, if I understand them correctly, I think extend beyond any of the decisions in the former cases, and, if I may say so very respectfully, appear to me to be inconsistent with the law as it stood at the time when the case of *Automatic Self-Cleansing Filter Syndicate Co v. Cuninghame* was decided.

In this case, however, Neville J. held that under art. 55, the majority of the shareholders in a general meeting have 'a right to control the actions of the directors, so long as they do not affect to control it in a direction contrary to any of the provisions of the articles which bind the company.'

The decision in *Marshall's Valve* was followed in Australia in *Dowse v. Marks* (1913) 13 SR NSW 332. This case was a demurrer to a suit brought by three shareholders of a company to restrain M, the company's governing director, from interfering with the management of the company by W, the managing director. The company had been formed to take over the theatrical business carried on by M. M was governing director and held the majority of shares, the plaintiffs holding the remainder. Under the articles, management was vested in the directors and the decision of the managing director on questions of policy was to be final. It was alleged that M consistently vetoed decisions made by W. The Court relied on the interpretation given in *Marshall's Valve* that the company retains the power to control the directors by an ordinary majority in the general meeting. Therefore, the wishes of the majority were to prevail. Merely to appoint a 'managing director' was not to give him complete power to control the company against the board or the shareholders.

The confusion over the extent of the general meeting's powers led one commentator as relatively late as 1970 to remark that:

One concludes that the old faith is still the true faith, that the residuary powers of the company do reside in the general meeting of shareholders acting by ordinary resolution; and that it is not true that the shareholders are powerless to act save by special resolution "even as regards matters not specifically delegated to the directors." Put positively this means that under Table A the shareholders in general meeting are able by special resolution to exercise all the powers of the company which are not either specially delegated to the directors (which category includes the day-to-day control of the business) or required by the Act or the articles to be done by some special procedure; provided always that such exercise does not constitute a fraud on the minority.<sup>21</sup>

An attempt was made in *Integrated Medical Technologies Ltd v. Macel Nominees Pty Ltd v. Another* (1988) 13 ACLR 110 to reconcile delegation and contractual theory. In this

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<sup>21</sup> GD Goldberg, 'Article 80 of Table A of the Companies Act 1948', (1970) 33 *MLR* 177.

case, the shareholders sought to convene a general meeting of the company. Their notice proposed the appointment of three additional directors. The company alleged that its articles excluded the general meeting's power to appoint directors. The shareholders succeeded, Bryson J. stating that:

The members and the directors are not rival versions of the true identity of the company; the directors can never lose their true nature as delegates, none the less because the delegation is very extensive, in this case taking the very extensive although common form expressed in art. 106 of the company which opens by stating 'the management and control of the business and affairs of the company shall be vested in the board.' From this starting point the allocation of particular functions in the articles, in some cases to an annual general meeting, in some cases to a general meeting and in some cases to directors carries no implication of an intention to make an exclusive prescription of what a general meeting can do; for that clear language or unmistakable implication would be required.' (at 114)

The inconsistent adoption of the delegation or contractual theory in different cases may be attributed to judicial desire to ameliorate the problems flowing from the pursuit of self-interest within the corporation. Thus, for instance, in *Isle of Wight*, it would appear intuitively unjust that the directors could refuse to call a meeting which would seek to question their continued administration, whilst in *Integrated Medical Technology*, it seems correct that the shareholders should be able to convene a meeting to appoint directors. *Marshall's Valve* is a clear case of directors acting for an improper purpose whilst the decision in *Cunninghame* seems calculated to avoid an oppression of the minority by the majority.

The Courts have been slow to analyse the meaning of the 'business of the company' for the purposes of the division of power. The adoption of the Rousseauian principles, first that the association has the right to determine policy and the directors have the right to administer that policy on a day to day basis; and second that the directors should be called to account at regular and fixed intervals would provide some guidance in such cases. A contributing factor in some cases has been the failure of management to take into account the expectations of shareholders to participate in management. This problem is addressed by Rousseau's belief that the form of government adopted by an association must be one tailored to the nature of that association. I turn now to discuss Rousseau's analysis of constitutional form.

### **Constitutional Form and Indeterminacy**

The second element of Rousseau's theory relevant to this discussion is that of the need to select the correct constitutional form for any particular corporation. Rousseau argued that the contractual bond was stronger in smaller states. As associations increased in size, administration became more difficult and more costly, there was less affection for rulers

and government must be stronger (and, in consequence, there was less liberty for the individual). Even the pace of government was altered in a larger association.

[A]s there is only one mean proportional between each relation, there is also only one good government possible for a State. But, as countless events may change the relations of a people, not only may different governments be good for different peoples, but also for the same people at different times.<sup>22</sup>

Hence, Rousseau argued that democracy was not suited to all associations: there was a real need for different types of constitutional forms to suit different types of association.

The best type of government was, therefore, indeterminate:

What, then, it is asked absolutely which is the best Government, an insoluble and likewise indeterminate question is propounded; or, if you will, it has as many correct solutions as there are possible combinations in the absolute and relative positions of the nations.

No form of constitution was, in Rousseau's view, eternal, but choosing the correct form of constitution could prolong the life of the association.

It is important to note, at this point, the very specialised sense in which Rousseau used the term 'democracy'. Democracy was that constitutional form where the majority were both magistrate and sovereign. What Rousseau termed an 'aristocracy', was in fact a democracy in the modern sense: that is, where a minority of elected officials performed the governmental functions. A true democracy, in the Rousseauan sense, was only suitable under certain defined conditions: where the state was sufficiently small; where there was equality of fortune and rank; where there was little or no luxury and where there were simple manners, business being kept to a minimum. Rousseau recognised the difficulty of what he called 'true' democracy, one of these difficulties being that 'it is impossible to imagine that the people should remain in perpetual assembly to attend to public affairs, and it is easily apparent that commission could not be established for that purpose without the form of administration being changed'. This practical consideration was not the only reason preventing the people upon deciding every aspect of their affairs: 'It is not good that he who makes the laws should execute them, nor that the body of the people should divert its attention from general considerations in order to bestow it on particular objects'. Yet, he cites the Romans with approbation:

What a difficulty, we might suppose, there would be in assembling frequently the enormous population of the capital and its environs. Yet few weeks passed without the Roman people being assembled, even several times. Not only did they exercise the rights of sovereignty, but a part of those of Government. They discussed certain affairs and judged certain causes, and in the public assembly the whole people were almost as often magistrate as Citizen.<sup>23</sup>

An aristocracy, on the other hand, (and 'aristocracy' is used here in the sense of Rousseau's preferred form, that is, government by elected magistrates) 'is expedient in general that the administration of public affairs should be entrusted to those who are best able to devote their whole time to it.'. Indeed, he claims that '...it is the best and most natural order of things that the wisest should govern the multitude, when we are sure that they will govern it for its advantage and not for their own'. Monarchy, as a form of government, was most suited to very large associations, but was a problematic form of government to maintain, due to the conflict between the will of the ruler, and that of the ruled:

But if no government is more vigorous than this, there is also none in which the particular will holds more sway and rules the rest more easily. Everything moves towards the same end indeed, but this end is by no means that of the public happiness; the very strength of the administration is constantly prejudicial to the State.<sup>24</sup>

### **The indiscriminate adoption of standard provisions**

Despite the fact that corporations have this freedom to choose their preferred form of organisation, it is often the case that the standard Table A is adopted for the company. Large public companies and small private, family companies, then, often adopt this division indiscriminately, despite their very different natures and the different expectations of shareholders. Although writing in regard to the American situation, Eisenberg,<sup>25</sup> identifies two basic types of private company: one, similar to a partnership, where all shareholders expect to participate actively in the business and the other where some shareholders do not wish to be active in business. Even in the latter case, he claims, shareholders should have control over 'structural decisions', that is, 'decisions which, although economic in character, are not made within the general framework or structure of the business as it then exists, but make a substantial change in that structure'. The

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23 SC III:xii.

24 SC III:vi.

25 Eisenberg, note 11, at 12.

examples he gives are complete liquidation, sale of substantially all the assets or merger with another business which alters ownership interests and increases, to a significant extent, total size. He argues further that even in the case of public companies, (where many commentators argue that it is impractical to bestow powers of management upon shareholders because it would be unwieldy)<sup>26</sup> participation in structural decisions by shareholders is desirable:

[A]t the present time one-third of the stock in corporations listed on the New York Stock Exchange is held by highly sophisticated investors with a growing interest in structural changes other than changes in management; that the proportion of such stock held by such investors will soon reach 40-50 percent; and that much of the balance of the stock of such corporations seems to be held by wealthy individual shareholders with very substantial shareholdings who may be assumed to be either themselves sophisticated investors or guided by professionals in their investment decisions. Only a small fraction of stock even in publicly held corporations appears to be under the direct ownership of unsophisticated investors with tiny holdings. "The average shareholder" who holds centre stage in the theories of so many commentators, appears to be only an extra in the real corporate world.<sup>27</sup>

The received legal model is, according to Eisenberg, descriptive, rather than prescriptive and insufficiently articulated to provide a normative model. These comments are, I suggest, equally applicable in the Australian context. The corporate form should reflect the expectations of the members of the association. Should shareholders wish to participate in management, then their corporate constitution should adopt a democratic division of power. Should shareholders wish to leave all management functions to the board, then the constitution should reflect this. If this latter form is adopted, however, it does not imply that shareholders should be passive. The active and involved member, in Rousseau's view, was the primary safeguard against governmental abuse.

### **The active shareholder**

The third element of Rousseau's theory relevant to the associative constitutional structure is that of the role of the shareholder. Regardless of the form of constitution adopted by the association, the sovereign had three primary roles. These roles were: to fix the

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<sup>26</sup> See, for example, HAJ Ford and RP Austin, *Principles of Corporations Law* (7th ed) (Sydney: Butterworths, 1995), at 203.

<sup>27</sup> Eisenberg, note 11, at 53, but note the very different view held by Slutsky, note 11, who quotes Eells: '...the stockholders...resolutely refuse to participate in corporate affairs; they obey the management; they are interested in their stock only as investments; and their participation in the corporate electoral process, so far as it goes, is an empty ritual'.

constitution of the association; to give sanction to its laws; and to establish a perpetual government or to provide for election of the magistrates.

The sovereign, as discussed earlier, controlled the government by its fixed and periodical meetings 'which nothing can abolish or adjourn, so that, on the appointed day, the people are rightfully convoked by the law, without needing for that purpose any formal summons'. The frequency of these periodic meetings 'depend on so many considerations that no precise rules can be given about them. Only it may be said generally that the more force a Government has, the more frequently should the sovereign displace itself.' These assemblies were directed to the maintenance of the contract, and 'the opening of these assemblies, which have as their object the maintenance of the social treaty ought always to be undertaken with two propositions, which no one should be able to suppress, and which should pass separately by vote'. The first of these was whether to uphold the existing government; and the second was whether to leave the current administrators in office.

Apart for these meetings which were lawful by date alone, assemblies not called by the magistrates were null and void:

[E]very assembly of the People that has not been convoked by the magistrates appointed for that duty and according to the proscribed forms, ought to be regarded as unlawful and all that is done in it as invalid, because even the order to assemble ought to emanate from the law.

In stark contrast to Rousseau's theory, shareholder passivity in company matters is widespread. Shareholders in many large, public companies are no more than investors. This problem is made more acute by the rise of institutional investment, which relegates shareholders to the role of mere beneficiaries. Even where shareholders desire to play a more active role, the ability of management to take de facto control of the general meeting through proxy voting, may effectively thwart that desire. Hadden writes:

The more usual and accepted conclusion from the available evidence is that shareholders as such have lost all genuine control over the affairs of 'their' companies. The board of directors, or management as a whole, is in a much better position to dominate the affairs of the company both on a day to day basis, as is their duty, and also in general meeting....Management typically controls not only the conduct of meetings but the content of the various resolutions, and in addition is generally in control of the proxy voting system, despite the various attempts both in Britain, and more especially in America, to ensure that the proxy system gives genuine voting power to the mass of shareholders who cannot be expected to attend, nor could be physically accommodated at company meetings.<sup>28</sup>

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28 Tom Hadden, *Company Law and Capitalism* (London: Weidenfeld and Nicolson, 1972), at 131.



He concludes that the effect of this is that:

For practical purposes the management of any large public company may safely be regarded as a self-perpetuating oligarchy, largely free from effective pressures from their shareholders.<sup>29</sup>

In Rousseau's view, passive membership leads inexorably to abuse and ultimately the downfall of the corporation. The inability of shareholders to call directors to account has ramifications not only for the possibility of oppressive conduct within the association, but for the possibility of corporate crime and lack of corporate social responsibility (discussed at greater length in Chapters 9 and 10).

## Conclusion

In this chapter, I have examined both the contractual and delegation theories of corporate governance in the light of Rousseau's theory of 'right' government. I have sought to show that the application of Rousseau's model suggests that many of the problems in this area arise from the lack of a coherent principle of the corporate division of power; from the lack of an active and critical examination of company goals, structure, size and shareholder expectation before the company constitution (and hence division of power) is decided upon; and from the ready acceptance of shareholder passivity. In addition, there has been insufficient judicial analysis of the meaning of the 'business of the company'.

The implications of Rousseau's theory for the division of corporate power are as follows: Firstly, the indiscriminate adoption of Table A should be discouraged. It would be necessary for a company to look at its size and proposed nature before determining its constitution. A small family company would, for instance, appear be more suited to a democratic form of government (in the Rousseauan sense of active participation of members as both sovereign and government) than a large company with diverse shareholders. A medium sized company, on the other hand, would require 'elected' magistrates (ie an 'aristocracy'), more along the lines of the current scheme. The number of such directors would vary according to the needs of the corporation. The shareholders in meeting would determine in general terms the objects and operation of the company (along Eisenberg's view of 'structural' decision making) but the directors would be expected to make all day to day decisions, that is, to apply these general principles to particular cases.

The maintenance of power in any these types of constitution would be by the vote in the fixed and periodic meetings. In those meetings, the opening issues would be whether the

current form of constitution should be maintained, and if so, whether the current directors should remain in their positions.

Despite the belief that the members of the association should retain the power to dismiss the rulers and to change the constitutional form of the association, Rousseau did not advocate changing government lightly:

It is true that such changes are always dangerous, and that the established Government must never be touched except when it becomes incompatible with the public good; but this circumspection is a maxim of politics, not a rule of right; ....

At present, of course, shareholders retain the right to dismiss the directors or to change their constitutional form by altering the company articles. As has been discussed, the former power is often rendered a fiction by de facto director control of the general meeting. Importantly, on Rousseau's model, members could not vote by proxy, nor would voting power be attached to share ownership. In addition, all voting would be subject to the overriding requirement that the vote be for the objective good of the company and not for some private and particular interest. I shall now turn to examine the internal relations of corporations. I shall start by examining the rights and remedies of majority shareholders within the corporation, before proceeding to consider the acts of directors.

## **CHAPTER 7**

# **ACTS OF THE SOVEREIGN: THE RIGHTS AND REMEDIES OF MINORITY SHAREHOLDERS**

### **Introduction**

In Chapter 5, I discussed one principle common both to the Rousseauan contract and to the contract of association: namely, that in both the minority is deemed to consent to the will of the majority, provided that will is legitimate. At what point, however, does an exercise of majoritarian power cease to be legitimate? Where an exercise of power is found to be illegitimate, what mechanisms are provided for a minority to seek redress for such abuse? Rousseau was careful to provide a number of safeguards, both procedural and substantive, against the possibility of abuse by a majority. Company law, on the other hand, has traditionally limited the rights and remedies of minority shareholders against a delinquent majority. As discussed earlier, liberal theory places the individual at the apex of the hierarchy of rights and duties. The courts' adoption of this view can be seen doctrinally in the rule that the individual can vote in self-interest and in the policy of non-interference in internal company matters. These views effectively limited minority rights. Minority remedies, in turn, were limited by the application of the separate entity doctrine. In recent years, however, corporate regulation in Australia has moved away from a strict adherence to these tenets as a result of the recognition of the inherent tension between the individual pursuit of self-interest and the welfare of the group as a whole. In particular, the introduction of the statutory oppression remedy was intended to provide some redress for minority shareholders. In this chapter, I shall use Rousseau's theory to show the ways in which corporate regulation has failed to provide effective mechanisms for the control of a delinquent majority. I shall argue that it would be possible, and indeed preferable, to base corporate procedure on much of Rousseau's model. At the very least, his standards would provide a clearer and more coherent statement of legitimate majority action than the existing law. I shall begin by outlining Rousseau's theory in this area, before proceeding to compare corporate law with that theory.

### **Outline of Rousseau's theory**

Despite the criticism Rousseau attracted by his conception of majority rule, his theory contained a number of safeguards to protect the minority against abuse. As outlined in the previous chapter, the sovereign, the lawful assembly of all members of the association, determines the general, constitutional rules that bind each member of the association. The government, that is, those who exercise power on trust for the

sovereign, acts as an intermediary between the sovereign and the state, applying the general laws of the sovereign to specific circumstances in accordance with general will. From this fundamental distinction, it follows that an exercise of majoritarian power must be both procedurally and substantively legitimate. I shall discuss each of these requirements in turn.

### *Procedural legitimacy*

By definition, the sovereign can only act when the people are assembled.

The Sovereign, having no force other than the Legislative Power, acts only in accordance with the law. And since laws are nothing but authentic acts of the general will, the sovereign cannot act save when the People are assembled.<sup>1</sup>

Not every assembly, however, confers procedural legitimacy upon the majority decision: The assembly must be lawful; and, at the point of assembly, government must cease. Rousseau proposed two types of assembly: the first is the fixed and periodic assembly. This is lawful by virtue of its date alone. The primary purpose of this type of assembly is to call the current government to account.<sup>2</sup> The other type of assembly is that lawfully called by the magistrates.

[E]xcept for those meetings, however, legitimized by the recurrence of certain fixed dates, assemblies of the People not called by the magistrates appointed for that purpose must be regarded as having no legal sanction. Any business transacted at them must be held to be null and void, since even the order to assemble must proceed from the law.<sup>3</sup>

The second procedural requirement is that each member of the association vote directly. As sovereignty cannot be alienated or divided, the members of the association must attend the meeting and vote in person - the good citizen, in Rousseau's view, is the active one. Indeed, the level of participation in public affairs is the major indication of the health of the association:

The better constituted a State is, the more do public affairs occupy men's minds to the exclusion of their private concerns....In a well-run city every citizen hastens to the assembly: under a bad Government no one will move a step in order to attend it, knowing that the general will will not prevail, and because, in the long run, the cares of home drive out all others....As soon as a man, thinking of the affairs of the State, says: 'They don't concern me,' it is time to conclude that the State is lost.<sup>4</sup>

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<sup>1</sup> SC III:xii.

<sup>2</sup> SC III:xiii.

<sup>3</sup> Ibid. By implication, then, the members themselves cannot call an assembly.

<sup>4</sup> SC III:xv.

Further, the members of the association must not come to the meeting as part of a pre-arranged faction. The general will can only be known through the genuine clash of individual wills.<sup>5</sup>

In order to be legitimate, then, a resolution of the majority must be passed at a lawful assembly and all voters must vote in person. In addition to these procedural requirements, the resolution must also be substantively legitimate.

#### *Substantive legitimacy*

Three primary rules determine the substantive legitimacy of any act of the sovereign and seek to protect the minority against oppression and discrimination: The first of these is that the act must be in accordance with the general will; the second is that the acts of the sovereign must be general in nature; and the third is that there must be substantive equality among the parties.

A legitimate act of the sovereign is one in accordance with the general will:

The first, and most important, consequence of the principles established is that the general will can only direct the powers of the State in such a way that the purpose for which it has been instituted, which is the good of all, will be achieved. For if the establishment of societies has been made necessary by the antagonism that exists between particular interests, it has been made possible by the conformity that exists between these same interests. The bond of society is what there is in common between these different interests, and if there were not some point in which all interests were identical, no society could exist...it is solely on the basis of this common interest that society must be governed.<sup>6</sup>

A legitimate resolution, then, is one that seeks to further the interests of the group as a whole, and not merely serve the interests of the one or even of the many. The second rule is that a legitimate act is one that is general in nature. It is by this means that Rousseau seeks to avoid oppression:

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<sup>5</sup> SC II:iii.

<sup>6</sup> SC II:i.

In fact, as soon as issue is joined on some particular point, on some specific right arising out of a situation which has not previously been regulated by some form of general agreement, we are in the realm of debate. The matter becomes a trial in which certain interested individuals are ranged against the public, but where there is no certainty about what law is applicable nor about who can rightly act as judge. It would be absurd in such a case to demand an ad hoc decision of the general will, since the general will would then be the decision of one of the parties only. To the other it would appear in the guise of a pronouncement made by some outside power, sectarian in its nature, tending to injustice in the particular instance, and subject to error. Thus, just as the will of the individual cannot represent the general will, so, too, the general will changes its nature when called upon to pronounce upon a particular object. In so far as it is general, it cannot judge of an individual person or an isolated fact.<sup>7</sup>

By virtue of these two rules, acts of the sovereign are limited to the public utility. The sovereign cannot impose a burden that is useless to the community, nor can the sovereign harm an individual or burden one individual over another.<sup>8</sup>

Provided that the rules of procedure and substance are abided by, the majority vote binds the minority. The source of the obligation of the minority to submit to the majority will, as outlined in Chapter 5, is the social contract itself. To dissent from the majority view, according to Rousseau, merely indicates that an individual is mistaken as to the general will. Thus, as freedom is the ultimate political good sought to be achieved, the individual can be 'forced to be free', that is, forced to accept the majority will.<sup>9</sup> The number by which votes must be in the majority is not fixed, but one that is determined by the specific circumstances.

With regard to the proportional number of votes needed to declare this will, I have also stated the principles on which it can be determined. The difference of a single vote destroys unanimity: one voice raised in opposition makes unanimity impossible. But between unanimity and equality there are many unequal divisions, at each of which this number can be fixed as the State and the needs of the body politic may demand.

Two general principles may serve to regulate this proportion: one, that the more important and solemn the matters under discussion, the nearer to unanimity should the voting be: two, that the more it is necessary to settle the matter speedily, the less should be the difference permitted in balancing the votes for and against. The first of these rules seems to be more suited to the passing of laws, the second to the transaction of business. Be that as it may, only a combination of them can give the best proportion for the determining of majorities.<sup>10</sup>

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<sup>7</sup> SC II:iv.

<sup>8</sup> SC II:iv.

<sup>9</sup> SC I:vii.

<sup>10</sup> SC IV:ii.

This ideal of majoritarian rule presupposes, however, that the majority vote expresses the general will. Rousseau saw that the greatest danger to this scheme would be that the general will is not followed, and the individual is forced to submit to the sum of particular wills. Convinced that the general will cannot be destroyed or corrupted,<sup>11</sup> Rousseau's answer to this problem is the legislator, an individual who stands outside the association. The legislator is neither member of the sovereign nor of the government.<sup>12</sup> This individual would always recognise the general will but could not employ force or reason in his efforts to point out the 'true path' to the association: 'Because the legislator cannot employ either force or reasoning, he must have recourse to an authority of a different order, which can compel without violence and persuade without convincing.'<sup>13</sup> His ultimate goal is to ensure that the laws of the sovereign reach the highest possible point; that is, the point at which the force of the association is equal or superior to the individuals that comprise it.<sup>14</sup>

The final requirement of legitimacy in Rousseau's scheme is that acts of the sovereign are not legitimate where those acts are the outcome of violence or exploitation of inequality of power. Rousseau argued that the 'greatest good' or aim of legislation (that is, acts of the sovereign) is liberty and equality. He then goes on to argue that:

Let it be clearly understood that, in using the word, I do not mean that power and wealth must be absolutely the same for all, but only that power should need no sanction of violence but be exercised solely by virtue of rank and legality, while wealth should never be so great that a man can buy another or so lacking that a man is compelled to sell himself...It is just because the pressure of events tends always to the destruction of equality that the force of legislation should always be directed to maintaining it.<sup>15</sup>

Rousseau was a staunch upholder of majority rule but he did not advocate a totalitarian majority. Rather, he sought to protect the minority against abuse and oppression by both procedural and substantive safeguards. Provided, however, these safeguards were complied with, dissent was not permitted. In Rousseau's view, the collective good was of greater importance than individual interests.

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<sup>11</sup> SC IV: i.

<sup>12</sup> SC II: vii.

<sup>13</sup> SC II: vii.

<sup>14</sup> SC II: vii.

<sup>15</sup> SC II: iv.

## A comparison of Rousseau's theory and company law provisions

In contrast, corporate regulation has been much slower to provide safeguards and avenues for redress against a delinquent majority. This reluctance has posed particular difficulties in the case of small, private companies where minority shareholders may have no market for their shares or where the company constitution places restrictions upon the transferability of shares or confers pre-emptive rights over shareholdings. In addition, shareholders in such companies are often more vulnerable to oppressive conduct, such as the withholding of dividends or diversion of corporate assets to majority interests, or the alteration of the corporation so as to devalue minority interests. Like Rousseau's theory, company law provides some procedural and substantive requirements that must be satisfied in order to confer legitimacy upon a majority decision. These requirements do not, however, effectively protect the vulnerable minority. I shall discuss these different requirements in turn.

### *Procedural legitimacy*

As in Rousseau's theory, company law provides for two types of assembly: the fixed and periodic assembly - the annual general meeting - and ad hoc meetings. Rousseau's theory would hold that the frequency of the fixed meetings should be determined according to the circumstances and needs of the association. The fixed meetings provided by law, on the other hand, are annual. CL 245(1) provides that an annual general meeting be held each calendar year and within five months (or six in the case of an exempt proprietary company) of the end of the financial year. Of the non-periodic meetings, company law, like Rousseau, provides that lawful meetings may be called by those who govern the association. Table A, reg 40 provides that 'Any director may whenever he thinks fit convene a general meeting.' Unlike Rousseau, however, the *Corporations Law* also allows two other parties to call lawful meetings: the shareholders and the courts.<sup>16</sup>

In addition to being lawfully convened, proper notice may be essential to the validity of a resolution. The *Corporations Law* specifies that 14 days notice of a general meeting must be given (or longer if the articles so specify): CL 247(2). Shorter notice will suffice, however, where the consent of all members, in the case of an annual general

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The directors are required, on the requisition of members entitled to 5% of voting rights in a company (or who satisfy the alternatives in CL 246(1) to convene a meeting as soon as practicable (but within two months of the requisition). This applies regardless of anything in the articles. If the directors do not convene the meeting within 21 days, the requisitioners may do so: CL 246(3). Two or more members with 5% of the issued capital can convene a general meeting provided that the articles do not provide otherwise: CL 242(1). The court may order a meeting to be convened: CL 251(1). See *Re Totex-Adon Pty Ltd* [1980] 1 NSWLR 605; *LC O'Neil Enterprises Pty Ltd v Toxic Treatments Ltd* (1986) 10 ACLR 337.



meeting, or a majority of members holding 95% of the nominal value of the shares, is obtained: CL 247(3).

There are two notable differences, however, between corporate law and Rousseau's theory. The first is that, where Rousseau required, by implication, that all members of the association must be present in the assembly, the *Corporations Law* provides that a quorum will be sufficient to proceed: CL 249(1)(a). In Rousseau's view, a quorum could not effectively state the good of the association: this could only be expressed by a clash of individual wills. Obviously, a quorum overcomes the practical barriers to corporate action posed by non-attendance of members at meetings. It can, however, lead to passivity in corporate affairs and leave members open to abuse of power. Although it may be possible, if not always practical, for small corporations to demand a full assembly, it would not even be possible to require such an attendance in the case of large and/or international corporations. To some extent, the problems of personal attendance could be overcome by utilisation of communications technology. The development of audio and teleconferencing and computer networking offer the possibilities of direct and active participation in corporate affairs where physical attendance is not possible.

The problems posed by passive membership are exacerbated by the use of proxy votes.<sup>17</sup> It is notable that, at common law, the shareholder did not have the right to vote by proxy.<sup>18</sup> This was because 'the voting privilege [is] in the nature of a personal trust, committed to the discretion of the member, and hence not susceptible to exercise through delegation.'<sup>19</sup> The statutory recognition of proxy voting has, however, caused some problems for corporations. Maugham J. in *Re Dorman Long and Co. Ltd.* [1934] Ch 635, 657-658, identified some of these difficulties:

In these days, in many of the cases that come before me, only a fraction of the persons who are concerned can get into the room where the meeting is proposed to be held, and in the great majority of cases the proxies given to the directors before the meeting begins have in effect settled the question of the voting once and for all. It is perhaps not unfair to say that in nearly every big case not more than 5 per cent of the interests involved are present in person at the meeting. It is for this reason that the court takes the view that it is essential to see that the explanatory circulars of the company are perfectly fair, and, as far as possible, give all the information reasonably necessary to enable the recipients to determine how to vote...In a sense, in all these cases, the

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<sup>17</sup> CL 245(1) and Table A reg 54.

<sup>18</sup> *Harben v Phillips* (1883) 23 Ch D 14; *McLaren v Thompson* [1917] 2 Ch 261, 236.

<sup>19</sup> *Walker v Johnson* 17 DC App 14 (1900).

dice are loaded in favour of the views of the directors: the notices and the circulars are sent out at the cost of the company, the board have had plenty of time to prepare the circulars, all the facts of the case are known to them, proxy forms are made out in favour of certain named directors and, although it is true that the word 'for' or 'against' may be inserted in the modern proxy form, the recipients of the circulars very often are in doubt as to whether the persons named as proxies are bound to put in votes by proxy with which they are not in agreement. If we contrast with that position the position of a class of objectors, it is to be observed that a member of the class who receives a notice of the meeting and a circular from the directors is generally alone: he has no funds with which to fight the case and he has no information except sometimes, that information which has been contained in reports and balance sheets which have probably long ago been relegated to the waste paper basket. In any case, he has a minimum of information, his personal interest in the matter may be exceedingly small, probably he knows few persons in the same position as himself and, if he manages to get in touch with them, they together have to raise funds for the purposes of an opposition, which is often an expensive matter. They have then to get the names and addresses of the members of the class who are concerned, and to frame and send out a circular representing their views. Very often there is scarcely sufficient time for those purposes between the moment when the notice of the meeting reaches objectors by post and the date of the meeting.

The argument that the ability to vote by proxy has encouraged abuse is supported by the fact that the courts have had to ensure that sufficient information is given to shareholders who are to vote by proxy.<sup>20</sup> Directors are under a fiduciary obligation to make full and fair disclosure to shareholders.<sup>21</sup> In Rousseau's view, this would not be satisfactory. Nothing less than direct and active participation in meeting is sufficient to control the abuse of majority power. On this basis, a return to the common law prohibition on proxy voting would appear preferable.

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<sup>20</sup> A number of challenges to resolutions have been made on this basis. See, for example, *Re Pheon Pty Ltd* (1987) 11 ACLR 142; *Devereaux Holdings Pty Ltd v Parry Corp Ltd* (1985) 9 ACLR 837; *Bancorp Investments Ltd v Primac Holdings Ltd* (1984) 9 ACLR 263.

<sup>21</sup> See, for instance, *Chequepoint Securities Ltd v Claremont Petroleum NL* (1987) 11 ACLR 94, 96 per McLelland J:

[Their fiduciary obligations] would, for example, require the directors to make full and true disclosure of any benefits which any director may derive from the passing of any resolution at the general meeting. As I have already indicated, no non-disclosure of that kind is now alleged in the present case. The fiduciary obligation of directors, however, goes further than that. Where directors take it upon themselves to urge or recommend or advise members to exercise their powers in general meeting in a particular way, they are in general required to make a full and fair disclosure of all matters within their knowledge which would enable the members to make a properly informed judgment on the matters in question.

### *Substantive legitimacy*

In regard to substantive legitimacy, Rousseau and the model of corporate regulation differ considerably. Firstly, unlike Rousseau, in company law not all acts or decisions need be undertaken in the interests of the association as a whole; Secondly, where corporate regulators have required individuals to vote 'in the interests of the company as a whole', there has been confusion as to what constitutes the general interest and, indeed, just who constitutes 'the company' for this purpose; thirdly, there is no distinction made in company law between particular and general acts; fourthly, substantive equality among the parties is not required; fifthly, the minority shareholder's remedies have, traditionally, been limited by the application of the rule in *Foss v. Harbottle*; and finally, the courts have adopted a policy of non-intervention in internal company matters. I shall discuss each of these differences in turn.

As discussed previously, the traditional rule is that a share is personal property and therefore, the shareholder may vote in his own interests.<sup>22</sup> Shareholders are thus not under fiduciary obligations, as are directors:

The shareholders are not trustees for one another, and unlike directors, they occupy no fiduciary position and are under no fiduciary duties. They vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owner's personal advantage.<sup>23</sup>

On this view, for instance, a director may exercise her voting rights as a shareholder at a general meeting called to ratify her actions as a director which are in breach of duty.<sup>24</sup> In certain circumstances, however, as discussed in Chapter 5, such as alteration of the articles or ratification of a director's breach of duty, the courts have held that this voting right must be exercised 'bona fide for the benefit of the company as a whole'. For instance,

[A] director of a company is precluded from dealing, on behalf of the company, with himself, and from entering into engagements in which he has a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound by fiduciary duty to protect;... Any such dealing or engagement may, however, be affirmed or adopted by the company, provided such affirmance or adoption is not brought about by unfair or improper means, and is not illegal or fraudulent or oppressive towards those shareholders who oppose it...<sup>25</sup>

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<sup>22</sup> See *North-West Transportation v Beatty* (1887) 12 AC 589, where a director, also majority shareholder in a company, approved actions executed in his capacity as director.

<sup>23</sup> *Peters American Delicacy Company Ltd v Heath* (1939) 61 CLR 457 per Dixon J.

<sup>24</sup> *Mills v Mills* (1938) 60 CLR 150.

<sup>25</sup> *North-West Transportation v Beatty* [1887] 12 AC 589.

This test has been given statutory recognition in the CL 461 and 260. For instance, CL 260(1) provides as follows:

260(1) An application to the Court for an order under this section in relation to a company may be made:

(a) by a member who believes:

(i) That affairs of the company are being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members, or in a manner *that is contrary to the interests of the members as a whole*; or

(ii) That an act or omission, or a proposed act or omission, by or on behalf of the company, or a resolution, or a proposed resolution, of a class of members, was or would be oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members or *was or would be contrary to the interests of the members as a whole*.<sup>26</sup>

The expression 'contrary to the interests of the members as a whole' has been taken to correspond to the expression 'bona fide for the benefit of the company as a whole'.<sup>27</sup> This test would, at first glance, appear to be very similar to the idea of the general will. Unfortunately, few expressions in company law have caused as much difficulty of interpretation as that of the 'benefit of the company as a whole.' The problems of interpretation derive from two aspects of the expression: Must the act in question be

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<sup>26</sup> It is worth noting, however, that even the interpretation of this section has often relied upon the proprietary analysis. For instance, in *Re Tivoli Freeholds* [1972] VR 445, it was noted that:

It appears [in the interpretation of the section] that there must be something adverse or detrimental to the members' financial interests as shareholders. In all the reported cases of which I am aware, where oppression has been found, this has been the fact and it was this aspect to which I understand Jacobs J. referred when he said in *Re Broadcasting Station 2GB Pty Ltd*...that the word oppressive involves, among other things, that 'some member or members have suffered in a pecuniary sense in their capacity of members...that is to say, their rights as members have been affected.

<sup>27</sup> In *Wayde v New South Wales Rugby League Ltd* (1985) 3 ACLC 177, 180, the Court stated that:

...corporate decision whether at director or at shareholder level must be made 'bona fide for the benefit of the company as a whole': *Allen v Gold Reefs of West Africa Ltd* [1900] 1 CH 656, per Lord Lindley at 671. The phrase used in s. 320 is 'the interests of the members as a whole'. This phrase in the statute has not, so far as we are aware, been the subject of reported judicial consideration since its insertion in 1983, but as at present advised, it seems difficult to place any meaning on 'the interests of the company as a whole' that differs from 'the benefit of the company as a whole'. The only legitimate interests of the members would be their interests as corporators. As corporators, considered as a whole, their legitimate interests must be circumscribed by, or found within, the constituting documents of the company. The legitimate benefit of the company to which Lord Lindley referred must likewise be circumscribed by, and found within, the constituting documents of the company. It follows that the principles that have been evolved in development of Lord Lindley's basic requirement of 'the benefit of the company as a whole' are equally applicable to the statutory element in s. 320 of 'the interests of the members as a whole.

objectively or subjectively for the benefit of the company as a whole?; and does the expression refer to the 'company' as a separate, ongoing commercial entity, or does it refer to the individual shareholder or the shareholders as a group?

### Objective or subjective test

In cases where the question of whether the majority has voted bona fide for the benefit of the company as a whole has arisen, the courts have been unsure whether to apply an objective or a subjective test (or indeed, both) to the resolutions of the general meeting. The expression bona fide for the benefit of the company as a whole is generally attributed to Lindley MR in *Allen v. Gold Reefs of West Africa Ltd* [1900] 1 Ch 656. The expression was interpreted in *Brown v. British Abrasive Wheel Company* [1919] 1 Ch 290 by Astbury J. as requiring a two stage test. Firstly, the alteration must be made in good faith; and secondly, it should tend to benefit the company as a whole. In this case, the impugned conduct was wrongful, not because it involved an element of 'dishonesty' but because it was oppressive.<sup>28</sup> This two stage test was rejected, however, by Scrutton L.J. in *Shuttleworth v. Cox Bros and Co Ltd* [1927] 2 KB 9, 23. His Honour stated that the expression meant 'that the shareholders must act honestly having regard to and endeavouring to act for the benefit of the company.' Speaking of the alteration of articles, Bankes L.J. said that 'The alteration may be so oppressive as to cast suspicion on the honesty of the persons responsible for it, or so extravagant that no reasonable men could really consider it for the benefit of the company'. On this interpretation, non-intervention of the court in internal management was ensured, at least in the majority of cases. The Court could not substitute its opinion on the questions for that of company members. It could only interfere where a decision, 'though honest, was such that no reasonable people could have come to it upon proper materials'. The test in *Shuttleworth* was subsequently adopted in Australia.<sup>29</sup>

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<sup>28</sup> See also *Dafen Tinplate Co Ltd v Llanelly Steel Co* [1920] 2 Ch 124 where the article in question conferred an arbitrary power to compel transfer of shares exercisable without cause and on unspecified grounds, and without apparent limitation.

<sup>29</sup> See *Peters American Delicacy Co Ltd v Heath* (1939) 61 CLR 457, 460 per Latham CJ:

It is not for the court to impose upon a company the ideas of the court as to what is for the benefit of the company. It is for the shareholders to determine whether an alteration of the articles is or is not for the benefit of the company, subject to the proviso that the direction is not such as no reasonable man could have reached...This is not an absolute rule, but it is the prima facie general rule.

The formula adopted in *Shuttleworth* was also used by the High Court in *Phosphate Co-operative Co. of Australia v Shears* (1989) 7 ACLC 1,225.

Rousseau's test of legitimacy is objective. This is implied from the fact that, although the general will cannot be destroyed or corrupted, the members of the association can be mistaken or deceived as to the general will:

It follows from what precedes that the general will is always right and always tends to the public advantage; but it does not follow that the deliberations of the People are always equally beyond question. It is ever the way of men to wish their own good, but they do not at all times see where that good lies. The People are never corrupted though often deceived, and it is only when they are deceived that they appear to will what is evil.<sup>30</sup>

A subjective test, that is, 'did the members of the association pass the resolution because they were acting under the bona fide belief that they were acting for the benefit of the company as a whole?' is meaningless because the members could be wrong.

### **The meaning of 'company'**

The meaning of 'company' in the 'benefit of the company as a whole' has also proved to be obscure. In *Greenhalgh v. Arderne Cinemas Ltd* [1951] 1 Ch 286, 291 Evershed M.R. offered this interpretation:

[I]t is now plain that 'bona fide for the benefit of the company as a whole' means not two things but one thing. It means that the shareholder must proceed on what, in his honest opinion, is for the benefit of the company as a whole. Second, the phrase, 'the company as a whole', does not (at any rate in such a case as the present) mean the company as a commercial entity as distinct from the corporators. It means the corporators as a general body. That is to say, you may take the case of an individual hypothetical member and ask whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit. I think the thing can, in practice, be more accurately and precisely stated by looking at the converse and by saying that a special resolution of this kind would be liable to be impeached if the effect of it were to discriminate between the majority shareholders and the minority shareholders so as to give to the former an advantage of which the latter were deprived...It is, therefore, not necessary to require that persons voting for a special resolution should so to speak, dissociate themselves altogether from the prospect of personal benefit and consider whether the proposal is for the benefit of the company as a going concern. If, as commonly happens, an outside person makes an offer to buy all the shares, prima facie, if the corporators think it is a fair offer and vote in favour of the resolution, it is no ground for impeaching the resolution because they are considering the position of themselves as individual persons.

In *Greenhalgh and Ngurli v. McCann* (1953) 90 CLR 425, 'company' was taken to mean the corporators as a general body. This interpretation, however, is of little assistance where the question is one of the relative rights of different classes of shareholders. Although in *Greenhalgh*, it was held that an act of the majority will not be bona fide for

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SC II: iii.

the benefit of the company as a whole if it discriminates between majority and minority shareholders so as to confer an advantage on the majority shareholders, the test being that of the 'hypothetical minority shareholder', discrimination against the minority will not always invalidate the actions of the majority.<sup>31</sup> Discrimination between majority and minority shareholders was sufficient, however, to invalidate a resolution to alter the articles in *Australian Fixed Trust Pty Ltd v. Ors v. Clyde Industries Ltd and Ors* (1959) 59 SR (NSW) 33. Here, the general meeting proposed to alter its articles so as to prevent members who held shares on trust for unit holders from voting in respect of those shares unless under the direction of the majority of unit holders in each unit trust. The practical effect of this alteration was to make it virtually impossible for holders of such shares to vote. McLelland J., at 53, held that this was not an alteration that the reasonable man could consider to be for the benefit of the company as a whole. 'The benefit of the company' was a 'general expression negating purposes foreign to the company's operations, affairs and organisations' and thus the resolution in question 'did not imply any purpose outside the scope of the power'.

In *Clemens v. Clemens Bros Ltd* [1976] 2 All ER 268, Foster J. took a wider and more flexible view of the test. His Honour interpreted the individual hypothetical member test of *Greenhalgh* as meaning that one should ask whether the majority shareholder, when voting for the resolutions, honestly believed that these resolutions would be for the benefit of the minority shareholder.<sup>32</sup> His Honour went on to say at 282:

I think that one thing which emerges for the cases...is that...[the aunt] is not entitled to exercise her majority vote in whatever way she pleases. The difficulty is in finding a principle, and obviously expressions such as 'bona fide for the benefit of the company as a whole', 'fraud on a minority' and 'oppressive' do not assist in formulating a principle...[I]t would be unwise to try to produce a principle, since the circumstances of each case are infinitely varied...[The right to vote] is 'subject...to equitable considerations which may make it unjust... to exercise [it] in a particular way.

Although *Clemens* is a notable decision for its express adoption of a wider and more flexible test based upon equitable considerations, the different interpretations of the expression suggest that the courts' approach generally (although not explicitly) has not been one based upon a textual analysis of the expression but upon more instinctive notions of fairness. In *Shuttleworth v. Cox Brothers And Co (Maidenhead) Ltd* [1927] 2 KB 9, 11, Atkin L.J. said:

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<sup>31</sup> See *Peters American Delicacy Co Ltd v Heath* (1939) 61 CLR 457.

<sup>32</sup> See also *Woods v Cann* (1964) 80 WN (NSW) 1583, 1596 where the Court claimed that 'it is quite impossible to ascertain what is for the benefit of the company as a whole and it is quite impossible to ascertain what is for the benefit of an individual hypothetical member'.

But neither this court nor any other court should consider itself fettered by the form of words, as if it were a phrase in an Act of Parliament which must be accepted and construed as it stands. We must study what its real meaning is by the light of the principles which were being laid down by the Master of the Rolls [Lindley MR] when he used the phrase.

Jacobs J. in *Crompton v. Morrish Hall Pty Ltd* [1965] NSW 240 at 244 took this approach one step further, going beyond the 'original intent' of Lindley M.R.:

It seems to me that the truth is that the courts in each generation or in each decade have set a line up to which shareholders have been allowed to go on affecting the rights of other shareholders by alterations of articles of association, but beyond which they have not been allowed to go. It seems to me that no amount of legal analysis or analytical reasoning can conceal the fact that the decision has in the past turned, and must turn ultimately, on a value judgment formed in respect of the conduct of the majority—a judgment formed not by any strict process of reasoning or bare principle of law but upon a view taken of the conduct.<sup>33</sup>

If Rousseau's theory were to be applied to the corporation, 'the company' must be taken to mean the incorporators as a whole.<sup>34</sup> The difficulty of the judicature in determining the meaning of the 'company' stems, I suggest, from an attempt to alleviate oppression before the statutory remedy was available. Rousseau, however, separated the two issues of the general will and the possibility of oppression. A strict application of the general will principle alone would suggest that an act which is, objectively, for the good of the whole, could oppress the individual member - hence the controversy over the idea of being 'forced to be free'. Yet Rousseau's second requirement of generality was intended to prevent such oppression. The acts of the sovereign must be general and not specific, thus

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<sup>33</sup> In a similar vein, Dixon J in *Peters American Delicacy* (1939) 61 CLR 457, 513 claimed that the resolution in question was valid because it 'involved no oppression, no appropriation of an unjust or reprehensible nature and did not imply any purpose outside the scope of power'.

<sup>34</sup> A further problem raised by cases involving share issues in company law is whether the power of ratification must be exercised with due regard to third party interests, particularly those of creditors. Thus, Powell J at first instance in *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1983) NSWLR 452 at 463, considering the decisions in *Bamford v Bamford* [1970] Ch 212 and *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666 said:

I confess to having considerable difficulty in accepting the correctness of such a principle if it is to be held to apply to cases in which the interests which have been or are to be, affected, are those of persons other than shareholders... Despite my difficulties, however, I do not think that it is open to me to give effect to my own reservations, for the principle stated in *Bamford v Bamford* and adopted in *Winthrop v Winns*... is cast in broad terms.

Clearly, in Rousseau's theory, the decision of the general meeting cannot take third party interests in account: the assembly can only be guided by the general will and the general will cannot accommodate outside interests.



avoiding the oppression of particular individuals or groups because all members are bound by the same rules.

### Particular and general acts

In company law, the circumstances in which majority resolutions may be challenged are limited primarily by the proprietary analysis. Majority acts may be challenged because they constitute a fraud on the minority, in that they deprive the minority or the company of property, or they deprive the minority of their shares. More recently, such acts may be challenged because they constitute oppressive conduct against the minority. For the purposes of this discussion, I shall divide majority decisions into two classes: The first class is where the majority ratifies breaches of directors' duties; the second class is where the decision determines company action.

In regard to the first type of resolution, directors may breach their duties in a number of ways: By exceeding their powers; by abusing their powers; by breaching their fiduciary obligations; and by failing to act with the required standard of care, diligence and skill. In such cases, the general meeting may vote to ratify these breaches of duty.<sup>35</sup> At common law, in such cases, ratification must be bona fide for the benefit of the company as a whole. Under the *Corporations Law*, the minority shareholder may seek redress by alleging that the purported ratification is oppressive under CL 461 (g) or CL 260. There is some question, however, under Rousseau's theory, as to whether the general meeting could affirm the directors' decision in this way. Certainly, the general meeting has the power to retain or dismiss the directors in such a case; and perhaps, then, by implication, it can be said the general meeting has affirmed or rejected a specific decision or contract made by the directors; but Rousseau does not give any guidelines as to whether the assembly could vote on such an issue. If this is an example of rule-making, it would appear to be invalid because it is specific, not general, in nature.

The requirement of generality is also relevant in the second class of majority decision: that of determining company action. For instance, for a majority to deprive a member of his or her shares it would usually be necessary to alter the articles. Under company law, two requirements must be satisfied in order for this act to be legitimate. These are that adequate compensation be paid for these shares; and, as we have seen, that the alteration be bona fide for the benefit of the company as a whole. In *Brown v. British Abrasive Wheel Co.* [1919] 1 Ch 290, a company required further capital. The majority shareholders held 98% of the issued capital but would only provide more capital if they

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<sup>35</sup> See, for example, *Grant v UK Switchback Railways Co* (1888) 40 Ch D 135; *Boschoek Property Co Ltd v Fuke* [1906] 1 Ch 148; *Hogg v Cramphorn* [1967] Ch. 254; *Bamford v Bamford* [1970] Ch 212, *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666.

could buy up the remaining issued shares. The minority shareholders, however, refused to sell, so the general meeting passed a special resolution to alter the articles, so as to require the minority shareholders to sell their shares if requested by nine-tenths of the shareholders. The Court held that this alteration was invalid: it constituted a fraud on the minority because the majority attempted to achieve their desired outcome by compulsion. The alteration was thus not bona fide for the benefit of the company as a whole. Under Rousseau's model, it may be argued that the act was for the objective good of the company. It may be possible to challenge such a resolution, however, on the basis that this was a specific, rather than a general act. Even though such an alteration may be couched in general terms (ie that any shareholder may be required to sell her shares if requested by nine-tenths of the shareholders), it can be argued that in such a case, the resolution is specifically directed at certain individuals and therefore illegitimate. It is necessary to distinguish clearly between the sum of particular wills and the will of all.

### **Substantive equality**

A further distinction between corporate regulation and Rousseau's theory relates to Rousseau's demand of approximate equality. Where a vote is taken by a show of hands, each member has one vote (subject to any rights or restrictions being attached to any class or classes of shares: reg. 49(b)) but in the case of a poll, each member has one vote for one share held (reg. 49(b), CL 249(1)(c)). Obviously in the latter case, dramatic inequality in shareholdings can pave the way for oppressive conduct. The problems posed by the ability to pass particular, as opposed to general resolutions may be exacerbated by the ability of a shareholder to vote according to his or her ownership of shares. This problem is illustrated by *Eastmanco (Kilner House) Ltd v. Greater London Council* [1981] 1 WLR 2 in which a council formed a company which owned a block of flats. The council decided to sell long leases to the flats. On each sale, the purchaser would acquire a share in the company, but until all the flats were sold, the council retained sole voting rights. After it sold twelve leases and shares, the council changed its policy and decided to rent the remaining flats with no transfer of shares. The existing owners were not to be granted voting rights in respect of their shares. In an action brought by one of the twelve shareholders, the Court said:

Plainly, there must be some limit to the power of the majority to pass resolutions which they believe to be in the best interests of the company and yet remain immune from interference by the courts. It may be in the best interests of the company to deprive the minority of some of their rights or some of their property, yet I do not think that this gives the majority an unrestrained right to do this, however unjust it may be, and however much it may harm shareholders whose rights as a class differ from those of the majority. If a case falls within one of the exceptions from *Foss v. Harbottle*, I cannot see why the right of the minority to sue under that exception should be taken away from them merely because the majority of the company reasonably believe it to be in the best interest of the company that this should be done. This is particularly so if the exception from the rule falls under the rubric of 'fraud on a minority'.

Under Rousseau's theory, it is unlikely that this situation could occur. Firstly, all shareholders would have to be deprived of voting rights in order for the alteration to be legitimate, otherwise the act is specific, rather than general in nature. To be general in nature, all must be subject to the same rights and duties. Secondly, Rousseau's method of voting would require one vote per shareholder, not one vote per share.

### **The rule in *Foss v Harbottle***

At common law, a minority shareholder could only bring an action to redress an abuse of minority power if she could bring herself under one of the exceptions to the rule in *Foss v. Harbottle* (1843) 2 Hare 461; 67 ER 189. In this case, promoters of a company, who were also its directors, sold the company plots of land at allegedly exorbitant prices. The Court refused to allow two minority shareholders to bring an action on the company's behalf, holding that the company itself was the proper plaintiff in the action. It was for the company (effectively the majority) to determine whether proceedings should be brought. It was not the place of the Court to interfere in this decision. Together, these two aspects of the *Foss v. Harbottle* decision, the 'proper plaintiff' rule and the 'indoor management' rule operated to uphold the majority will despite minority opposition.

The exceptions to the rule were circumscribed. A minority shareholder could seek redress where the act complained of was *ultra vires*;<sup>36</sup> where the act complained of could only be effective only if supported by more than a simple majority (eg a special resolution) which had not been obtained;<sup>37</sup> where the personal rights of the shareholder were infringed as a result of wrongful conduct by the company which could not be rectified by ordinary

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<sup>36</sup> *Hawkesbury Development Co Ltd v Landmark Finance Pty Ltd* [1969] 2 NSW 782; *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474; *Nankivell v Benjamin* (1892) 18 VLR 543.

<sup>37</sup> *Baillie v Oriental Telephone and Electrical Co Ltd* [1915] 1 Ch 503.

resolution;<sup>38</sup> where those in control of the company perpetrated a fraud on the minority; or where the interests of justice so required.

The rule and its exceptions have been covered in considerable length elsewhere.<sup>39</sup> For the purposes of this discussion, it is important to note the shortcomings of the *Foss v. Harbottle* rule insofar as minority shareholders were restricted in their redress against a delinquent majority: the formulation of the exceptions to the rule are ambiguous and the scope of the exceptions uncertain. Further, the exceptions focus upon single acts or transactions rather than providing redress for conduct that occurs over a period of time; and the element of control, for the purposes of the fraud on the minority exception, is often difficult to make out.

Importantly, CL 260(2)(g) was introduced into the Australian corporations legislation in 1983 and was directed at the procedural barriers imposed by the *Foss v. Harbottle* decision. Under this section, the Court may direct the company to institute specified proceedings or may authorise a member to do so in the name of and on behalf of the company.<sup>40</sup> Although this section overcomes many of the barriers of the 'proper plaintiff' rule,<sup>41</sup> the ethos of the 'indoor management' rule remains.

## The Court as legislator

As I have outlined, Rousseau recognised that a fundamental problem to be faced in his theory was that the association may not always act in accordance with the general will. His answer to this was to create a third party who was neither sovereign nor magistrate to

<sup>38</sup> *Edwards v Halliwell* [1950] 2 All ER 1064; *Kaye v Croydon Tramways Co.* [1898] 1 Ch 358; *Pender v Lushington* (1877) 6 Ch D 70; *Grant v John Grant and Sons Pty Ltd* (1950) 82 CLR 1; *Kraus v JG Lloyd Pty Ltd* [1965] VR 232; *MacDougall v Gardiner* (1875) 1 Ch D 13; *James v Buena Ventrura Syndicate Ltd* [1896] 1 Ch 456.

<sup>39</sup> See, for example, Karen Yeung, 'Desentangling the tangled skein: the ratification of directors actions', (1992) 66 ALJ 343; Jennifer Hill, 'Protecting minority shareholders and reasonable expectations', (1992) 10 CSLJ 86; David Wishart, 'A conceptual analysis of the control of companies', (1984) 14 MULR 601; Saul Fridman, 'Ratification of directors' breaches', (1992) 10 CSLJ 10; SM Beck, 'An Analysis of *Foss v Harbottle*', in JS Ziegel (ed) *Studies in Canadian Company Law* (Toronto: Butterworths, 1967) at 556-557.

<sup>40</sup> This section was applied in *Re Overton Holdings* (1984) 2 ACLC 777, where the court authorised a shareholder to bring proceedings in the name of and on behalf of a company in regard to loan arrangements which had been made with its controlling shareholder in circumstances where attempts to convene a general meeting had been thwarted.

<sup>41</sup> See, however, the debate over a statutory derivative action: Michael J Neylan, 'The rule in *Foss v Harbottle* and the statutory derivative action', (1992) 6 Com LQ 11; Ian Ramsay, 'Corporate Governance, shareholder litigation and the prospects for a statutory derivative action', (1992) 15 UNSWL 149; John Kluver, 'Derivative Actions and the rule in *Foss v Harbottle*: Do we need a statutory derivative remedy?', (1993) 11 CSLJ 7.

declare the general will, that is, who could, from an impartial viewpoint, determine the objectively correct decision for the association. Within the corporate scheme, this role could conceivably be played by the court.

Traditionally, however, the courts have adopted a policy of non-intervention in internal company matters. As discussed above, part of the decision in *Foss v. Harbottle* rested upon what is termed the 'indoor management rule'. In *Burland v. Earle* [1902] AC 83 at 93, Lord Davey restated the rule:

[It is] an elementary principle of the law relating to joint stock companies that the court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so.

Similarly, MacNaughten LJ in *Dovey v. Corey* [1901] AC 477 said:

I do not think it desirable for any tribunal ...to formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs.

This policy of non-intervention is far from dead.<sup>42</sup> Even the judicial interpretation of the oppression remedy shows, in some cases, a persistence of the non-interventionist policy in that some judges are reluctant to find conduct oppressive unless it is fairly extreme. 'Oppression' was intended by the legislature to mean a departure from a standard of fair dealing and fair play, but has been read restrictively by some courts to require that conduct was 'burdensome, harsh or wrongful'; lacking in probity' and 'overbearing'. Further, 'wrongful' in this context has been interpreted as requiring actual illegality or invasion of legal rights.<sup>43</sup> This restrictive interpretation has, on one level, been an attempt by the Courts to limit shareholder actions by distinguishing between 'mere' minority disagreement and cases of abuse of power, in the absence of clear and unambiguous standards.<sup>44</sup> Thus, Lord Cooper in *Elder v. Elder and Watson Ltd* [1959] SC 49 stated that oppressive conduct should be equated with:

unfair abuse of powers and an impairment of confidence in the probity with which the company's affairs are being conducted, as distinguished from mere resentment on the part of a minority at being outvoted on some issue of domestic policy...The essence of the matter seems to be that the conduct complained of should at the lowest involve a visible departure from the standards of fair play on which every shareholder who entrusts his money to the company is entitled to rely.

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<sup>42</sup> See J Farrar, 'Business judgment and defensive tactics in hostile takeover bids' (1989) 15 *Can Bus LJ* 15.

<sup>43</sup> *Re Broadcasting Station 2GB* [1964-5] NSWLR 1648; *Re Bright Pine Mills* [1969] VR 1002, 1012.

<sup>44</sup> For a general discussion of the oppression remedy, see GP Stapledon 'Use of the oppression provision in listed companies in Australia and New Zealand', (1993) 67 *ALJ* 575; and for a discussion of the non-interventionist stance in this area, David Wishart, 'A fresh approach to s. 320', (1987) 17 *UWALR* 94.

The policy is seen by some not only as outdated but somewhat illogical: the courts defer to directors' judgment, despite the fact that the common law does not require that a director have particular qualifications or expertise.<sup>45</sup> Despite amendments to the oppression remedy in Australia in 1983 to extend the application of that remedy to behaviour which was unfairly prejudicial, unfairly discriminatory or contrary to the interests of members as a whole, conduct that continued over time and past conduct; and to allow members to redress wrongs done to other companies of which they were members, it would appear that this section has, once again, been given a narrow interpretation.<sup>46</sup> A minority shareholder would face difficulty maintaining an action where management policy was not 'wrongful' or 'lacking in probity' in the restrictive sense applied by the courts. In regard to the oppression remedy, the traditional 'non-interventionist' stance can also be seen in the decision of *Wayde v. New South Wales Rugby League Ltd.* (1985) 3 ACLC 799, where the Brennan J. said:

Prima facie, it is for the directors and not for the court to decide whether the furthering of a corporate object which is inimical to a member's interests should prevail over those interests or whether some balance should be struck between them.

Rousseau's theory, I suggest, provides a clearer and more consistent model by which to judge the necessity for court intervention. Such intervention should take place where it could be shown that an act of the majority was oppressive in the sense that it was specific, rather than general or the outcome of violence of inequality of power; or the act was not executed for the benefit of the company as a whole (on the Rousseauan interpretation of that expression given above).

## Conclusion

In this chapter, I have sought to argue that Rousseau's theory attempted to provide safeguards both procedural and substantive, to protect the minority from oppression and abuse. In contrast, company law has not provided effective mechanisms for the control of a delinquent majority. This failure stems primarily from three tenets of nineteenth century company law: strict adherence to the separate entity doctrine; a policy of non-interference in internal company matters; and adherence to the view that a share, as personal property, gives the individual the right to vote in her own interest irrespective of the interest of the company. Despite the introduction of, and amendments to, the oppression remedy, the ideas of non-intervention by the courts in internal company matters and the proprietary analysis of shareholder rights, continue to influence judicial

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<sup>45</sup> Hill, note 39, at 88 fn 21.

<sup>46</sup> See *Re G Jeffrey (Men's Store) Pty Ltd* (1984) 2 ACLC 421. A far wider interpretation, however, was given in *Re H Thomas Ltd* (1984) 2 ACLC 610.

decision making and hence to restrict minority rights. My argument has been twofold. I have suggested that it would be possible for corporate procedure to be based upon Rousseau's model. This would require: Firstly, that corporate members determine the frequency of fixed and periodic meetings in which directors could be called to account; and secondly, a prohibition of proxy voting. Although full assembly at meetings may not be practicable, direct and active participation of members should be encouraged and facilitated, where physical presence is impossible, by communications technology. In addition, I have suggested that an adoption of Rousseau's theory of illegitimate use of majoritarian power provides a more coherent and less ambiguous standard upon which to test the legitimacy of majority acts. This standard would require that individuals exercise their votes for the good of the association as a whole; that the general meeting vote on general and not particular matters; and that the vote is not the outcome of violence or the exploitation of inequality of power. I shall now proceed to compare the mechanisms provided to control delinquent directors under Rousseau's theory and corporate regulation.

## CHAPTER 8

### ACTS OF GOVERNMENT: THE DIRECTORS

#### Introduction

In the last chapter, I examined the relationship between the majority and the minority. In this chapter, I am concerned with the relationship between the 'ruler and the ruled', that is between the directors and the shareholders. The contract of association, as discussed in Chapter 6, is a constitutional document that defines this relationship. In theory, control of shareholders over the board under the contractual division of power theory is maintained by the constitutional right of shareholders to appoint, dismiss, and fix the remuneration of, directors. In reality, however, this theoretical control is very often a fiction. Shareholders, particularly in very large organisations, may be too apathetic to exert effective control over the board and, as has been discussed, this problem is exacerbated by the use of proxy voting. The tension between the board and shareholders is often highest in small companies where directors are also shareholders (but not the only shareholders). Here, the opportunity exists for directors to pursue their own interests by exercising their proprietary right to vote for their own ends, as opposed to corporate ends. In addition, the scope for oppression in such cases (as observed in the previous chapter) is very great. It is essential, because of this potential for directors to pursue their own interests with little (or no) control by shareholders, that directors' duties are clearly formulated and shareholders have effective remedies available to them. This has not, however, tended to be the case. Directors' duties are not clearly defined, directors usually control the shareholders' access to corporate information, shareholders must overcome the very practical barrier of costly litigation, and courts have, through the rule in *Foss v. Harbottle* and a restrictive interpretation of the oppression remedy, played a very limited role in the regulation of the internal company affairs.

In contrast, Rousseau's theory imposed considerable control over the governing body: rulers were restricted to specific acts; these acts had to be undertaken for the corporate good; and at all fixed meetings the sovereign was required to determine whether the present rulers and the present form of government were to be retained. Many of the relevant issues here have already been covered in the previous chapters: the problems posed by passive membership, the use of proxy voting, the ability of directors to vote in their own interest when ratifying breaches of duty, and the restricted role played by the courts. These issues, then, need only be flagged in this context. In this chapter, I shall use Rousseau's theory to identify the inherent conflict of interests between the governing body and the association and to argue for a clearer exposition of directors' duties. I shall begin by outlining Rousseau's theory of government.



## Rousseau's theory of government

The citizen in Rousseau's state performed a dual role:<sup>1</sup> He was at once sovereign and subject, maker of the rules and subject to them. An intervening body was thus necessary to administer the rules made by the sovereign. This was the task of government:

What, then, is the Government? An intermediate body established between the subjects and the Sovereign for their mutual correspondence, charged with the execution of the laws and with the maintenance of liberty both civil and political.

The members of this body are called Magistrates or *Kings*, that is, Governors; and the body as a whole bears the name *Prince*....

Consequently, I give the name Government or supreme administration to the legitimate exercise of the executive power, and that of Prince or Magistrate to the man or body charged with that administration.<sup>2</sup>

Government had no independent existence. It existed only through the Sovereign and was therefore always subject to the Sovereign.<sup>3</sup> Government, as discussed in Chapter 6, was a mere commission, not a contract.<sup>4</sup> The Sovereign retained the right to change both the form and the constitution of government at any fixed meeting.

The inherent problem of all associations, according to Rousseau, is that governments constituted a particular association within the wider associative body. Logically, then, government has its own 'general will' (often at variance with the general will of the wider association) and would seek its own preservation.

The Government is on a small scale what the body politic which includes it is on a large scale. It is a moral person endowed with certain faculties, active like the Sovereign, passive like the State, and it can be resolved into other similar relations; from which arises as a consequence a new proportion, and yet another within this, according to the order of the magistracies, until we come to an indivisible middle term, that is, to a single chief or supreme magistrate, who may be represented, in the middle of this progression, as unity between the series of fractions and that of the whole numbers.<sup>5</sup>

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<sup>1</sup> In a true Rousseauan democracy, this role was a tripartite one, as the citizen was also magistrate.

<sup>2</sup> SC III:i.

<sup>3</sup> SC III:i.

<sup>4</sup> SC III:i.

<sup>5</sup> SC III:i.

Further, in order that the body of the Government may have an existence, a real life, to distinguish it from the body of the State; in order that all its members may be able to act in concert and fulfil the object for which it is instituted, a particular personality is necessary to it, a feeling common to its members, a force, a will of its own tending to its preservation. The individual existence supposes assemblies, councils, a power of deliberating and resolving, rights, titles, and privileges which belong to the Prince exclusively, and which render the position of the magistrate more honourable in proportion as it is more arduous. The difficulty lies in the method of disposing, within the whole, this subordinate whole, in such a way that it may not weaken the general constitution in strengthening its own; that its particular force, intended for its own preservation, may always be kept distinct from the public force, designed for the preservation of the State; and, in a word, that it may always be ready to sacrifice the Government to the people, and not the people to the Government.<sup>6</sup>

This being the case, tiers of will, or interest, could be identified within any associative body.<sup>7</sup> These were, in ascending order: the will of the individual, the will of the government, and the will of the entire association. The problem with this conflict of wills is that:

...these different wills become more active in proportion as they are concentrated. Thus the general will is always the weakest, the corporate will has the second rank, and the particular will the first of all; so that in the Government each member is, firstly, himself, next a Magistrate, and then a citizen - a gradation directly opposed to that which the social order requires.<sup>8</sup>

A single ruler eliminates one tier:

But grant that the whole Government is in the hands of a single man, then the particular will and the corporate will are perfectly united, and consequently the latter is in the highest possible degree of intensity. Now, as it is on the degree of will that the exertion of force depends, and as the absolute power of the Government does not vary, it follows that the most active Government is that of a single person.

On the other hand, let us unite the Government with the legislative authority; let us make the Sovereign the Prince, and all the Citizens Magistrates; then the corporate will, confounded with the general will, will have no more activity than the latter, and will leave the particular will in all its force. Thus the Government, always with the same absolute force, will be at its minimum of relative force or activity.<sup>9</sup>

Yet, to eliminate one tier of government does not eradicate the problems of particular wills:

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<sup>6</sup> SC III:ii.

<sup>7</sup> SC III:ii.

<sup>8</sup> SC III:ii.

<sup>9</sup> SC III:ii.

But if there is no Government which has more vigour, there is none in which the particular will has more sway and more easily governs others. Everything works for the same end, it is true; but this end is not the public welfare, and the very power of the administration turns continually to the prejudice of the State.<sup>10</sup>

The size of government is a question of proportionality:

Let us suppose that the State is composed of ten thousand Citizens. The Sovereign can only be considered collectively and as a body; but every private person, in his capacity of subject is considered as an individual. Therefore the Sovereign is to the subject as ten thousand is to one, that is, each member of the State has as his share only one ten-thousandth part of the sovereign authority, although he is entirely subjected to it. If the people consists of a hundred thousand men, the position of the subjects does not change, and each alike is subjected to the whole authority of the laws, while his vote, reduced to one hundred-thousandth, has ten times less influence in their enactment...the more the State is enlarged, the more does liberty diminish.

Now, the less the particular wills correspond to the general will, that is, customs to laws, the more should the repressive power be increased. The Government, then, in order to be effective, needs to be relatively stronger in proportion as the people are more numerous.<sup>11</sup>

The more magistrates there are, the weaker the government<sup>12</sup> but this is more likely to achieve the general will:

The more numerous the magistracy is, the more does the corporate will approach the general will; whereas under a single magistrate, this same corporate will is, as I have said, only a particular will. Thus, what is lost on one side can be gained on the other, and the art of the Legislator consists in knowing how to fix the point where the force and will of the Government, always in reciprocal proportion, are combined in the ratio most advantageous to the State.<sup>13</sup>

As a general rule, however, :

The ratio of the magistrates to the Government ought to be inversely as the ratio of the subjects to the Sovereign; that is, the more the State is enlarged, the more should the Government contract; so that the number of chiefs should diminish in proportion as the number of the people is increased.<sup>14</sup>

The idea that government should have its own will and seek its own preservation would come as no surprise to most people. Indeed, Western democracies are usually based on systems of checks and balances to control these competing interests. In Rousseau's

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<sup>10</sup> SC III:vi.

<sup>11</sup> SC III:i.

<sup>12</sup> SC III:ii.

<sup>13</sup> SC III:ii.

<sup>14</sup> SC III:ii.

scheme, this control was established in a number of ways: Firstly, in the division of function between the Sovereign and the State. The Sovereign made the general rules of the association, the policy that governed all members of the group. The government then applied those rules to particular situations. Secondly, the government was constrained to act only in the interest of the association as a whole. Thirdly, as mentioned above, the association retained the right, at fixed intervals, to remove the government or change its form.<sup>15</sup>

Despite these controls, Rousseau was ultimately pessimistic about associations. In the final analysis, the continuous tension between the will of the government and the will of the state, would destroy the association:

As the particular will acts incessantly against the general will, so the Government makes a continual effort against the Sovereignty. The more this effort is increased, the more is the constitution altered; and as there is here no other corporate will which, by resisting that of the Prince, may produce equilibrium with it, sooner or later it must happen that the Prince at length oppresses the Sovereign and breaks the social treaty. Therein is the inherent and inevitable vice which, from the birth of the body politic, tends without intermission to destroy it, just as old age and death at length destroy the human body.<sup>16</sup>

The best that could be hoped for, then, was to establish the association on the most durable footing. This could only be achieved by carefully choosing the best constitutional form and abiding by the institutional controls.

It is Rousseau's clear understanding of the inherent tension between private interests and group interests, and in turn, between competing group interests, that distinguishes his model from that upon which corporate regulation has been based. The duties of the government were quite clear: it must function in the general interest and it must not determine general policy.

## Directors' duties

Under the traditional model of corporate governance, the status and concomitant obligations of directors<sup>17</sup> have never been clearly defined. From around 1844, directors

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<sup>15</sup> SC III:xxviii.

<sup>16</sup> SC III:x.

<sup>17</sup> Those subject to these duties has been extended both under common law and statute from directors to other company officers. Under CL 9 the duty is incurred by those who occupy or act in the position of director. This may thus include secretaries, executive officers, receivers, receiver/managers, liquidators and scheme managers in appropriate circumstances. Under common law, directors duties may be incurred by employees who are authorised to act as company agents: *Timber Engineering v Anderson* [1980] 2 NSWLR 488; or third parties who assist with knowledge in a breach of trust: *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373; *Rolled Steel Products Ltd v British Steel Corporation* [1985] 3 All ER 32.

were described as 'fiduciaries' but the exact nature and extent of their status as fiduciaries has been unclear. Courts likened directors' status to trustees, but directors are not properly trustees because they hold no title to corporate property and different expectations apply to them. Courts likened directors to agents, but directors powers are wider than those of ordinary agents and directors are usually free of close supervision by any readily identifiable principal. The search for a suitable analogy went on: directors were described variously as 'managing partners', 'mandatories', 'fiduciary agents', and 'commercial men managing a trading concern for the benefit of themselves and all others'.

I suggest that the problem of definition stems from at least two factors: Firstly, the obligations of directors must be sufficiently general to apply to a very diverse range of corporations. There is a considerable difference in the conduct we would expect, for example, from a shopkeeper with a small proprietary, family company as compared to the managing director of a large, multinational. This is one reason Hadden gives for the inapplicability of the trustee model:

It seems unrealistic in view of the universal acceptance of the personal involvement of directors as shareholders in their own companies to suggest that they may not operate in their personal capacity in other ways, so long as no unfair advantage is taken of their special position.<sup>18</sup>

Secondly, directors are caught in a web of interests created by the company structure. On the one hand, they must manage the corporation for the benefit of their shareholders (and, perhaps, for third parties such as creditors) but on the other, they must take risks and exercise business judgment which, in the main, is free of assessment by any outside body.

Thus, in order to cater for different sizes and types of corporation and to allow for risk-taking by directors, regulation has been by way of imposing a general minimum standard of conduct - the requirements of due care, skill and honesty. The standards are intentionally made broad and flexible. The danger is that they become so broad and flexible that they fail to provide effective guidelines for legitimate conduct.

It is also unclear as to whom directors' duties are owed. At common law, the traditional rule was that these duties were owed only to the company. *Percival v. Wright* (1902) 2 Ch. 421 is authority for this view. In this case, the directors bought shares from their shareholders. The directors did not disclose that negotiations were on foot for the sale of the company's undertaking at a price greater than that paid by the directors. The

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<sup>18</sup> Tom Hadden, *Company Law and Capitalism* (London: Weidenfeld and Nicolson, 1972), at 79.

shareholders argued that the directors held a fiduciary position as trustees for them. The Court, however, rejected this argument.<sup>19</sup>

More recently, it has been suggested that directors' duties may be owed to employees, creditors, related companies and individual shareholders. The possibility that duties were owed to individual shareholders was canvassed in *Coleman v. Myers* [1977] 2 NZLR 225. At first instance, Mahon J. held that *Percival* had been wrongly decided. In this case, shareholders in a family company relied upon the directors for advice as to a takeover bid by a company owned by one of the directors. It was held that the directors owed a fiduciary duty to the shareholders to disclose material facts which would affect the decision of the shareholders whether to buy or sell.<sup>20</sup> An even wider view of directors' duties was expressed by Hodgson J. in *Darvall v. North Sydney Brick and Tile Co Ltd and Others* (1988) 6 ACLC 154, 175-6:

In my view, it is proper to have regard to the interest of the members of the company, as well as having regard to the interests of the company as a commercial entity. Indeed, it is proper also to have regard to the interests of the creditors of the company. I think it is proper to have regard to the interests of present and future members of the company, on the footing that it would be continued as a going concern.<sup>21</sup>

In *Walker v. Winbourne* (1976) 137 CLR 1, directors were held liable for misapplication of funds in a breach of duty. Mason J. said, at 7, that:

...the directors of a company in discharging their duty to the company must take account of the interest of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.<sup>22</sup>

This wider common law view is more in accordance with legislative reforms. For instance, in regard to directors and other insiders who deal in securities whilst in possession of insider information, statutory provisions have replaced the rule in *Percival v. Wright*. In addition, under CL 588G, creditors can recover compensation from directors who knowingly allow the company to incur debts which it cannot repay, and under CL 201, where dividends are paid other than out of profits.

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<sup>19</sup> See also, *Australian Growth Resources Corporation Pty Ltd v van Reesema and Ors* (1988) 6 ACLC 529; *Esplanade Developments Ltd v Divine Holdings Pty Ltd* [1980] ACLC 40-637.

<sup>20</sup> See also *Walker v Wimborne* (1975-6) CLC 40-251 and *Hurley and Anor v BGH Nominees Pty Ltd and Ors* (No 2) (1984) 2 ACLC 497.

<sup>21</sup> For another example of the wide view, see *Jeffree v NCSC* (1989) 15 ACLR 217.

<sup>22</sup> See also *Equiticorp Financial Services Ltd v Equiticorp Financial Services Ltd (NZ) And Ors* (1993) 11 ASCR 642.

In one sense, I believe that the dichotomy between the wide and narrow views is analogous to the uncertainty surrounding politician's duties in the nation state. In particular, the dichotomy between company/third party interests can also be seen in the difficulties posed to government by the dichotomy of domestic interests and international interests. In addition, in our particular form of government, politicians owe duties to their party as well as to their constituents and the nation as a whole; interests that may well be competing.

This 'wide' view of interests is contrary to Rousseau's theory. Government must act in the general interest, not in the interests of individuals or partial groups. What Rousseau recognised was that the consideration of a multiplicity of interests may have one of two effects: either the interests of the group as a whole may be subverted to the interests of partial groups; or action may well become impossible as the association becomes atomised by the conflict of interests it creates. A similar view is expressed by O'Toole. Writing about American democracy and its implications for corporate management, he claims that:

[C]onflict-ridden pluralistic systems regress into stasis; immobilized by the forces of competing factions, they become unable to change in the face of a growing number of intractable problems. On this score, American democracy has recently been criticized as a 'trap' in which the self-indulgent pursuit of individual interests precludes any sacrifice for the common good.<sup>23</sup>

The narrow view, that duties are owed to the company as a whole, is more in keeping with Rousseau's theory provided that the company as a whole is defined, as has been discussed earlier, as the whole association as an ongoing entity. The major difficulty with the narrow theory as it stands is that it prevents an individual shareholder from taking redress against the wrongdoers under the rule in *Foss v. Harbottle* (and even the oppression remedy may not avail the aggrieved shareholder where a narrow judicial interpretation is applied).

### **Risk taking v. shareholder protection**

Under the minimal standards of honesty, due care and skill imposed by the law, directors are under the following duties:

- The duty to act honestly and in the best interests of the company (this is often broken down into the subcategories of the duty to avoid a conflict of interest and duty;<sup>24</sup>

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<sup>23</sup> James O'Toole, *The Executive's Compass* (New York: Oxford University Press, 1993), at 112.

<sup>24</sup> *Aberdeen Railway Co v Blackie Bros* (1884) 1 Macq 461; *Charterbridge Corporation Ltd v Lloyds Bank* [1970] Ch 62; *Reid Murray Holdings Pty Ltd* (1972) 5 SASR 387;

the duty to avoid competing with the company;<sup>25</sup> the duty to avoid contracts with the company;<sup>26</sup> and the duty not to misuse company opportunities or information).<sup>27</sup>

- The duty to act for a proper corporate purpose;<sup>28</sup>
- The duty to act with due care and skill.<sup>29</sup>

These duties arose originally from the directors' fiduciary status and have been incorporated into the legislative provisions. As discussed above, however, the analogy between directors and other fiduciaries, such as agents or trustees, has not been exact. Although the directors' duties are simply stated, their operation in practice has been problematic. This has primarily been because of the need to recognise competing tensions: the interests of parties affected by management decisions; and the economic interest in encouraging directors to take risks.

Rousseau required that government be constrained by the general will, by specificity of action and ultimately, by sovereign control. Directors are, in theory, constrained in similar ways: they must act bona fide for the good of the company as a whole; their functions are generally confined to managing 'the business of the company' and they may

*Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324; *Re Broadcasting Station 2GB* [1964-5] 2 NZLR 150.

<sup>25</sup> *Bell v Lever Brothers Ltd* [1932] AC 161; *On the Street Pty Ltd v Cott* (1990) 8 ACLC 1; *Industrial Development Consultants Ltd v Cooley* [1972] 2 All ER 162; *Riteway Express Pty Ltd v Clayton* (1987) 5 ACLR 1045; *Mordecai v Mordecai and Others* (1988) 6 ACLC 370.

<sup>26</sup> *Keech v Sandford* (1726) Sel Cas Ch 61, 25 ER 223; *Transvaal Land Company v New Belgium (Transvaal) Land and Development Company* [1914] 2 Ch 488; *George A Bond & Co v Bond* (1929) 30 SR (NSW) 15; *Re James* [1949] SASR 143; *Bouling v Association of Cinematograph Television and Allied Technicians* [1963] 2 QB 606; *Baker v Palm Island Resort Pty Ltd* [1970] Qd R 210; *North West Transportation v Beatty* (1887) 12 App Cas 589; *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549.

<sup>27</sup> *Burland v Earle* [1902] AC 83; *Cook v Deeks* [1916] 1 AC 554; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; *Furs Ltd v Tomkies* (1936) 54 CLR 538; *Peso Silver Mines v Cropper* (1966) 58 DLR 2d 1; *Queensland Mines Ltd v Hudson* (1978) 52 ALJR 399; *R v Chew* (1992) 10 ACLC 831; *Grove v Flavel* (1986) 4 ACLC 654.

<sup>28</sup> *Mills v Mills* (1938) 60 CLR 150; *Ngurli v McCann* (1953) 90 CLR 425; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 ACLC 215; *Jeffrey v NCSC* (1989) 7 ACLR 556; *Harlowe Nominees v Woodside Petroleum* (1968) 121 CLR 483; *Advance Bank Australia Ltd v FAI Insurance Ltd* (1987) 5 ACLC 725; *Hannes and Ors v MJH Pty Ltd and Ors* (1992) 10 ACLC 400; *Bailey v Mandala Private Hospital Pty Ltd* (1988) ACLR 43; *Whitehouse and Another v Carlton Hotel Pty Ltd* (1987) 5 ACLC 421; *Darvall v North Sydney Brick and Tile Company Ltd and Others* (no 2) (1989) 7 ACLC 659.

<sup>29</sup> *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Company NL* (1968) 121 CLR 483; *Re Brazilian Rubber Estates* [1911] 1 Ch 437; *Pavlidis v Jenson* [1956] Ch 565; *Marquis of Bute's Case* (1892) 2 Ch 100; *Re Equitable Fire Insurance Co* (1925) Ch 407; *AWA Ltd v Daniels t/a Deloitte Haskins and Sells and Ors* (1992) 10 ACLR 933; (no 2) (1992) 10 ACLC 1643.



be appointed or dismissed by the shareholders. In reality, however, we have already seen that the courts have never been able to provide a precise content for the idea of 'the interests of the company as a whole'; that 'the business of the company' has never been the subject of rigorous analysis; and that shareholder control is, very often, merely a fiction. There are, in addition, other aspects of the doctrinal formulation of directors' obligations which contribute to the inefficiency and complexity of the law in this area.

Under directors' fiduciary duties, directors must avoid a conflict of interests between their personal interests and those of the company. The classic formulation of this rule is to be found in *Aberdeen Railway Company v. Blackie Bros.* (1884) 1 Macq. 461, 471 per Lord Cranworth LC:

A corporate body can only act by agent, and it is, of course, the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such agents have duties to discharge of a fiduciary nature towards their principal. And it is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.

This rule encompasses the principles that directors should not contract with the company; that directors should not take bribes or hidden profits; that directors should not misuse corporate funds, corporate opportunities or corporate information; and that they should not enter into competition with the company. These duties arise under both common law and the *Corporations Law*.

This distinction between legitimate acts of directors being those directed to the corporate good, and illegitimate acts being those directed to the personal good, accords with Rousseau. Corporate regulation, however, was also driven by the desirability of entrepreneurial activity. This distinction between self-interest and the corporate interest, strictly applied, would limit such activity. Lord Herschell stated in *Bray v. Ford* [1896] AC 44, 51 that:

It is an inflexible rule of a Court of Equity that a person in a fiduciary position...is not, unless otherwise expressly provided entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is, as has been said, founded on principles of morality. I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than duty, and thus prejudicing those whom he was bound to protect. It has, therefore, been deemed expedient to lay down this positive rule. But I am satisfied that it might be departed from in many cases, without any breach of morality, without any wrong being inflicted and without consciousness of wrongdoing.

The rule against directors acting in their own self interest was thus not absolute. Taking one area of the duty, that of contracting with the company, as an example, the rule was relaxed in a number of ways: Firstly, directors could, for instance, contract with the company, provided that the articles allowed them to do so.<sup>30</sup> Secondly, the rule that directors cannot contract with the company is qualified by the rule that, in order for directors to be in breach of their duty, they must have a 'material interest' in the contract<sup>31</sup> with the company and this interest must be certain and enforceable, not the mere prospect of deriving a benefit. Thirdly, directors can avoid being in breach of duty if they make full and frank disclosure of their interest in any contract with the company.<sup>32</sup> The original requirement for disclosure was that this disclosure should be made to the general meeting.<sup>33</sup> This, too, has been relaxed in some cases so that disclosure to the board is sufficient.<sup>34</sup>

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<sup>30</sup> See, for instance, *Re Automotive & General Industries Ltd* [1975] VR 454, where the relevant articles provided:

No contract made by a director with the company and no contract or arrangement entered into by or on behalf of the company, with a company or partnership of or in which any director is a director, member or otherwise is any way interested shall be avoided, nor shall any director so contracting or being so interested be liable to account to the company for any profit realised by any such contract or arrangement by reason only of such director holding his office or of the fiduciary relation thereby established.

The Court in this case held that this provision saved contracts made with directors even though such contract gave rise to a conflict of interests.

<sup>31</sup> See CL 231(2).

<sup>32</sup> *Furs Ltd v Tomkies* (1936) 54 CLR 583; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378. In addition, under CL 1318(1) officers of a corporation may be relieved from liability if, in any civil proceedings against them for negligence, default, breach of trust or breach of duty, it appears to the Court that they acted honestly and ought fairly to be excused. Where the court grants such relief, the officer may be indemnified under the articles for his or her legal costs in relation to the proceedings under CL 241(2).

<sup>33</sup> *Furs Ltd v Tomkies* (1936) 54 CLR 583; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378. In addition, a director, although precluded from voting as a director in a resolution to absolve him/her from a breach of duty, can vote as a shareholder. Thus, in *East Pant Du United Lead Mining Co Ltd v Merryweather* (1864) 2 H & M 254, 261; 71 ER 460, 463, Sir W Page Wood VC stated that:

Now as to the management of the company be the board, no director is entitled to vote as a director in respect of any contract in which he is interested; but the case is different when he acts as one of the whole body of shareholders. The shareholders of one company may have dealings with interests in other companies, and therefore it would be manifestly unfair to prevent an individual shareholder from voting as a shareholder in the affairs of the company.

See also *Estmanco Ltd v Greater London Council* [1982] 1 All ER 437; *Northern Counties Securities Ltd v Jackson & Steeple Ltd* [1974] 1 WLR 1133; *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589, but contra the statements of

### *Nominee directors*

Apart from relaxation of the strict rule against the conflict of interest and duty, difficulties have been caused by the increase in modern times of nominee directors and company groups<sup>35</sup> and the inherent conflicts of interest these create. Nominee directors are placed in an invidious position. On the one hand, they are under a duty to act in the best interests of the company. If they do so to the detriment of their appointer, however, they face the possibility of being removed. Crutchfield<sup>36</sup> suggests that there are three possible approaches to this problem. The first is the strict approach: once appointed, directors must act only in the best interests of the company, in preference to the wishes of appointers.<sup>37</sup> Crutchfield criticises this approach as failing to accord with commercial reality. The second approach is to allow a nominee director to have regard to the appointer's interest provided that interest coincides with that of the company.<sup>38</sup> Crutchfield notes that this approach may be criticised on the basis that directors would then take advantage of the courts' traditional reluctance to intervene in company matters. In answer to this, he claims that there are built-in safeguards: first, the test of legitimacy is both subjective and objective; and second, an action in oppression may still lie. He cites the decisions in *Re Spargos Mining NL* (1991) 3 ASCR 1 and *Re Enterprise Gold Mines NL* (1991) 9 ACLC 168; 3 ACSR 531 in support of this. The third approach is to look to the constitutive documents of the company to determine the scope and nature of the fiduciary duty and hence determine the company's 'best interests'. Effectively, in this last scenario, shareholders determine the scope and nature of management obligations.<sup>39</sup>

Under Rousseau's theory, the discussion would appear to be misplaced. The issue of nominee directors arises in regard to appointment, rather than in regard to actions. The

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Vinelott J *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1980] 3 WLR 543, to the effect that, in ascertaining the shareholders' views, 'the court will disregard the votes cast or capable of being cast by shareholders who have an interest which conflicts with the interests of the company'.

<sup>34</sup> *Queensland Mines Ltd v Hudson* (1978) 52 ALJR 399.

<sup>35</sup> On the question of company groups, see *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 11 ASCR 642.

<sup>36</sup> Philip D Crutchfield, 'Nominee directors: the law and commercial reality' (1992) 20 *Aust Bus LR* 109.

<sup>37</sup> *Bennetts v Board of Fire Commissioners of NSW* (1967) 87 WN (NSW) 307.

<sup>38</sup> See, for instance, *Re Broadcasting Station 2GB Ltd* (1964-5) NSW 1648, 1662 per Jacobs J and *Re News Corporation Ltd* (1987) 70 ALR 419, 436-7 per Bowen LJ.

<sup>39</sup> *Levin v Clark* [1962] NSW 686; *Berlei Hestia (NZ) Ltd v Fernyhough* [1980] 2 NZLR 150.

appointment of a nominee can serve no purpose unless it is to represent the interests of an outside body (for instance, creditors, employees etc) or the interests of a partial group within the association (for instance, a corporate shareholder or class of shareholders). In either case, the appointee represents a particular interest. If outside the association, it is clearly not possible to acknowledge the interests of an outside body in the general will. If from inside the organisation, the appointment would conflict with Rousseau's rule against partial associations. Assuming, however, that appointees for particular interests within the association were allowed, then each interest within the corporation would need to appoint such a representative. In such a case, the second of Crutchfield's scenarios would be most appropriate - Rousseau's theory does not state that the general will is always contrary to the particular will; but rather, that it may be. At times, then, it would be possible for the general and the particular will to coincide.

### *Proper purposes*

The parameters of 'proper corporate purpose' have not been clearly defined. Directors are under a duty to exercise their given powers for a 'proper corporate purpose'. There are considerable problems, however, in defining the purposes for which a duty is conferred. This issue has occurred frequently in the context of corporate takeovers.<sup>40</sup> In what circumstances can directors exercise their power to issue shares or to manage the company in order to resist a hostile takeover?<sup>41</sup>

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<sup>40</sup> See further, Bernard McCabe, 'The roles and responsibilities of company directors in a takeover' (1994) 4 *AJCL* 36; Antiano Luzung, 'Should directors be allowed to use takeover defensive measures?', (1993) *UTLR* 75; L Ritson, 'The "proper purposes" duty of directors and defensive measures against company takeovers', (1985) 10 *Sydney LR* 627; SJ Burridge 'Wrongful Rights Issues', (1981) 44 *MLR* 40; AAD Easterbrook and R Fischel, 'Takeover bids, defensive tactics and shareholders' welfare' (1981) 36 *Bus Law* 1733; Easterbrook and Fischel, 'The proper role of a target's management in responding to a tender offer' (1981) 94 *Harv LR* 11611; GFK Santow 'Defensive measures against company takeovers', (1979) 53 *ALJ* 374; P Health 'The proper purpose doctrine: the law and its implications', (1978) 3 *Auck LR* 307; BH McPherson, 'Duties of directors and the power of shareholders', (1977) 51 *ALJ* 460; NCA Franzi, 'The subjective and objective elements of a company board's power to issue shares', (1976) 10 *MULR* 392; KE Lindgren, 'The fiduciary nature of a company's power to issue shares', (1972) 10 *UWALR* 364; F Iacobucci 'The exercise of directors' powers:-The battle of Afton Mines', (1973) 11 *OHLJ* 313.

<sup>41</sup> Tactics used under the management power to resist takeovers include exploiting company opportunities (see *Winthrop Investments Ltd v Winns Ltd* [1975] 2 *NSWLR* 666; *Pine Vale Investments Ltd v McDonnell and East Ltd* (1983) 8 *ACLR* 199); on market purchase of company shares (see *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] *AC* 821; *Hogg v Cramphorn Ltd* [1967] *Ch* 254); the so-called 'Pacman defence', ie, making a takeover offer for a raider or forming a new company to make a bid for the target or transfer the assets or business of the existing company (see *Rossfield Group Operations Pty Ltd v Austral Group Ltd* [1981] *Qd R* 279). In the US, a common tactic has also been to amend the company articles. See RJ Gilson, 'The case against shark-repellant amendments: structural limitations on the enabling concept' (1982) 34 *Stan L R* 775; ES Friedenberg, 'Jaws III: The propriety of shark-repellant amendments as a takeover defence', (1982) 7 *Del J Corp Law*, 32.

Although the duty to act for a proper purpose is commonly seen to arise from the directors' duty to act bona fide in the interests of the company as a whole, Steele<sup>42</sup> argues that the duty actually arises from the evidentiary difficulties of proving a director's lack of bona fides, particularly in the takeover context. Lack of bona fides, he argues, may be proved by showing that there were: no sound commercial reasons for a share issue; statements of improper motives made by directors in the board minutes and in answers to interrogatories; or evidence given by the directors in court; but all of these are capable of manipulation. Thus plaintiffs allege improper purpose, rather than a lack of bona fides. This distinction may be seen in *Advance Bank Australia Ltd v. FAI Insurances Ltd* (1987) 5 ACLC 725 where, although directors had acted bona fide, their single-minded and misleading actions to ensure their re-election to the board constituted a collateral purpose. In this case, Kirby P. gave some indication of the extent of this duty in the context of elections of the board. The director's exercise of the use of company funds in a board election must be bona fide in the interests of the company as a whole, and for a proper corporate purpose. In determining the latter, the Court should look at the real purpose behind the directors' actions: this is not to be wholly determined by the directors' statements as to their subjective intentions. Even where a director has acted bona fide and the proper company purposes, their conduct may still be illegitimate if they exceed or abuse their powers. In the context of elections, this may occur where an unreasonable amount of company money has been spent; where the money is spent on material relevant to personality and not to corporate policy or otherwise acted in a manner excessive or unfair in the circumstances.<sup>43</sup>

Nevertheless, part of the difficulty in defining the parameters of the duty stems from the ambiguity of the expression 'the interests of the company as a whole'. Particularly in the context of company takeovers, should directors exercise their powers in the interests of the company as an ongoing corporate entity (the 'commercial entity' doctrine); or should

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<sup>42</sup> Tony Steele, 'Defensive tactics in company takeovers', (1986) 4 *CSLJ* 30, at 36.

<sup>43</sup> In *Hannes and Ors v MJH Pty Ltd and Ors* (1992) 10 ACLC 400, H, governing director of a company was granted management, government, and control of the company under the company constitution. His shares also gave him control over any majority of votes at meetings. Other family members held the remaining shares. H and the other director passed a resolution which gave H a service agreement between himself and the company and established a superannuation fund of which H was the only member. No notice of these resolutions was given to other shareholders. No approval was given in the general meeting. The other shareholders alleged this action was invalid, on the basis of the equivalents of CL 232 and CL 260. The NSW Court of Appeal found H was in breach of his fiduciary duty because the substantial object of his action was self-interest. He had placed self-interest before the interests of the company. Even if the exercise of H's powers was *intra vires*, there was no legitimate rationale for his actions. Although H had wide powers conferred upon him, this did not alter the prohibition against the exercise of those powers for an improper purpose.

directors exercise their powers in the interests of the body of shareholders (the 'body of corporators' doctrine)?

The duty to act for a proper corporate purpose in its 'commercial entity' formulation can, of course be likened to the general will. 'Government' should act for the common good of the association, that common good being primarily directed to the continued existence of the association so long as the associative members are benefited by that continuation. On this view, directors would be justified in exercising their powers to resist a takeover where, for instance, it can be shown objectively that a raider intends to transform the business so that it no longer reflects the goals of the corporators<sup>44</sup> or where the changed control would be disadvantageous to the conduct of company business.<sup>45</sup> For instance, in *Teck Corp. Ltd. v. Millar* (1973) 33 DLR (3d) 288 at 337, Berger J. upheld this view, albeit applying a subjective test (rather than an objective test as required by Rousseau):

I think that the directors are entitled to consider the reputation, experience and policies of anyone seeking to take over the company. If they decide, on reasonable grounds, a takeover will cause substantial damage to the company's interests, they are entitled to use their powers to protect the company.<sup>46</sup>

Similarly, in *Darvall v. North Sydney brick and Tile Co Ltd and Ors* (No 2) (1989) 7 ACLC 659, a shareholder made a takeover bid for the company. The directors entered the company into a joint venture with a third party to develop some real estate owned by the company. This was done in an attempt to secure an alternative (and more lucrative) takeover bid. The shareholder alleged that this was an improper purpose. The majority of the Court (Mahoney and Clarke J.J.A.) dismissed the action. Mahoney J. at 704 said:

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<sup>44</sup> As in *Re Tivoli Freeholds* [1972] VR 445. For support for the 'corporate entity' interpretation, see BH McPherson, 'Duties of directors and the powers of shareholders', (1977) 51 ALJ 364, at 368; GFK Santow 'Defensive measures against company takeovers', (1979) 53 ALJ 374, at 375; JD Heydon, 'Directors' Duties and the Company's interests', in PD Finn (ed) *Equity and Commercial Relationships* (North Ryde, NSW: Law Book Co, 1987), at 134.

<sup>45</sup> As in *Rossfield Group Operations Pty Ltd v Austral Group Ltd* [1981] Qd R 279 and *Teck Corp Ltd v Millar* (1973) 33 DLR (3d) 288.

<sup>46</sup> See also *Cayne v Global Natural Resource PLC* (Unrep 12 Aug 1982 Ch Div) and *37883 Alberta Ltd v Producers' Pipeline Inc* (1991) 80 DLR (4d) 359.

It is not correct that ...a company has no legitimate interest in who are its shareholders or the price paid for its shares. In some circumstances, it will be proper for a company to concern itself with those who take its shares on transfer. Thus, a company may lose a government licence or a customer may refuse to do business with a company if a particular person takes a transfer of shares. It may then be 'in the interest of the company as a whole' for action to be taken. What a company may do in the circumstances will depend upon the circumstances.....<sup>47</sup>

Critics of this 'corporate entity' doctrine argue that such an interpretation authorises directors to frustrate a bid and deny the shareholders the opportunity to make large returns on their investment, and on the other, prevents directors from taking action designed to increase the share price or maximise shareholder benefits.<sup>48</sup> There is thus authority for the 'body of corporators' view,<sup>49</sup> that is, that the 'proper purpose' for which a power is exercised is that of ensuring the commercial well-being of corporators as individuals. For instance, in *Greenhalgh v. Aderne Cinemas Ltd.* [1951] Ch 286, 291, the test was stated this way by Evershed M.R.:

...the phrase, 'the company as a whole', does not (at any rate in such a case as the present) mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body. That is to say, the case may be taken of an individual hypothetical member and it may be asked whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit.<sup>50</sup>

On the basis of this view, directors can legitimately exercise their powers so as to maximise shareholder share prices.

Rousseau's theory highlights the problem, however, that directors cannot accommodate 'the sum of particular interests', that is, the will of all. In the takeover context, for example, it can be argued that a higher share prices will seldom benefit all the

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<sup>47</sup> There are, of course, some limits to how far the directors can go in protecting company interests. See, for instance, *Bailey v Mandala Private Hospital Pty Ltd* (1988) ACLR 43, where a share allotment undertaken to place company assets beyond the reach of potential litigators was held to be an improper purpose.

<sup>48</sup> See, for instance, Steele, note 42, at 32.

<sup>49</sup> See, for example, *Rossfield Group Operations Pty Ltd v Austral Group Ltd* [1981] Qd R 279; *Ngurli Ltd v McCann* (1953) 90 CLR 425; *Greenhalgh v Aderne Cinemas Ltd* [1951] Ch 286.

<sup>50</sup> In some situations, of course, it may also be necessary to have regard to the interests of creditors. In *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 ACLC 215, a lease was executed between the company as landlord and Mr and Mrs Kinsela, two directors of the company as tenants. This occurred when the company was about to collapse. The lease was an attempt to put the company assets beyond the reach of creditors. All shareholders of the company approved the deal. After the company went into liquidation, the liquidator sought to have the transaction set aside. The Court held that where a company is insolvent, the interests of the creditors must be regarded. Thus the shareholders did not have the power to absolve the directors from their breach of duty.

shareholders - after all, the raider is often a substantial shareholder who will be unlikely to see acceptance of a higher price as being in his/her/its interests!

### **The reluctance to question management decisions**

A final problem in the doctrinal formulation of directors' duties is that judges have been reluctant to judge management decisions. For instance, in *Harlowe's Nominees Pty Ltd v. Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483, the High Court stated:

Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations and their judgment if exercised in good faith and not for irrelevant purposes is not open to review by the court.

This reluctance can, I suggest be attributed to a number of causes. Firstly, it may be seen to stem from philosophical and economic ideas of the limited state. The public/private dichotomy<sup>51</sup> and the nineteenth century determination that the internal workings of companies were 'private' matters, meant that courts should not intervene in management decisions. This divide was, however, highly artificial in a number of ways. One artificiality in this context is that the so-called 'private' matter of a boards' decision could have far reaching ramifications upon a range of third parties, including employees, creditors and members of the community. Secondly, this reluctance can be seen to stem from judicial deference to directors' business expertise. This can, in turn, be attributed to the desire to encourage risk-taking but it is difficult to reconcile with the notion that directors need have no particular standard of expertise.<sup>52</sup> The traditional rule was that directors need only exercise that degree of care demanded by their particular level of expertise. For instance, in *Re Brazilian Rubber Estates* [1911] 1 Ch 437, Neville J. said:

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<sup>51</sup> See further Charles Sampford, 'Law, institutions and the public/private divide', (1992) 20 *FLR* 185-222. The public/private dichotomy is a recurring theme in much feminist jurisprudence and in family law analysis. See, for instance, Sandra S Berns, 'Towards a theory of relational equality', (1993) 16 *UNSWLJ* 394; Marcia Neave, 'From difference to sameness - law and women's work', (1992) *MULR* 768; Jenny Morgan, 'Feminist theory as legal theory', (1988) 16 *MULR* 743; Margaret Thornton, 'Feminist jurisprudence: illusion or reality?', (1986) 3 *AJLS* 5; Hester Lessard, 'The idea of the 'private': a discussion of state action doctrine and separate sphere ideology', (1986) 10 *Dal L J* 108; Fran Olsen, 'The family and the market: a study of ideology and legal reform', (1985) 96 *Harv LR* 1499.

<sup>52</sup> This can be likened to the democratic ideal of 'government by amateurs'.



[One cannot say whether a man has been guilty of negligence, gross or otherwise, unless one can determine what is the extent of the duty which he is alleged to have neglected. A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. His is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance; while if he is acquainted with the rubber business he must give the company the advantage of his knowledge when transacting the company's business. He is not, I think, bound to take any definite part in the conduct of the company's business, but so far as he does undertake it he must use reasonable care in its dispatch.

At common law, the director was not even required to attend board meetings if this would be inconvenient or onerous.

A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.<sup>53</sup>

The combination of this permissive attitude to the conduct of company affairs and full corporate privileges (including limited liability) created a climate for abuse. Although these doctrines have been reformed to some degree by the *Corporations Law*,<sup>54</sup> a recent case, *AWA Ltd v. Daniels t/a Deloitte Haskins and Sells and Ors* (1992) 10 ACLC 933, suggests that reform has not gone far enough. In this case,<sup>55</sup> a company made

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<sup>53</sup> *Re City Equitable Fire Insurance Co* (1925) Ch 407 per Romer J. In the *Marquis of Bute's Case* (1892) 2 Ch 100, the Marquis had attended one meeting in 38 years. He was not liable for neglecting his duty, Stirling J noting that neglect or omission to attend meetings is not the same as neglecting or omitting a duty that should be performed at those meetings.

<sup>54</sup> The *Corporate Law Reform Act* (Cth) 1992, amended CL 232(4) to stress the fact that the duty of care and diligence is an objective one. The section now reads:

In the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances.

<sup>55</sup> This case has given rise to a considerable body of literature. See, for example, Jenine Pascoe, 'Has the reasonable company director arrived at last? Recent developments in the law concerning directors' duties of care and diligence', (1993) 2 *Current Com Law* 47; John H Farrar, 'Corporate governance, business judgment and the professionalism of directors', (1993) 6 *CBLJ* 1; Robert Baxt, 'Company law: duties of care, honesty, good faith: related party transactions legislation: a strong statement from the Federal Court', (1993) 67 *ALJ* 694; Sue Woodward, 'Directors: be informed or beware!' (1993) 67 *Law Inst J* 274; AS Seivers, 'Farewell to the sleeping director: the modern judicial and legislative approach to directors' duties of care, skill and diligence', (1993) 21 *Aust Bus LR* 111; AAD Easterbrook, 'Caveat duces revisited, Mr Gallagher and NIFO', (1993) 7 *Com Law Q*, 10; Stephen Bottomley and Roman Tomasic, 'Corporate governance and responsibility - *AWA Ltd v Daniels*',

considerable losses because of the ineffective implementation of the company's foreign exchange policy. The broad policy on foreign exchange established by the board could not be sufficiently enforced because of lack of internal controls and reporting. On the issue of the failure of the directors to monitor the enforcement of the policy, Rogers CJ, said:

[M]any companies today are too big to be supervised and administered by a Board of Directors except in relation to matters of high policy... Senior management and, in the case of mammoth corporations, even persons lower down the corporate ladder exercise substantial control over the activities of such corporations involving important decisions and much money.

His Honour held that non-executive directors were entitled to rely on information provided by the company's management and auditors without further inquiry. The Chief Executive, however, who was privy to management information which suggested that internal controls were insufficient, and who failed to investigate the matter further, was in breach of his duty to exercise reasonable care and diligence.<sup>56</sup>

Two further decisions, *ASC v. Gallagher* (1993) 10 ASCR 43 and *Vrisakis v. ASC* (1993) 11 ASCR 162 applied the decision in *AWA v. Daniels*. In the former case, Gallagher was a non-executive director of Rothwells. There were a number of problems with Rothwells' loan portfolio, including very large exposure to related groups and no security for many loans, information of which Gallagher was unaware. Gallagher was charged under the equivalent of CL 232(4) with failing to exercise a reasonable degree of care and diligence by failing to reasonably inform himself as to the financial affairs of Rothwells Ltd. The magistrate at first instance dismissed the offence. This was upheld on appeal by Pidgeon J.

[T]he test is basically an objective one in the sense that the question is what an ordinary person, with the knowledge and experience of the defendant might be expected to have done in the circumstances if he was acting on his own behalf. (at 53)

On the basis that Gallagher was dealing with a reconstituted board with the imprimatur of the State government, he was justified in his belief that relevant information would be passed on to him.

In the latter case, Vrisakis was a director appointed as part of the arrangements associated with the rescue package of Rothwells. He was a non-executive director but was an experienced commercial solicitor. He successfully appealed a conviction for breaches of

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(1992) 2 *AJCL* 232; Nicolette Rogers, 'Recent Developments in Company Law', (1992) 22 *Queens LSJ* 487.

<sup>56</sup> In *AWA Ltd v Daniels t/a Deloitte Haskins and Sells and Ors* (No 2) (1992) 10 *ACL* 1,643, His Honour refused to relieve this executive from liability on the basis that he made honest errors of judgment: 'honest bungling' was not, in His Honour's view, a sufficient basis for relief.

the duty of care and diligence under s. 232 (4). It was alleged that Vrisakis had failed to take reasonable steps to ensure that effect was given to the terms of a business plan and management restructure which were contained in the paper prepared by him and adopted by the resolution of the directors of Rothwells at a meeting in 1987.<sup>57</sup> Ipp J. said:

[T]he mere fact that a director participates in conduct that carries with it a foreseeable risk of harm to the interests of the company will not necessarily mean that he has failed to exercise a reasonable degree of care and diligence in the discharge of his duties. The management and direction of companies involve taking decisions and embarking upon actions which may promise much, on the one hand, but which are, at the same time, fraught with risk on the other. That is inherent in the life of industry and commerce; the legislature undoubtedly did not intend by s. 229(2) [now s. 232(4)] to dampen business enterprise and penalise legitimate but unsuccessful entrepreneurial activity. Accordingly, the question whether a director has exercised a reasonable degree of care and diligence can only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question. (at 212)

Ford and Austin consider the decision in *AWA v. Daniels* to be an 'unhelpful' one which sets the standard of directors duties of care too low. They cite recent Royal Commission Reports into the Tricontinental Group and the Royal Commission into the State Bank of South Australia and write:

The Commissioners' view is that the courts are likely to examine critically any failure by directors to be sufficiently well informed about matters affecting the financial performance and health of their corporations, even if they are non-executive directors...They assert that it is not enough for directors to pronounce on policy...and emphasise 'the need for directors to be of an inquiring mind'.<sup>58</sup>

These cases show the continued deference of the courts to directors' 'business expertise' and to the desirability of risk taking over the other considerations.

## Conclusion

In this chapter, I have sought to show that corporate governance has not been clearly defined by the law because of the difficulties posed by the expression 'best interests of the company as a whole', by the desire not to discourage entrepreneurial action by directors and by the problems created by allowing conflict of interest situations to arise (as in the case of nominee directors). Rousseau's theory is useful in this context by highlighting the dangers inherent in the failures, firstly, to demand that corporate officers act in the corporate interest at all times, and secondly, in defining the expression 'the best interests

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<sup>57</sup> See Keturah Whitford, 'The year that was in company law', (1994) 4 *AJCL* 20; Note (1993) 9 *Co Director* 6.

<sup>58</sup> HAJ Ford and RP Austin, *Ford's Principles of Corporation Law* (6th ed) Supplement, (Sydney, Butterworths, 1994), 19.

of the company' as the corporate entity. I turn now to discuss issues arising from the operation of corporations in the wider society.

## CHAPTER 9

# ‘FICTITIOUS OFFENCES AND FICTITIOUS PERSONS’:<sup>1</sup> CORPORATE LIABILITY FOR LEGAL WRONGS

### Introduction

One of the more contentious issues of corporate citizenship is that of the liability of the corporation for legal wrongs. Under the Anglo-Australian law, a corporation may be attract liability for legal wrongdoing in two ways: Vicariously, for the acts of its agents and employees; or primarily, for corporate deeds. Although vicarious liability for tort is reasonably well developed in Australia, vicarious and primary liability for criminal acts is restricted. A number of commentators have argued for the desirability of an expanded conception of group liability for criminal wrongs. The western liberal tradition, however, has restricted the imposition of such accountability. Given the significance of individual freedom, it has conventionally been considered unjust or impractical to impose group responsibility. Further, some commentators have argued that the corporation itself cannot commit a legal wrong: only those individuals who compose the corporation can commit such an act.<sup>2</sup> These differences in opinion<sup>3</sup> between individual and group responsibility reflect the theoretical schism between the organic and the

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<sup>1</sup> From a quote by Donald Cressey, ‘The Poverty of Theory in Corporate Crime Research’, in Brent Fisse and John Braithwaite, ‘The Allocation of Responsibility for Corporate Crime: Individualism, Collectivism and Accountability’, (1988) 11 *Sydney LR* 468, at 475:

[T]he concept of corporate crime is a fiction the uncritical use of which has forced criminologists into the position of trying to find the cause of fictitious offences perpetrated by fictitious persons.

<sup>2</sup> For early examples of this point of view, see NC Collier, ‘Impolicy of Modern Decision and Statute making Corporations Indictable and the Confusion in Morals thus Created’, (1910) 71 *CLJ* 421; JF Francis, ‘Criminal Responsibility of a Corporation’, (1923) 18 *Illinois LR* 305. For later examples, see LH Leigh, *The Criminal Liability of Corporations in English Law* (London: London School of Economics, 1969); and JT Byam, ‘The Economic Inefficiency of Corporate Criminal Liability’, (1982) 73 *JCLC* 582.

<sup>3</sup> For the contrast between individualism and corporatism, see J Surber, ‘Individual and Corporate Responsibility: Two Alternative Approaches’, (1983) 2 *Bus and Prof Ethics J* 67. Civil law countries have rejected the idea of corporate criminal responsibility because the corporation lacks the requisite *mens rea* to commit the crime. See Gerard OW Mueller, ‘Mens Rea and the Corporation’, (1957) 19 *U Pitt L Rev* 21. For further discussion on corporate punishment, see B Fisse, ‘Responsibility, prevention and corporate crime’, (1973) 6 *NZ Universities L R* 250l; Fisse, ‘Reconstructing corporate criminal law: Deterrence, retribution, fault and sanctions’, (1982) *S Calif LR* 1141.

contractual/fictional theories of corporations. In this chapter, I shall argue that Rousseau's model is valuable in this area for its discussion of the possibility of, and the necessary conditions for, the imposition of group liability. The chapter is divided into two main parts: In the first, I shall discuss the doctrinal response to the problem of corporate liability, focussing upon the individualist bias in both law and ethics in this area; I shall then proceed to consider the normative view of corporate responsibility, examining the opinions of both Rousseau and modern judicial and academic commentators.

### **Of bodies and souls: The development of the law of corporate liability**

Although group accountability was possible, the law relating to responsibility for corporate wrongdoing developed upon a decidedly individualistic course. Historically, there are some examples of collective responsibility in the Western legal tradition. For instance, Ts'ai refers to the collective responsibility that applied to men of the hundred who were fined for murders and robberies taking place in the locality.<sup>4</sup> Stoljar, too, records three instances of collective responsibility: Firstly, a territorial community in early common law might be subject to certain duties, such as paying tallage or repairing the local road and local residents may have an execution levied upon them if the community did not pay the relevant fine; secondly, in medieval Europe, a whole city may be penalised for the offences of a small minority; and thirdly, until the decretal of Innocent IV in 1245, the Church could excommunicate entire religious houses for the misdemeanours of a few.<sup>5</sup> Notably, however, these examples are from the medieval period, when, as has been discussed previously, there was a stronger conception of community. As the old feudal ties broke down, however, there arose an increasing emphasis upon the individual as the focus of legal rights and obligations.

Even with this rise of individualism, there was some theoretical support for the feasibility of group liability. As a result of the separate entity doctrine, it was possible for liability to attach to a corporation (as opposed to the members of the corporation) for its wrongdoings. In *Saloman v. Saloman* [1897] AC 22, 51 Macnaghton stated that:

The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act.

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<sup>4</sup> Lim Wen Ts'ai, 'Corporations and the Devil's Dictionary: The problem of Individual Responsibility for Corporate Crimes', (1990) 12 *Sydney LR* 311.

<sup>5</sup> SJ Stoljar, *Groups and Entities: An Inquiry into Corporate Theory* (Canberra: ANU, 1973), Ch 11.

Indeed, this conception of separate personality allowed for a comprehensive development of corporate vicarious liability in tort.<sup>6</sup> Corporations became liable in trover, trespass and torts involving fraud and malice.<sup>7</sup>

The legal fiction of corporate personality operated, conversely, to restrict corporate responsibility in the criminal law. The criminal law was based upon an individualistic theoretical and doctrinal basis in the sense that the natural person was the focus of criminal accountability, procedure<sup>8</sup> and punishment.<sup>9</sup> In order for criminal liability to be

<sup>6</sup> *Citizens' Life Assurance Co Ltd v Brown* [1904] AC 423; *Northern Publishing Co Ltd v White* [1940] NZLR 75.

<sup>7</sup> *Yarborough v Bank of England* (1812) 16 East 6; *Smith v Birmingham Gas Co* (1834) 1 A & E 525; *Maund v Monmouthshire Canal Co* (1842) 4 M7G 452; *Eastern Counties Railway Co v Broom* (1851) 6 Exch 314.

<sup>8</sup> Historically, a limited company could not be committed for trial on an indictment, as criminal courts expected the prisoner to stand at the bar and did not permit appearance by attorney. If there was no statutory authority, a company could not be committed by a magistrate in preliminary proceedings for trial of an indictable offence. See Mr Justice Gowans 'Some Experiences in Criminal Trials in Relation to Company Offences', (1966) 39 *ALJ* 328. Such legislation as the *Criminal Justice Act* 1925 (UK) s 33 and the *Crimes Act* 1900 (NSW) s 360A overcame this problem by providing that a magistrate could make an order for presentment. Once presented, however, the problem remained of how a company was to plead, given that, at common law, the accused had to appear in person.

<sup>9</sup> The problem of corporate crime was considered recently by Roman Tomasic, *Corporate Crime and Corporations Law Enforcement Strategies in Australia* (Belconnen, ACT: Centre for National Corporate Law Research, University of Canberra, 1993) who notes that in recent years there has been a tendency by sociologists and criminologists to include in the definition of corporate crime 'any misconduct involving a corporation whether it is in breach of a criminal or civil law or regulatory rule'. Tomasic quotes the definition given by Kramer:

...criminal acts (of omission or commission) which are the result of deliberate decision making (or culpable negligence) by persons who occupy structural positions within the organisation as corporate executives or managers. These decisions are organisational in that they are organisationally based - made in accordance with the operative goals (primarily corporate profit), standard operating procedures and cultural norms of the organisation - and are intended to benefit the corporation itself.

Tomasic, proceeds, however, to point out that much corporate crime is directed to the manipulation of the corporation or corporate form itself and not committed for corporate benefit, for example, insider trading, corporate tax evasion and manipulation of corporate treasuries. Thus, he expands upon Kramer's definition: '...corporate crime is therefore also taken to refer to a breach of the corporate criminal law by a corporation or its agents or a breach of corporate criminal law involving the manipulation of the corporation from itself.' Corporate crime may thus include securities fraud, abuse of directors' duties, auditing abuses, money laundering and insolvency fraud.

For a discussion of corporate crime from an American perspective, see MB Clunard and PC Yeager, *Corporate Crime*, (New York: Free Press, 1980) and from the English perspective, Leigh, note 2. See also, LH Leigh, 'The Criminal Liability of Corporations and other Groups: A comparative view', (1982) 80 *Mich L R* 1508. For

attracted, it was necessary to prove that the wrongdoer possessed a certain state of mind. Conceptually, regulators and commentators struggled to reconcile the principle of separate entity with such notions of intrinsically human responsibility. In particular, it was difficult to reconcile ideas of responsibility based upon sin with an entity that lacked a soul: A company had 'neither body, parts or passions',<sup>10</sup> 'no soul to be damned, and no body to be kicked';<sup>11</sup> It was claimed that '[T]he capacity to commit crime presupposes an act of understanding and an exercise of will'<sup>12</sup> but case law held that a corporation was incapable of any act of understanding, and had no will to exercise.<sup>13</sup> In the *Mayor of Norwich Case* (1481) YB 21 Edw 4, fol. 13, for instance, it was declared that a corporation could not be assaulted or imprisoned, could not commit treason or a felony, 'because these offences belong to the 'corporeal law' while the corporation is only a name, which cannot be seen and has no substance'. Similarly, in *Sutton's Hospital Case* (1613) 10 Co Rep 23a, 32b, Coke asserted that a corporation could not receive punishment, could not be outlawed, nor excommunicated for corporations 'have no souls, neither can they appear in person but by attorney.' The company is 'invisible, immortal and rests only in intendment and consideration of the law'. It is 'an abstraction, an impalpable thing and a metaphysical entity'.<sup>14</sup> Behind these statements is the implied rejection of the organic theory of the corporation. The conventional assumption of regulators, both judicial and legislative, was that only individuals, not groups, could be accountable for wrongdoing.<sup>15</sup>

As a consequence of this ethos, many legislative provisions were drafted specifically for natural persons (for instance, legislation in a number of jurisdictions defined homicide as the killing of a human being by another)<sup>16</sup> and corporations could not be convicted of

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a discussion of theory in this context, see SJ Stoljar, note 5, Ch 11 and see generally, PC Heerey, 'Corporate Criminal Liability - A Reappraisal', (1962) *UTLR* 677.

<sup>10</sup> *Continental Tyre & Rubber Co (GB) Ltd v Daimler Co Ltd* [1915] 1 KB 893, 916 per Buckley LJ.

<sup>11</sup> Lord Chancellor Thurlow, quoted in Paul Redmond, *Companies and Securities Law* (Sydney: LBC, 1988), at 136.

<sup>12</sup> Archbold, quoted in RS Welsh, 'The Criminal Liability of Corporations', (1946) 62 *LQR* 345.

<sup>13</sup> *Case of Suttons Hospital* (1612) 10 Co Rep 1.

<sup>14</sup> *Pharmaceutical Society v London and Provincial Supply Assoc* (1880) 5 AC 857, per Lord Blackburn.

<sup>15</sup> See, for instance, Eliezer Ledermann, 'Criminal Law, Perpetrator and Corporation: Rethinking a complex triangle', (1985) 76 *JCLC* 285.

<sup>16</sup> A company may, however, be convicted of manslaughter if a fine is the authorised penalty and the legislative definition of the crime includes companies: *R v Murray Wright Ltd* [1970] NZLR 476.



crimes which carried the penalty of imprisonment.<sup>17</sup> Both these difficulties are illustrated in *R v. Cory Bros & Co Ltd* [1927] 1 KB 810. During a coal strike directors of Cory Bros. & Co. erected a fence around the company power house to stop pilfering. The fence was electrified and an unemployed collier was killed when he stumbled accidentally against it. The company was prosecuted for his death, both on a charge of manslaughter and one of building a man trap or other engine calculated to kill or cause grievous bodily harm contrary to the *Offences Against the Persons Act* 1861 (UK) s. 31. For the reasons given above, however, Finlay J. (albeit with some reluctance) held that a corporation could not be guilty of either offence:

It is always a tempting argument to say that the common law ought to keep pace with modern developments and therefore it ought to be decided that these authorities are antiquated and that in 1927 they do not apply. Well, all I can say to that argument is that it may be that the law ought to be altered; on the other hand it may be that these authorities ought still to govern the law, but it is enough for me to say, sitting here, that in my opinion, I am bound by authorities, which show quite clearly that as the law stands an indictment will not lie against a corporation either for a felony or for a misdemeanour of the nature set out in the second count of this indictment.....(at 818)

The individualist bias of the law is also illustrated by the prioritisation of individual rights and obligations over the collective good in issues of punishment and enforcement. In issues of punishment, collective sanctioning was believed to be wrong because of the fear that the innocent, as well as the guilty would suffer.<sup>18</sup> In questions of enforcement, research has shown that civil actions have conventionally been, in the main, preferred to criminal ones by regulators.<sup>19</sup>

As a consequence of this individualistic, human bias, the Anglo-Australian legal system restricted corporate liability, particularly in criminal matters. As stated above, corporations could, and were found to be, vicariously liable in both tortious and criminal matters, although the situations where this could apply in criminal matters were somewhat more restricted than in tort. Under the common law, the general principle was that 'the law does not regard the master as having any such connection with acts done by his servant as will involve him in any criminal liability for them ...unless he has himself

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<sup>17</sup> *R v ICR Haulage Ltd* [1944] KB 551.

<sup>18</sup> See, for instance, Mueller, note 3.

<sup>19</sup> In Australia, there has been some criticism of the ASC's failure to pursue more criminal prosecutions of offenders. The Commonwealth Director of Public Prosecutions noted that the ASC saw themselves:

...as gentleman regulators. They see themselves as protecting the interests of the injured corporation or the disadvantaged shareholder, and they honestly believe that, if they impose a commercial penalty, then that by itself will act as a major deterrent to corporate crime. It will not. (Quoted by Tomasic, note 9, at 19).

actually authorised them or aided or abetted them.<sup>20</sup> There were, however, three accepted exceptions to this rule: common law offences of public nuisance<sup>21</sup> and criminal libel,<sup>22</sup> and certain statutory offences which were interpreted as imposing strict liability upon a company for the acts of its servants, whether authorised or not.<sup>23</sup> These latter offences arose primarily in the domain of social welfare laws, such as pure food and liquor licensing regulations:

Prima facie, then, a master is not to be made criminally responsible for the acts of his servant to which the master is not a party. But it may be the intention of the Legislature, in order to guard against the happening of the forbidden thing, to impose a liability upon a principal even though he does not know of, and is not party to, the forbidden act done by his servant. Many statutes are passed with this object. Acts done by the servant of the licensed holder of licensed premises render the licensed holder in some instances liable, even though the act was done by his servant without the knowledge of the master...In those cases the Legislature absolutely forbids the act and makes the principal liable without a *mens rea*.<sup>24</sup>

In an offence of strict liability, then, it was, of course, unnecessary to impute a state of mind to a corporation in order to attach liability. An illustration of this is to be found in *Moussell Bros. Ltd. v. London & North-Western Railway Co.* [1917] 2 KB 836. In this case, the *Railway Clauses Consolidation Act* 1845 (UK) s. 98, required the owners of goods conveyed by rail to give to the collector of tolls, on demand, an account of the number and quantity of the goods. Under s. 99, a fine would be imposed for the failure to do so 'with intent to avoid the payment of tolls'. The servants of Moussell failed to pay the tolls. The company argued that it was not liable. Atkin J noted that the general common law rule was that a company was not liable for the wrongs of its servants but proceeded to state that legislation may render a company liable if the duty it imposed was absolute. Whether a duty was absolute was a question of:

[T]he object of the statute, the words used, the nature of the duty laid down, the person upon whom it is imposed, the person by whom it would in ordinary circumstances be performed and the person upon whom the penalty is imposed. (at 845)

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<sup>20</sup> Welsh, note 12, at 348, quoting Raymond CJ.

<sup>21</sup> *R v Stephens* (1866) LR 1 QB 702.

<sup>22</sup> *R v Holbrook* (1878) 4 QBD 42; *R v Kellow* [1912] VLR 162.

<sup>23</sup> *Moussell Bros Ltd v London and North-Western Railway Company* [1917] 2 KB 836; *R v Australasian Films Ltd* (1921) 29 CLR 195; *Morgan v Babcock and Wilcox Ltd* (1929) 43 CLR 163; *Schenker and Co (Aust) Pty Ltd v Sheen* (1983) 48 ALR 693.

<sup>24</sup> *Moussell Brothers Ltd v London and North Western Railway Co* [1917] 2 KB 836, 840 per Viscount Reading. See also *R v Australasian Films* (1921) 29 CLR 195; *Ex parte Colonial Petroleum Oil Pty Ltd* (1944) 44 SR (NSW) 306.

After noting that this case was one where the duty was absolute, His Honour proceeded:

Once it is decided that this is one of those cases where a principal may be held liable criminally for the act of his servant, there is no difficulty in holding that a corporation may be the principal. No mens rea being necessary to make the principal liable, a corporation is in exactly the same position as a principal who is not a corporation.(at 845)

In addition to this vicarious liability, in certain cases, the common law attached primary liability to the company by imputing to it the intention or purpose of its controllers at the relevant time.<sup>25</sup> This became known as the identification theory or organic theory of the corporation:

A corporation ...must act through living persons, though not always one or the same person. Then the person who acts is not speaking or acting for the company. He is acting as the company and his mind which directs his acts is the mind of the company...He is an embodiment of the company...he hears and speaks through the persona of the company...and his mind is the mind of the company. If it is a guilty mind then that guilt is the guilt of the company.<sup>26</sup>

Here, then, was a way in which the corporation, an entity without a soul, could be held morally responsible for its wrongs. The corporation was 'reconstructed' as a human individual, with a mind, an ego and a body. This approach is illustrated by *Lennard's Carrying Co Ltd v. Asiatic Petroleum Co. Ltd* [1915] AC 705, in which a ship's cargo was lost because of the vessel's unseaworthy condition. The ship owners and managing owners were both limited companies. Lennard was the managing director of the latter. He knew (or ought to have known) of the ship's unseaworthiness but took no steps to prevent the vessel putting to sea. When the cargo owners sued, the shipowners relied on the *Merchant Shipping Act* 1894 (UK) s. 502, which provided that the owner of a British Ship would be exempted from liability for 'any loss or damage [to cargo] happening without his actual fault or privity'. It was held by the House of Lords that the company could not rely on the section in the absence of evidence rebutting the presumption of liability:

...a corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation...

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<sup>25</sup> *FCT v Whitfords Beach Pty Ltd* (1982) 39 ALR 521; *DPP v Kent and Sussex Contractors Ltd* [1944] 1 KB 146; *Moore v I Bresker Ltd* [1944] 2 All ER 575; *Tesco Supermarkets Ltd v Natrass* [1972] AC 153; *Universal Telecasters (Qld) Ltd v Guthrie* (1977) 15 ALR 439. On the *Tesco* doctrine, see *Collins v State Rail Authority of NSW* [1986] 5 NSWLR 209; *Nordick Industries Ltd v Regional Controller of Inland Revenue* [1976] 1 NZLR 194; *Canadian Dredge and Dock Co Ltd v the Queen* (1985) 19 CCC (3d) 1; *Kehoe v Dacol Motors Pty Ltd* [1972] Qd R 59.

<sup>26</sup> *Tesco Supermarkets Ltd v Natrass* [1972] AC 153, 170, per Lord Reid.

It must be upon the true construction [of s. 502] ...that the fault or privity is the fault or privity of somebody who is not merely a servant or agent for whom the company is liable upon the footing respondeat superior, but somebody for whom the company is liable because his action is the very action of the company itself.(at 713-714)<sup>27</sup>

The identification theory and its limits were considered in *Tesco Supermarkets Ltd v. Nattrass* [1972] AC 153. In this case, Tesco owned a chain of supermarkets. It reduced a certain washing powder in price as a special offer and posters in its shops advertised this reduction. A pensioner went to one of Tesco's supermarkets to buy a packet of the powder but could only find those packets marked at the original price. When he asked the cashier for the reduced price, he was told that only the higher priced items were in stock. He complained to the inspector of weights and measures who brought a prosecution under the *Trade Practices Act* 1968 (UK). It was a defence to the charge under s. 24 (1) if it could be shown that the offence was committed due to 'a mistake or reliance on information supplied to him or through the act or default of 'another person...' or (b) that he took all reasonable precautions...'. In this case, a shop assistant had put out the packs at the regular price and ought to have told the shop manager but did not. The shop manager did not pick up the error. The issue was whether the shop manager was 'another person' to the company; and whether the 'he' in s. 24(b)(1) referred to the shop manager or to the company. In delivering his judgment, Lord Reid quoted from the judgment of Denning L.J. in *H.L. Bolton (Engineering) Co. Ltd. v. T.J. Graham & Sons Ltd.* [1957] 1 QB 159, 172 who said:

A company may in many ways be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with the directions from the centre. Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.

Lord Reid proceeded to note that the board, the managing director and some other superior officers of the company speak and act as the company, but ordinarily subordinates do not. However, in some cases the board might delegate some of its functions and give the delegate full discretion to act independently of instructions from them. He proceeded to note, at 171-2 that:

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<sup>27</sup> The identity doctrine has been applied in a number of merchant shipping cases. See, for instance, *The Garden City* [1982] 2 Lloyd's Rep 382; *The Lady Gwendolen* [1965] P 294.

In some cases the phrase alter ego has been used. I think is misleading. When dealing with a company the word alter is I think misleading. The person who speaks and acts as the company is not alter. He is identified with the company. And when dealing with an individual no other individual can be his alter ego. The other individual can be a servant, agent, delegate or representative but I know of neither principle nor authority which warrants the confusion (in the literal or original sense) of two separate individuals.

These means of attaching liability to the corporation have, however, attracted some criticism. In regard to vicarious liability, it has been acknowledged that the range of crimes capable of being committed vicariously is narrow. In regard to the identification theory, the application of that theory is relatively unproblematic where the mental state of the majority shareholder or director is imputed to the corporation<sup>28</sup> but becomes more difficult where the corporate officer at fault cannot be said to be the 'alter ego' of the company.<sup>29</sup> Management may restrict its activities to policy making, however, and delegate much of its decision-making power to subordinates. Thus, in appropriate circumstances, those to whom the directors have delegated management of the company must be found to be 'controllers' for the purposes of attaching liability. In *Canadian Dredge & Dock Co Ltd v. The Queen* (1985) 19 DLR (4th) 314,<sup>30</sup> this problem led the Court to criticise the *Tesco* doctrine in the following terms:

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<sup>28</sup> *Bernard Elsey Pty Ltd v FCT* (1969) 121 CLR 119.

<sup>29</sup> Some legislation provides that, where it is necessary to establish the state of mind of a corporation, it is sufficient to show a director/servant or agent of the company had the requisite state of mind, being a director/servant or agent by whom the conduct was engaged in within the scope of their actual or apparent authority. See, for example, *Proceeds of Crime Act* 1987 (Cth); *Fair Trading Act* 1985 (Vic) s 39 (1). The *Tesco* doctrine has also been extended by cases which have held that the necessary state of mind need not be of any one individual. Rather, a company may have knowledge which is a composite of different pieces of knowledge possessed by different individuals: *Brambles Holdings Ltd v Carey* (1976) 15 SASR 270; 2 ACLR 176. By virtue of the application of the separate entity doctrine, it is also possible for a company to aid and abet its manager or vice versa. See *Lewis v Crafter* [1942] SASR 30; *R v Goodall* (1975) 11 SASR 94; *Hamilton v Whitehead* (1989) 7 ACLC 34. In *Hamilton*, a company was charged with six offences under the *Companies Code* (WA) ss 169 and 174 in relation to the issue of prescribed interests. The manager of the company had placed the offending advertisement and dealt with those who replied to it. He was found to have aided and abetted the company. It was said at 101 that:

...the logical consequence of *Saloman's Case* ...is that the company, being a legal entity apart from its members, is also a legal person apart from the legal personality of the individual controller of the company, and that he in his personal capacity can aid and abet what the company speaking through his mouth or acting through his hand may have done.

<sup>30</sup> In this case, a company was charged with conspiracy to defraud arising out of bid-rigging of dredging contracts. The bid-rigging was performed by the officers of each corporation in charge of the dredging operations, and in each case were president, vice-presidents or general managers of the relevant corporations.

The identity doctrine merges the board of directors, the managing director, the superintendent, the manager or anyone else delegated by the board of directors to whom is delegated the governing executive authority of the corporation and the conduct of any of the merged entities is thereby attributed to the corporation....[A] corporation may, by this means, have more than one directing mind. This must be particularly so in a country such as Canada where corporate operations are frequently geographically widespread. The transportation companies, for example, must of necessity operate by the delegation and subdelegation of authority from the corporate centre; by the division and subdivision of the corporate brain, and by decentralising by delegation the guiding forces in the corporate undertaking. The application of the identification rule in *Tesco* may not accord with the realities of life in our country, however appropriate we may find to be the enunciation of the abstract principles of law there made. (at 336-7)<sup>31</sup>

A further criticism that has been made of the current means of establishing corporate liability is that, in Australia, there has been some tendency to confuse the two types of liability. For instance, in *Morgan v. Babcock and Wilcox Ltd* (1929) 43 CLR 163 at 173-4, Knox C.J. and Dixon J. said:

An offence involving corrupt intention can be committed by a corporation only through a servant or agent who, with the necessary mens rea, does or causes to be done, the forbidden act for and on behalf of the corporation acting within the course of his employment or authority.

There are thus two lines of authority: one that holds that there are two distinct forms of liability,<sup>32</sup> and another that holds that a corporation may be criminally liable for the acts of its agents and employees committed in the course of their employment or authority.<sup>33</sup>

#### **Of information and immortality: The possibility of corporate liability**

In the modern context, the reality of corporate wrongdoing is evident in a number of areas and the individualistic bias of the law would appear to be outdated:

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<sup>31</sup> There have been some attempts to place liability upon middle managers. See *Kehoe v Dacol Motors Pty Ltd; Ex parte Dacol Motors Pty Ltd* [1972] Qd R 59; *Brambles Holdings Ltd v Carey* (1976) 15 SASR 270; *Wells v John R Lewis (Int'l) Pty Ltd; Wells v Spaton* (1975) ATPR 40-007; *Hamilton v Whitehead* (1989) 7 ACVLC 34.

<sup>32</sup> *Grain Sorghum Marketing Board v Supastok Pty Ltd* [1964] Qd R 98; *Ex parte Falstein* (1948) 49 SR (NSW) 133; *Charlesworth v Penfold Wines Pty Ltd* [1943] VLR 76; *Fraser v Dryden's Carrying and Agency Co Pty Ltd* [1941] VLR 103.

<sup>33</sup> *Australian Stevedoring Industry Authority v Oversea and General Stevedoring Co Pty Ltd* (1959) 1 FLR 298; *Alford v Riley Newman Ltd* (1934) 34 SR (NSW) 261; *R v Police Magistrate at Brisbane* [1924] St R Qd 223.

When the law was forming, it was individual, identifiable persons who trespassed, created nuisances, engaged in consumer frauds. The law responded with contemporary notions about individuals - what motivated them, terrified them, and constituted justice toward them. Later, as corporations became the dominant vehicle for social action, only rarely did the law meet with specifically tailored adaptations. Since a body of law addressed to 'persons' already existed, it was simply transferred to corporations without distinction.

Today's giant corporations, however, are much more than persons who just happen to be especially large and powerful. They are complex sociotechnical organisms - not just men, or even men-and-machines-groups, but men, machines, patterns of reward, ways of doing things, all divided up onto loosely coordinated clusters of cells. There is no reason to believe (as the law implicitly does) that the way 'it' will respond and adapt to external threats, the way 'it' will calculate and weigh 'its' pleasures against 'its' pains is like that of an actual person.<sup>34</sup>

Grabosky and Sutton<sup>35</sup> present a series of case studies of corporate crime and harm in Australia, ranging from environmental degradation (lead pollution at Port Pirie) through health issues (the Dalkon shield, asbestos mining) and commercial fraud (the collapse of Bishopgate insurance; bottom of the harbour tax evasion schemes and MBF fraud). The prevalence and seriousness of corporate harm stresses the inadequacy of the current regulatory scheme and the necessity for an expanded conception of collective responsibility.

Rousseau argued that corporations are distinct moral entities from the individuals that compose them. His theory is based upon the contention that a corporation can be something more than the mere sum of individuals that comprise it:

As soon as the act of association becomes a reality, it substitutes for the person of each of the contracting parties a moral and collective body made up of as many members as the constituting assembly has votes, which body receives from this very act of constitution its unity, its dispersed self, and its will.<sup>36</sup>

This collective entity has interests, powers, limitations obligations and rights that may be distinguished from its members. A number of modern commentators appear to provide support for such a view. Far from being incapable of moral action, one analyst, for instance, has argued that corporations are, in fact, paradigm moral agents:

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<sup>34</sup> Christopher Stone, quoted by Tomasic, note 9, at 5.

<sup>35</sup> Peter Grabosky and Adam Sutton, (eds) *Stains on a White Collar* (Sydney: Hutchinson, 1989).

<sup>36</sup> SC I:vi.

Not only does the organisation have all the capacities that are standardly taken to ground autonomy - vis. capacities for intelligent agency - but it also has them to a degree no human can. Thus, for example, a large corporation has available and can make use of, far more information than one individual can. Moreover, the corporation is in principle, 'immortal' and so better able to bear responsibility for its deeds than humans whose sin dies with them.<sup>37</sup>

The increased interest in, and understanding of, corporate organisation has led to an awareness of the feasibility and desirability of collective responsibility. Fisse and Braithwaite, for instance, argue that both persons and corporations are a mix of observable and abstract characteristics. The reductionism inherent in the individualist theory is limited because the whole, they claim, is always more than the sum of parts. Thus, regulators should concentrate upon the way in which the parts interact to form wholes.<sup>38</sup> Against the argument that corporations cannot be shown to have the requisite *mens rea* to commit a crime, Fisse and Braithwaite argue that corporate policy is analogous to human intention. On this point, they quote Peter French:

It will be objected that a corporation's policies reflect only the current goals of its directors. But that is certainly not logically necessary or is it in practice true for most large corporations. Usually, of course, the original incorporators will have organized to further their individual interests and/or to meet goals which they shared. [But] even in infancy the melding of disparate interests and purposes gives rise to a corporate long range point of view that is distinct from the intents and purposes of the collection of incorporators viewed individually.<sup>39</sup>

This view may be seen as a logical extension of the organic theory. Other commentators have argued for corporate responsibility on a variety of different bases. The Chicago School, for instance, favours punishing the corporation on a deterrence basis: if the penalties imposed on the firm are sufficient to deter it, it will take internal corrective measures to prevent misconduct by its agents for which it is legally responsible.<sup>40</sup> From a psychological viewpoint, too, it can be reasoned that a corporation is more than the sum of individuals belonging to it. Coffee discusses, for instance, the 'risky shift' that occurs in groups: that is, business people in role plays will make 'riskier' decisions

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<sup>37</sup> M McDonald, 'The Personless Paradigm' (1987) 37 *U Toronto LJ* 212, at 219-220.

<sup>38</sup> As an example of this, Fisse and Braithwaite, note 1, at 480, suggest that 'the corporation', like the term 'the White House', is merely 'short-hand' for a complex organisational process.

<sup>39</sup> *Id.*, at 483.

<sup>40</sup> R Posner, *Economic Analysis of Law* (2nd ed) (Boston: Little Brown, 1977), at 165-7.



when acting in a small group than when acting alone.<sup>41</sup> This implies that individuals function differently when in groups. From a different perspective, Stoljar argues for corporate liability on the basis that the rationale for the imposition of primary liability is the fact that in some cases, no one person can be identified as at fault. If this were to be the case, liability must be assumed by the corporation as a whole.<sup>42</sup> In *London Association for Protection of Trade v. Greenlands* [1916] 2 AC 15 and *Campbell v. Thompson* [1953] 1 QB 445, the associations in question were held liable because of the common interests of their respective members. In the latter case, the judge held only the existing members liable. As Stoljar points out, this is not necessary if the association is held liable:

Unless persons acting in concert as joint tortfeasors, or act as principals or accessories in crime, they cannot as a group *commit* a tort or criminal offence, whether the group is incorporated or not. And to this extent the traditional doctrine of the delictual incapacity of a corporation cannot but be strictly and profoundly true. On the other hand, a group of persons may *incur* certain liabilities, of a pecuniary or compensatory kind, where the group engages in an enterprise or activities which are lawful but which in their execution of management may either cause an injury to another or may constitute a statutory (criminal) offence....though the distinction between committing a wrong and incurring a liability may sometimes look extremely fine, this second type of liability does not actually conflict with the first. For in the latter case, the members are not submitted to any kind of personal responsibility, whether several or joint, including the sanctions such individual responsibility involves. Rather, the members incur an, as it were, diminished or derivative liability that penalizes them only through their common fund.<sup>43</sup>

Rousseau's theory is valuable, in any discussion of corporate liability for wrongdoing, for providing the conditions necessary for the imposition of collective responsibility. His model highlights the fact that, in demanding such accountability, regulators must take care to distinguish clearly between an act of the corporation and one executed by an officer or employee of the corporation in his or her own interests. If we extend Rousseau's theory to the corporation, a wrongful act is that of the company, and hence attracts corporate liability, in one of two ways: If it is an act of the sovereign, that is; an act of the people acting in concert according to the general will; or if it is the act of the directors (who, under the theory, are merely agents of the company as a whole) acting in their administrative capacity, and in accordance with the general will. What makes a will

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<sup>41</sup> See, for instance, M Shaw, *Group Dynamics: The psychology of small group behaviour* (2nd ed) 1976.

<sup>42</sup> Stoljar, note 5, at 160.

<sup>43</sup> Id, at 172.

general is '... the common interest by which [the members of the group] are united.'<sup>44</sup> Therefore, if a wrongful act is done in pursuance of corporate goals, primary liability would attach to the corporation. A company would not, however, assume primary liability for an act if that act were to be done by a director, company member, or group within the company motivated by a particular private interest.

Again, there is some modern support for this view. In a similar vein, Fisse and Braithwaite argue for corporate ethos as a standard for corporate criminal responsibility. On this view, a corporation can be convicted where it can be shown that its ethos, or its corporate practices and policies, have encouraged the commission of the criminal act.<sup>45</sup>

A decision made by a rogue individual in defiance of corporate policy (including unwritten corporate policy) to undermine corporate goals, or in flagrant disregard of corporate decision making rules, is not a decision for which the organisation is morally responsible...Even though the key individuals do not personally intend to further corporate policy by the decision, it may be that they cannot secure the acquiescence of the rest of the organisation with the decision unless they can advance credible reasons as to why the decision will advance corporate policy. If the reasons given are accepted and acted on within the corporate decision-making process, then we can hold the corporation responsible irrespective of any games played by individual actors among themselves. It is not just that corporate intention ... is more than the sum of individual intentions, it may have little to do with individual intentions.<sup>46</sup>

A similar view was also adopted in *Canadian Dredge & Dock Co Ltd v. The Queen* (1985) 19 DLR (4th) 314. It was argued that the identification theory applied in the *Tesco Case* could not import into the criminal law a brand of vicarious liability where the wrongful acts of the directing mind were done, *inter alia*, in fraud on the employer, or for the benefit of the employee:

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<sup>44</sup> SC II: iv.

<sup>45</sup> See also Lim Wen Ts'ai, note 4; PH Bucy, 'Corporate Ethos: A standard for imposing corporate criminal liability' (1991) *Minn L Rev* 1095; A Foerschler, 'Corporate Criminal Intent: Toward a better understanding of corporate misconduct', (1990) 78 *California LR* 1287.

<sup>46</sup> Fisse and Braithwaite, note 1, at 484. It is to be noted, too, that individuals may act out of loyalty to a small group within the corporation which they identify. This is discussed at greater length by Coffee who notes that in a case where a large chemical corporation dumped substantial quantities of mercury into the Niagara River, the immediate motivation was the plant manager's fear that compliance with government regulations would have caused the corporation to close down its obsolete plant because the expense of the new equipment could not be justified. John C Coffee, 'No Soul to Damn: No Body to Kick: An unsandalized Inquiry into the Problem of Corporate Punishment', (1981) 79 *Michigan LR* 386, at 396, fn 37.

In my view, the outer limit of the delegation doctrine is reached and exceeded when the directing mind ceases completely to act, in fact or in substance, in the interests of the corporation. Where this entails fraudulent action, nothing is gained from speaking of fraud in whole or in part because fraud is fraud. What I take to be the distinction raised by the question is where all of the activities of the directing mind are directed against the interests of the corporation with a view to damaging that corporation, whether or not the result is beneficial economically to the directing mind, that may be said to be fraud on the corporation. Similarly, but not so importantly, a benefit to the directing mind in single transactions or in a minor part of the

activities of the directing mind is in reality quite different from benefit in the sense that the directing mind intended that the corporation should not benefit from any of its activities in its undertaking. A benefit of course, can, unlike fraud, be in whole or in part, but the better standard, in my view, is established when benefit is associated with fraud. The same test then applies. Where the directing mind conceives and designs a plan and then executes it whereby the corporation is intentionally defrauded, and when this is the substantial part of the regular activities of the directing mind in his office, then it is unrealistic in the extreme to consider that the manager is the directing mind of the corporation. His entire energies are, in such a case, directed to the destruction of the undertaking of the corporation. When he crosses that line he ceases to be the directing mind and the doctrine of identification ceases to operate...

Therefore, His Honour reasoned that:

[T]he identification doctrine only operates where the Crown demonstrates that the action taken by the directing mind (a) was within the field of operation assigned to him; (b) was not totally in fraud of the corporation, and (c) was by design or result partly for the benefit of the company.

...Where the corporation benefited or was intended to be benefited from the fraudulent and criminal activities of the directing mind, the *rationale* of the identification rule holds. Where the delegate of the corporation has turned against his principal, the *rationale* fades away. (at 351-356)<sup>47</sup>

A number of judicial and academic commentators, then, have acknowledged the possibility and desirability of corporate liability. There are, however, problems with establishing corporate liability. The first has been canvassed - that of the individualistic philosophical basis of the law. This is well-entrenched. Not only does this influence the law substantively and procedurally, but it has also tended to prioritise commercialism and ethical egoism over the common welfare. Even in the United States, where it has long been accepted that corporations are vicariously liable for the acts of their employees, whatever grade,<sup>48</sup> the imposition of corporate liability has attracted criticism:

The criticisms of the United States federal court doctrine are manifold. The net is flung too widely, it is said. Corporations are punished in instances where there is neither moral turpitude nor negligence. No public policy is served by punishing shareholders where the corporate governing body has been guilty of no unlawful act. The disparity between the treatment of the corporate employer and the natural employer is wide and wholly without basis in justice or political science....

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<sup>47</sup> See also *Belmont Finance Corporation Ltd v Williams Furniture Ltd* [1979] Ch 250.

<sup>48</sup> See, for instance, *New York Central and Hudson R v US* 212 US 481 (1909).

In the criminal law, a natural person is responsible only for those crimes in which he is the primary actor either actually or by express or implied authorisation. There is no vicarious liability in the pure sense in the case of the natural person....<sup>49</sup>

The second difficulty to overcome is that of determining the appropriate penalty for a corporation. As outlined above, punishment has been traditionally considered in individualistic and human terms. The punishment currently most frequently imposed upon a corporation is a fine. However, setting the appropriate level of fine is exceedingly difficult: the fine must be sufficient to counter realisable profit but a fine which is sufficient to achieve a deterrent effect would in many cases bankrupt the corporation. Thus, the sanction may, in practice, bear little relation to the harm inflicted or profits made by the breach.<sup>50</sup> There are, however, alternative punishments that are suited to the imposition of collective liability. These include a system of equity fines,<sup>51</sup> the use of adverse publicity orders,<sup>52</sup> corporate probation,<sup>53</sup> and community service orders.

The reluctance to prioritise the well-being of the state over the pursuit of profit can be directly linked, as noted earlier, to ideas of ethical egoism which arose in the nineteenth century. If pursuit of self-interest leads inexorably to the good of all, then there is no requirement for state control. The 'invisible hand' will ensure the common good.

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<sup>49</sup> *Canadian Dredge & Dock Co Ltd v The Queen* (1985) 19 DLR (4th) 314.

<sup>50</sup> As Peter Grabosky and Adam Sutton, note 35, at 257, observe:

Even in light of the paucity of sentencing options available to them, Australian judges and magistrates have shown a general lack of imagination in responding to corporate offenders. A fine of less than \$1000 imposed on the Australian subsidiary of a multinational company could hardly be expected to have much effect on the offender's subsequent behaviour.

<sup>51</sup> An equity fine is the allocation of a quantity of company shares to a public entity or those actually or potentially injured by wrongs committed by the company. Coffee, note 46, at 420, observes that the advantages of such action are that the overspill of corporate penalties to workers and consumers is reduced; the costs of deterrence are concentrated on the stockholder; higher penalties can be imposed; there is little impact on employees, creditors and suppliers; and the cost of the fine is less likely to be passed on to the consumers.

<sup>52</sup> Coffee, note 46, at 425 argues against adverse publicity on the bases that the government tends to be poor at publicity; such publicity may be drowned out by the great amount of criticism of corporations that exists; and corporations can dilute the effect of such publicity by counter-publicity. See also B Fisse, 'The use of Publicity as a criminal sanction against business corporations', (1971) 8 *MULR* 107.

<sup>53</sup> Corporate probation orders involve the idea that a corporation found to be guilty of a significant offence should have one or more outside directors appointed, perhaps from within regulatory authorities. Such directors would have responsibility for reforming communication channels within corporations so as to ensure that those who delegate authority to lower levels of management are aware of the activities of such delegates. This is to counter the tendency to use corporate channels of communication to shield decision makers from knowledge of wrongdoing.

Rousseau was adamant, in contrast, that an individual can only be permitted to pursue his interests insofar as those interests do not conflict with those of the company; and, in turn, the company can only pursue its interests<sup>54</sup> insofar as these interests do not conflict with the interests of the state:

Every political society is composed of other smaller societies of different kinds, each of which has its interests and its rules of conduct...The will of these particular societies has always two relations: for the members of the association, it is a general will; for the great society it is a particular will; and it is often right with regard to the first object and wrong as to the second...A particular resolution may be advantageous to the smaller community, but pernicious to the greater.<sup>55</sup>

In the Australian corporate context, the regulation of corporate crime has been much criticised. For instance, noting that research establishes that 'the vast majority of Australian business regulators prefer the gentler means of friendly persuasion', Grabosky and Sutton point to the inadequacy of the law, inadequate penalties, co-option of the enforcement agency by the industry which it oversees or inadequate resources available to the agency either because of administrative incompetence or political forces.<sup>56</sup>

The third difficulty, and one that is firmly entrenched, is the acceptability of shareholder passivity. Rousseau's theory places considerable emphasis upon the active political participation of all members of the association. Passivity was, he believed, the signifier of a decaying association. Our current regulatory scheme, in fact, encourages shareholder passivity in a number of ways, not least in the fact that the law is reluctant to punish the company on a collective basis. The traditional view of collective punishment is that the innocent as well as the guilty may be made to suffer. If, however, shareholder passivity has allowed a corporation to commit wrongdoing, is it so unjust that the shareholder is, albeit indirectly, punished? In response to the criticism that innocent shareholders will suffer if a corporation is penalised, the Court in *Canadian Dredge* said:

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<sup>54</sup> A notable piece of legislation in Australia that has upheld corporate responsibility, placing the well-being of consumers above that of commercialism, is the *Trade Practices Act 1974* (Cth). It is also to be noted that the power and wealth of corporations (discussed more fully in the next chapter) can hinder corporate criminal regulation. Tomasic, note 9, at 3, observes that:

By the use of some of the best lawyers, accountants and other advisers, corporations have been very skilled in persuading corporate regulatory bodies and legislators to redefine the character of corporate criminal conduct by resort to processes of negotiation, the use of protracted legal proceedings or by making some concession to the law enforcement agency which does not lead to any criminal action being taken.

<sup>55</sup> 'Discourse on Political Economy', at 253-254.

<sup>56</sup> Peter Grobosky and Adam Sutton, note 39, at xv.

The corporation which set the directing mind in position to do the wrong will suffer an economic penalty. While it is true that this penalty will feed through to the stockholders, who may well be totally innocent as in the case of a large public company, it may be seen as a risk or cost associated with the privilege of operating through the corporate vehicle. In the case of personal corporations, the imposition of a criminal penalty on the corporation may be an additional penalty imposed upon the 'personal' corporate stockholder but such a result would be an acceptable part of the sentencing process as it simply reflects the economic identification, as well as the legal identification, present in such a corporation. In the case of a public corporation, the economic identification factor is absent, and in a theoretical sense there is an additional penalty for the same act which must be justified in some way other than that suggested above. This is the inevitable result of the pragmatic adoption of the attribution of the acts of its delegates to the delegating corporation in order to bring that corporation within the system of criminal justice...The corporation in reality has three elements; the legal entity, the personal shareholder...and the employee. Once the process is set in motion, the criminal penalty will extend directly or indirectly to all three which is quite unlike the situation of a natural proprietor where only two of these elements are present. All this, in my view, while not entirely logical, is a tolerable result for a community where reality dictates corporate criminal accountability in certain circumstances.<sup>57</sup>

## Conclusion

To many commentators, the imposition of corporate liability has been inadequate. Tomasic, for instance, notes that:

...the historical bases of corporate criminal law have been such that notions of corporate criminal responsibility in the law have failed to come to terms to [sic] the nature of the modern complex corporation, whether this involves the corporate group structure or decision making processes within the corporation itself.<sup>58</sup>

This failure to come to terms with the modern complex corporation stems, I have argued, from a failure to relinquish the inherent bias toward individualistic theories of liability insofar as these underpin our conception of wrongdoing and our conceptions of enforcement and punishment. Rousseau's theory is valuable here for its acknowledgment of the possibility of corporate responsibility; its adherence to the distinction between corporate acts and private acts; its emphasis upon the need to tailor the association to the needs of its members; and for its realisation of the dangers of passive membership of the association. I turn now to consider a related problem: that of the responsibility of companies to the wider society.

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<sup>57</sup> *Canadian Dredge Dock Co Ltd v The Queen* (1985) 19 DLR (4th) 314, 337.

<sup>58</sup> Tomasic, note 9, at 12.

## CHAPTER 10

# THE ROLE OF THE COMPANY IN THE WIDER SOCIAL ENVIRONMENT

### Introduction

In previous chapters, I have discussed the ways in which our views of corporations and their purposes have been moulded by the western liberal tradition. A number of assumptions and values which may be traced to Locke and Hobbes are of particular significance in the area of corporate social responsibility. In particular, it is important to note the confusion between private interests and public interests engendered by these values and assumptions. As discussed in Chapter 3, companies were originally formed on a concessional basis, that is, the privilege of incorporation was granted so that certain public goals might be achieved or public interests served. In time, however, the public good came to be identified with, and ultimately confused with, private commercial interests. In the corporate context, this development is reflected in the fact that corporate goals were, and to a large extent, have continued to be, limited to the single objective of profit maximisation:

The market model offers a rigorously consistent and intellectually neat view of the corporation. It views the corporation not simply as an institution but more a set of rules that provides for sufficient exchanges. The corporation serves as an efficient substitute for the more costly and time-consuming means of doing business through multiple contractual arrangements. Of course, this arrangement has a purpose: to transact business efficiently, which under this model, means the maximisation of profits.<sup>1</sup>

This view has limited corporate action, in the main, to the pursuit of profit at the expense of other social considerations. The validity of this limitation is questionable, particularly in the modern context where it can be viewed as an oversimplification: Corporations today may have any number of goals, not necessarily restricted to the single-minded pursuit of profit. With the trend towards so called 'ethical investment', shareholders may wish to further environmental goals (the production, for instance, of 'green' products or eco-tourism).<sup>2</sup> On the other hand, management may aspire to model industrial or

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<sup>1</sup> Donald Schwartz, 'Defining the Corporate Objective: Section 2.01 of the ALI's Principles', (1984) 52 *Geo Washington LR* 511, at 523.

<sup>2</sup> See also the attempts by groups of American shareholders to force companies to pursue social objectives, often at the expense of profits. One such instance is the *Dow* case where shareholders tried to change the company constitution to prevent its sales of napalm. The Court in *Medical Committee for Human Rights v SEC* 432 F 2d 659 (DC



consumer relations policies.<sup>3</sup> There are, however, a number of problems associated with any theory advocating increased corporate social responsibility. The first is that of disenfranchisement of shareholders. Provided that the interests of management and shareholding coincide, there is little problem in the company furthering ethically-based common purposes. With the schism, however, that developed in the early twentieth century between management and ownership, the limitations of the conventional model became readily apparent. Empirically, shareholders who wish to further social goals may have little effective control over management. The second problem is the converse of the first: Doctrinally, management can be restricted by shareholders to the pursuit of profit in the exercise of the board's powers. A third dilemma, and one more directly attributable to the assumptions and values of the received liberal model, is that some corporations will attempt to pursue the goal of profit to the detriment of social well-being. Dahl,<sup>4</sup> for example, argues that corporate activities have ignored social costs, such as environmental degradation, consumer protection and industrial relations. In effect, some corporations have become 'demi-states' whose managers are not accountable to the people they affect. This problem is, of course, magnified in the case of multinational corporations. In this chapter, I shall use Rousseau's theory to provide some insight into the problems of expanded corporate responsibility in the absence of specific state (or indeed, international) action. For the purposes of this chapter, the term 'corporate social responsibility' is used:

[T]o denote the obligations and inclination, if any, of corporations organized for profit, voluntarily to pursue social ends that conflict with the presumptive shareholder desire to maximise profit.<sup>5</sup>

I shall argue that it is not possible for the corporation to voluntarily assume greater social responsibility from within. I shall begin by outlining Rousseau's principles of obligation, before proceeding to examine the present doctrinal and empirical limits on the exercise of corporate social responsibility.

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Cir 1970) considered that it was proper for shareholders to take such action even though this had a detrimental effect on profits.

<sup>3</sup> This is not to suggest, however, that the definition of corporate goals in terms of profit maximisation has not been pervasive in modern times. See, for instance, the works of Milton Friedman, such *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962).

<sup>4</sup> R Dahl, *After the Revolution? Authority in a Good Society* (New Haven: Yale University Press, 1970), at 115-40.

<sup>5</sup> David L Engel, 'An approach to corporate social responsibility', (1979-80) 32 *Stan L Rev* 6. In explicit opposition, however, to Engel, I use this definition to include the problem of disenfranchisement and doctrinal limitations upon management because I believe that the latter prevent the corporation from voluntarily assuming greater social responsibility. Rousseau's analysis highlights very similar problems in each case.

## Rousseau and obligation

As has been discussed, company law developed primarily in the nineteenth century, although much of its philosophical genesis had developed earlier. In the nineteenth century, it was largely assumed that the pursuit of the individual self-interest would inexorably lead to the common good.<sup>6</sup> Rousseau, on the other hand, recognised that the objective good of the corporation must be distinguished from, and indeed, is often at odds with, the objective good of the society within which it operates:

Every political society is composed of other smaller societies of different kinds, each of which has its interests and its rules of conduct;...The influence of all these tacit or formal associations cause, by the influence of their will, as many different modifications of the public will. The will of these particular societies has always two relations; for the members of the association, it is a general will; for the great society, it is a particular will; and it is often right with regard to the first object and wrong as to the second...A particular resolution may be advantageous to the smaller community, but pernicious to the greater.<sup>7</sup>

Rousseau maintained that, for the proper functioning of a democratic state, the will of the particular society (in this case the corporation) must always be subordinate to the will of the greater society. The duty of the citizen must always take precedence<sup>8</sup> over other obligations. In this recognition of the precedence of the responsibility of citizen, Rousseau's theory may be distinguished from Lockean-based theories of obligation which provided that the duty to preserve others only came into play only where self-preservation was not in issue. It is the latter model that served as a basis for the traditional model of corporate governance:

The contract model makes descriptive as well as prescriptive claims: the law recognizes the right of shareholders to demand management be strictly constrained by profit motivation; private property and contract rights ought to be respected even where they run counter to the public interest.<sup>9</sup>

Although Rousseau recognised the overriding importance of the obligations of citizenship, he also recognised that individuals are inevitably 'seduced' by their private interests, and then:

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<sup>6</sup> This was partially a result, of course, of Adam Smith's thesis of the 'invisible hand' of the market, but it is notable that Smith was highly suspicious of joint stock companies. See further, Adam Smith, *Wealth of Nations* (New York: Modern Library, 1937).

<sup>7</sup> SC III:xi.

<sup>8</sup> SC III:xi.

<sup>9</sup> R Collin Mangrum, 'In Search of a Paradigm of Corporate Social Responsibility', (1983) 17 *Creighton LR*, 21, at 30.

...the body of society is really divided into other bodies, the members of which acquire a general will, which is good and just with respect to these new bodies, but unjust and bad with regard to the whole, from which each is thus dismembered.<sup>10</sup>

Rousseau's theory highlights the inherent tension underlying the issue of corporate social responsibility. The duty to act for the good of the society must prevail over the duty to act for the good of the particular association but the inevitable tendency of individuals to act in self-interest must be controlled by state (or, as shall be discussed, international) action.

### **Ownership v. management: limits on corporate social responsibility**

In contrast, both doctrinally and empirically, the ability for corporations to further socially responsible goals under our received model of regulation has been hindered. This situation originates in the separation of ownership and management. The result of this separation is the loss of connection between the individual shareholder and the destiny of his or her savings and, correspondingly, a lack of political control over management. A considerable body of research has noted that, primarily since the Second World War, patterns of share ownership have changed dramatically.<sup>11</sup> The status of the shareholder in public companies has shifted from owner to investor and, in turn (as the number of individual investors has declined and there has been a corresponding rise in institutional investors) the status has shifted again from investor to mere beneficiary.<sup>12</sup> Along with this change in the nature of ownership the development of the contractual

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<sup>10</sup> SC III:xi.

<sup>11</sup> This divorce of ownership and control led to the well-known debate between 1931 and 1942 between Professors Berle and Dodd on the issue of 'For whom are Corporate Managers Trustees?'. Although Professor Berle argued at the outset that corporate managers were trustees for the shareholders, he later conceded that Professor Dodd's argument, that management powers were now held in trust for the entire community, was the preferable one. This changed stance was largely due to the decision in *AP Smith Manufacturing Co v Barlow* 13 NJ 145, 153-54 98 A 2d 581, 586 (1953) in which the New Jersey Supreme Court justified a corporate charitable contribution on the basis of the corporation's service to charity. See A Berle, 'Corporate Powers as Powers in Trust', (1931) 44 *Harv LR* 1049, and 'For Whom are Corporate Managers Trustees?', (1932) 45 *Harv L Rev* 1365; EM Dodd, 'For Whom are Corporate Managers Trustees?', (1932) 45 *Harv LR* 1145, and 'Is Effective Enforcement of the Fiduciary Duties of Corporate Trustees Practicable?', (1934) 2 *U Chicago L R* 194. See also J Weiner, 'The Berle-Dodd Dialogue on the Concept of the Corporation', (1964) 64 *Col L R* 1458. It is acknowledged that the argument for a separation of ownership and control, in its most simplistic form, has been largely discredited. See, for instance, CS Beed, 'The Separation of Ownership from Control', (1966) 1 *J Ec Studies* 29.

<sup>12</sup> Jeffrey Nesteruk, 'Corporations, Shareholders and Moral Choice: A New Perspective on Corporate Social Responsibility', (1989) 58 *U Cin LR* 460.

division of power between the board and the shareholder<sup>13</sup> has skewed the control of the corporation in favour of management. Shareholders may then have little effective control over a board that has no desire to further socially responsible objectives. On the other hand, managers who wish to pursue such objectives against the wishes of shareholders may be constrained by the law to policies concerned with the pursuit of profit.

In a considered discussion of this area, Stokes<sup>14</sup> argues that the barriers to the furtherance of socially responsible objectives that exist within the company are a consequence of the threat that managers pose to the liberal conception of political and economic organisation. In the public sphere, administrators are controlled by both the rule of law and by public accountability. In the traditional 'private' sphere, where ownership and control of property provides power and the means to contract, unlimited freedom is theoretically controlled by other parties of roughly equal power and by a competitive market. Companies defy this traditional model, however, in a number of ways: Firstly, monopolistic behaviour negates the possibility of control by other parties of approximately equal strength; secondly, the self-interest of directors can prevail over the interests of shareholders because of the separation of ownership and control; and thirdly, market regulation has largely given way to internal bureaucratic control. In consequence, the power of directors is largely unchecked and thus, in liberal constitutional terms, illegitimate.

Stokes<sup>15</sup> proceeds to argue that the doctrinal response to this problem has been twofold: firstly, regulation by the market has largely been replaced by competition law; secondly, legitimacy within the corporation is 'established' by conferring upon directors a broad discretion supposedly controlled by operational checks. These operational checks are imposed by way of contractual, constitutional and equitable principles: In the first place, the power of directors is legitimated by the contract of association. On classical contract lines, members of the corporation are, supposedly, free to contract with whomever they choose and on the terms that they choose. In the second place, shareholders, in a manner analogous to electors, may appoint or dismiss recalcitrant directors at will; and in the third place, directors are placed under fiduciary duties owed to the company.

Paradoxically, it would seem, however, that shareholders are deprived, in many cases, of the ability to pursue socially responsible goals because of the imperfections of this

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<sup>13</sup> *Automatic Self-Cleansing Filter Syndicate Co v Cuninghame* [1906] 2 Ch 34.

<sup>14</sup> Mary Stokes, 'Company law and legal theory', in W Twining (ed) *Legal Theory and Common Law* (Oxford: Basil Blackwell, 1986), at 155.

<sup>15</sup> *Id.*, at 174.

system; and managers are restricted in their pursuit of similar goals because these doctrinal checks are imposed in the first place. I have discussed in previous chapters the fact that few companies draw up a contract of association tailored to the specific needs of the prospective members of the company. This would, in fact, be one way in which shareholders could impose a socially desirable course of action upon management. This is rarely done, however (and would not be of assistance in those situations where the company is already in operation). Contractual control is thus largely a fiction. Further, the power of shareholders to appoint or to dismiss directors is only effective where shareholders are both active and have sufficient power (ownership) to exercise control. This is seldom the case. Minority shareholders may also have problems enforcing fiduciary duties of directors. For instance, Wedderburn states that:

[The] mixed, private and public function [of fiduciaries] is largely at the mercy of private beneficiaries. By ratification after full disclosure they-and only they-may cure the breach of duty where it is ratifiable. The duty to observe a proper business ethic can be largely nullified by a private group of 'owners' or 'members' whom it suits to permit inferior conduct. Questionable business conduct can, this far at least, be made moral by the engine of shareholder democracy.<sup>16</sup>

In addition, Stokes argues that because of the dispersion of shareholding in the large public company, shareholders may have no incentive to inform themselves of managerial action or to seek a remedy against them. Again, the problem of shareholder passivity is significant.<sup>17</sup> In addition, the conventional model is based upon the assumption that the board controls the daily business of the corporation, whereas, in practice (as discussed in the previous chapter), much day to day management is delegated to the lower levels of management. For all these reasons, effective shareholder control is, in reality, often a fiction.

Conversely, the doctrinal controls imposed upon directors may restrict pursuit of goals other than profit maximisation. In law, the corporate interest is identified with the collective interest of the shareholders and only derivatively with that of the community, consumers or employees. Management is thus limited in the extent to which it can take into account the interests of the society and of groups within the society other than the company's shareholders. Engel notes that:

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<sup>16</sup> Lord Wedderburn of Charlton, 'The Social Responsibility of Companies', (1985) 15 *MULR* 1.

<sup>17</sup> An important element in the original study by Berle and Means who maintained that this passivity 'place[s] the community in a position to demand that the modern corporation serve not alone the owners or [management] but all society.' See A Berle and G Means, *The Modern Corporation and Private Property* (rev ed) (New York: Harcourt, Brace and World, 1968).

Even the strongest proponents of "more" corporate social responsibility admit that shareholders invariably and overwhelmingly vote down proxy proposals opposed by management - including proposals that purport to seek a greater degree of corporate voluntarism.<sup>18</sup>

The limitations upon directors are imposed by the law in three primary ways. Firstly, where a company has an objects clause, the actions of the directors must always be to further the corporate purpose. Although the doctrine of *ultra vires* no longer operates so as to affect third parties, it does give a right of action *inter se*. Secondly, the board is constrained by the requirement that it acts within the powers conferred upon it by the corporate constitution (although where the articles take the form of art. 66, this is unlikely to pose a serious limitation). Finally, and most importantly, the imposition of fiduciary duties may operate to constrain management wishing to pursue goals other than profit maximisation. The 'best interests of the company' are considered, by the law, to be those of the pursuit of profit. Stokes gives two rationales for this limitation: firstly, profit-maximisation provides a purely objective test upon which directors and courts can base the legitimacy of decisions and this is a far easier practice than subjectively determining the goals of investors. Secondly, the imposition of fiduciary duties ensures, in theory, that directors act only within the ambit of their special expertise: and this expertise is considered to be inherently commercial in nature. It is this expertise, according to Stokes, then justifies the broad discretions granted to directors.<sup>19</sup> Her argument can be extended to show that belief in this supposed expertise, coupled with the liberal 'private/public' dichotomy, limits court intervention in management decisions: 'It is not the business of the court to manage the affairs of the company. That is for the shareholders and the directors'.<sup>20</sup> Thus, the state too, is restrained in its ability to encourage corporations to act for the social good.

The consequence of these limitations is that, even where a company constitution confers an express power to, for instance, give money to charity, that power is limited by the requirement that, in making such disposition, the directors act in the best interests of the company as a whole. A company may thus incur expenditure that is reasonably incidental to the execution of its authorised objects or contributes generally to the profitability of the business. As Bowen L.J. claimed in 1883, 'The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are

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<sup>18</sup> Engel, note 5, at 7. See, for instance, R Dahl, 'Governing the Giant Corporation' in R Nader and M Green (eds) *Corporate Power in America* (New York: Grossman Publishers, 1973), at 10, 15.

<sup>19</sup> Stokes, note 14, at 169-172.

<sup>20</sup> *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* [1927] 2 KB 9, 23 per Scrutton L.J.

required for the benefit of the company.<sup>21</sup> Where, however, the company ceases to have a long-term future upon which expenditure can be justified, then such expenditure will not be legitimate.<sup>22</sup>

The way in which the law may prevent corporate altruism is illustrated in a number of cases which concern the disposition of corporate assets without tangible return to the company.<sup>23</sup> In *Re Lee, Behrens and Co. Ltd.* [1932] 2 Ch 46, the issue was that of the validity of a deed by which a corporation purported to pay an annuity to the widow of a former managing director. The company constitution contained an express power to provide for the welfare, *inter alia*, of widows and children of former employees. Eve J. held at 56, that the validity of the corporation's action was to be determined by applying a three-stage test: i) Is the transaction reasonably incidental to the carrying on of the company's business? ii) Is a bona fide transaction? and iii) Is it done for the benefit and to promote the prosperity of the company? The application of this test struck down the distribution of residual monies arising from the sale of corporate assets to corporation employees in *Parke v. Daily News Ltd.* [1962] Ch 927, 962, as '...the defendants were prompted by motives which, however laudable, and however enlightened from the point of view of industrial relations, were such as the law does not recognise as a sufficient justification.'

There has, however, been some recognition that this limited view is inappropriate in the modern context. Tolmie<sup>24</sup> points to the symbiosis of the company and the state in order to argue that the traditional public/private dichotomy is otiose. 'The corporation' she claims, 'is a social entity operating in the context of a wider social environment.' At the same time, government may be heavily reliant upon business in its pursuit of economic and social prosperity. This symbiosis has been recognised by some groups. In Britain, for instance, the Confederation of British Industry has proposed:

a general legislative encouragement [for companies to]  
recognise duties and obligations ...arising from the company's  
relationships with creditors, suppliers, customers, employees and  
society at large; and in doing so to strike a balance between the  
interests of the aforementioned groups and between the interests of  
those groups and the interests of the proprietors of the company.'

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<sup>21</sup> *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, 671.

<sup>22</sup> See, for instance, *Hutton v West Cork Railway* (1883) 23 Ch D 654.

<sup>23</sup> *Evans v Brunner Mond and Co Ltd* [1921] 1 Ch 359; *Re W and M Roith Ltd* [1967] 1 WLR 432; [1967] 1 All ER 427; *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] 1 Ch D 62.

<sup>24</sup> Julia Tolmie, 'Corporate Social Responsibility', (1992) 15 *UNSWLJ* 268, at 273. See also HJ Glasbeek, 'The Corporate Social Responsibility - The Latest in Maginot Lines to Save Capitalism', (1988) 11 *Dalhousie LJ* 363, at 398.

This view is more closely aligned to that of the United States where there has been greater judicial acceptance of the ability of corporations to act in socially responsible ways. In *People v. Hotchkiss* 136 AD 150, 120 NYS 649, a life insurance company was permitted to purchase a hospital for the care and treatment of its employees suffering from tuberculosis. Some shareholders objected to this act but the Court maintained that:

We see corporations...doing many humane and praiseworthy acts which formerly might have been questioned as not fairly within the powers or duties of the corporation...[u]nless it is shown...unproductive of beneficial results, the practice may stand as well within the scope of its business. The reasonable care of its employe[e]s, according to the enlightened sentiment of the age and community, is a duty resting upon it, and the proper discharge of that duty is merely transacting the business of the corporation (at 651).

Similarly, in *State ex re Sorenson v. Chicago B & O R Co* 112 Neb 248, 199 NW at 535, the Court upheld the right of a railroad corporation to 'donate funds or services to aid in good works' and in *AP Smith Mfg Co v. Barlow* 13NJ 145, 98 A.2d 581, a \$1500 contribution to Princeton University was validated on the basis that the act was responsive to an increased sense of corporate responsibility:

It seems to us that just as the conditions prevailing when corporations were originally created required that they serve public as well as private interests, modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the community in which they operate.

A similar view is reflected in the proposal that:

A business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain, except that, whether or not corporate profits and shareholder gain are thereby enhanced, the corporation, in the conduct of its business:

- (a) is obliged, to the same extent as a natural person, to act within the boundaries set by law;
- (b) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
- (c) may devote a reasonable amount of resources to public welfare, humanitarian, educational and philanthropic purpose.<sup>25</sup>

Rousseau's model is useful in this context for emphasising the problems inherent in such an expanded view of corporate social responsibility. On a strict Rousseauian model, of course, the management of the association could not implement socially responsible

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<sup>25</sup> American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, Tentative Draft No 2 (1984) cl 2.01. See also Schwartz, note 1; Elliot Goldstein, 'The Relationship Between the Model Business Corporation Act and the Principles of Corporate Governance: Analysis and Recommendations', (1984) 52 *Geo Washington LR* 501 and MA Eisenberg, 'An Introduction to the American Law's Corporate Governance Project', (1984) 52 *Geo Washington LR* 495.



policies in the absence of the consent of the shareholders. Management can only act in the general will. Yet, even if we were to assume the legitimacy, for a moment, of the contractual model of the division of power within the corporation, the Rousseauian model is valuable for emphasising the fact that the interests of employees or creditors or consumers is not to be necessarily equated with the interests of the company. Employees, for instance, as a group, share a common interest (maximising their benefit) and therefore have a particular will which may, or may not, coincide with that of the corporation itself. Similarly, consumers stand outside the corporation, with interests that may be at odds with the corporation. This conflict of interests underlies the empirical barrier to greater corporate responsibility identified by Schwartz:

The voice of the community, expressed in the debate over shareholders' proposals, is relevant, but one must concede that management and shareholders alone make the ultimate decisions. Thus, shareholder proposals, properly viewed, do not seek to reorder basic principles of corporate governance, but only to moderate particular conduct...Proponents' social advocacy and management's reactions have remained fundamentally faithful to the economic model of the corporation;...<sup>26</sup>

It is, therefore, only the State which can recognise and enforce the interests of those outside the corporation. Rousseau recognises that the duties of the citizen should come first, but as he points out, individuals are 'inevitably seduced' by private (particular) interests. It is the role of the state to ensure that its objective good is upheld by enacting legislation to protect the consumer if such consumer protection is an objective good of the wider society. The corporation would not merely be permitted to pursue ethically sound principles and to pursue socially desirable policies: it would be required by the state to do so.<sup>27</sup> In Rousseau's view, only the clash of individual wills can ensure that the common interest is both recognised and implemented. This argument has two implications: First, it runs counter to those who profess a belief that corporations will, as a result of some sort of historical necessity, develop a social conscience.<sup>28</sup> Wedderburn expresses a similar view to that of Rousseau on this point:

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<sup>26</sup> Schwartz, note 1, at 526.

<sup>27</sup> For a contemporary view of such a scheme, see MA Eisenberg, 'Corporate Legitimacy, Conduct and Governance - Two Models of the Corporation', (1983-4) 17 *Creighton LR* 1, at 3.

<sup>28</sup> See, for instance, H Manne, 'The Limits and Rationale of Corporate Altruism', (1973) 59 *Virg L Rev* 708; C Kaysen, 'The Social Significance of the Modern Corporation', (1957) *Am Ec R* 314.

[N]one of the philosophies which have predicted an automatic socialisation of corporate life have been justified by the social facts of recent decades. Whereas the internal planning of giant corporations has become 'in effects social planning', the prime exercise of social control has become the task, not of a conscience stricken technocracy, but of government. No new and comprehensive ethic of business seems likely to be born by determined historical forces, springing fully armed like Athena from the head of our ageing economic order.<sup>29</sup>

It must be acknowledged that, to some extent, an expanded corporate social responsibility will inevitably arise because the corporation perceives that it is in its own interests to pursue socially responsible policies. It may consider it will attract favourable publicity and so increase sales, for instance if it donates money to a worthy cause or adopts more favourable consumer policies. I disagree on this point with Engel who maintains that this motive negates the voluntariness of corporate social responsibility. With corporations, as with human individuals, it can be extremely difficult, if not impossible, to determine the motive for a particular action.<sup>30</sup> Nor does the motive, of course, affect the beneficial result (and surely the result is of primary concern in this context) that may come about from such an act. There will be limits, however, to the extent of this form of social responsibility. In some cases, for instance, a company may fail to implement, say, environmentally sound practices if it cannot perceive an immediate or long term profit in such an act.<sup>31</sup> Similarly, such action will depend largely on the corporation's visibility to the public and its vulnerability to public criticism. Thus, success will largely depend upon informed and active public opinion. There may be no pressure for such conduct in the case of monopolies or firms which do not sell to the public.<sup>32</sup>

There is, of course, no little resistance to state regulation of corporate conduct. In particular, many law and economics adherents contend that such regulation creates economic inefficiencies. Martin,<sup>33</sup> however, argues that this economic viewpoint

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<sup>29</sup> Wedderburn, note 16, at 17.

<sup>30</sup> A point conceded by Engel, note 5, at 9 fn 30.

<sup>31</sup> Nor do I agree with Engel that a political decision 'to modify the likely longrun consequences to the corporation of some action or inaction that management may be considering -as, for example, by making it illegal, so that management's calculus must include at least the odds and longrun detriment of getting caught- cannot be viewed as a political determination that we want 'more' social responsibility.' Surely, this is just the way in which the state expresses its determination that more social responsibility is desired!

<sup>32</sup> Tolmie, note 24, at 280.

<sup>33</sup> Paul V Martin, 'The Law, Ethics, Business and Society: Reconsidering the Relationship', paper presented at the National Corporate Law Teachers Conference, (Brisbane, 1993), at 5.

neglects to recognise the contribution of the law to economic efficiency, that is, by providing a standard of minimal expectations upon which transacting parties might rely; and secondly, that the argument makes the implicit assumption that economic efficiency is the collective end of social functions. He remarks that '[t]hese assumptions are incomplete reflections of a more complex social and cultural reality'.

Secondly, by revealing the complex web of interests surrounding the corporation, Rousseau's theory highlights the difficulties faced by corporate managers in the absence of any limits upon their conduct. Whose interests should those managers serve? Decisions made in the broader social context require managers to wear a number of hats:

Managers [engage] in making 'purely business' decisions: by recognizing and properly addressing the broad social implications of such decisions, they can bring out more effective organizational performance. Two, as managers whose internal policies turn out to affect outside constituencies. Three, as managers who are participants and partners in government (that is, executives themselves are political players when they act as contractors, campaign contributors, and subjects of laws in whose making they have had a voice). Four, as citizens who vote and volunteer in the political process. Finally, five, as individuals who choose to examine their own lives and their potential legacies to society.<sup>34</sup>

Schwartz<sup>35</sup> argues that this could cause paralysis in the corporation. Depriving the corporation of its traditional goal (profit maximisation) in favour of, for instance, providing employment or preventing pollution, would deprive the corporation of standards on which to base policy choices, and thus, 'any choice is proper'. This, coupled with the extension of decision-making power to those who have no stake in the financial affairs of the corporation would, he argues, reduce managerial accountability and render shareholders vulnerable to those with no financial interest in the corporation.

### **Power, control and corporate citizenship**

A barrier to the implementation of such state action as Rousseau advocates, however, is that, in many cases corporations are not perceived as being 'citizens' in the same way that natural individuals perceive themselves to be citizens.<sup>36</sup>

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<sup>34</sup> James O'Toole, *The Executive's Compass: Business and the Good Society* (New York: Oxford University Press, 1993), at 10.

<sup>35</sup> Schwartz, note 1, at 526.

<sup>36</sup> For discussions generally of corporate citizenship, see V Brudney, 'The Independent Director-Heavenly City or Potemkin Village', (1982) 95 *Harv LR* 597; H Kripke, 'The SEC, Corporate Governance and the Real Issues', (1981) 36 *Bus Law* 173; and B Mundheim, 'A Comment on the Social Responsibilities of Life Insurance Companies as Investors', (1975) 61 *Va LR* 1247.

The concept that a corporation ought to act within the boundaries set by law might seem self-evident. Unfortunately, it is not. Some persons take the position that a corporation is free to decide whether to obey a given legal rule on the basis of a kind of cost-benefit analysis, in which probable corporate gains are weighed either against probable social costs, measured by the dollar liability imposed for such conduct, or probable corporate losses, measured by dollar liability discounted for likelihood of detection.<sup>37</sup>

This problem is made more pressing by the growth in concentration and power of some corporations.<sup>38</sup> Such corporations have potential for abuse both as to their internal functions and their external, or social functions. Internally, the objective good of the corporation may be subordinated to the growth of the power of management. Externally, giant international commercial enterprises have, in many cases, ceased to owe allegiance to any one state and often have the ability both to shape markets and to frustrate the political policies of the countries in which they operate. These developments bear out the observations of Berle and Means made in 1932:

The rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state...Where its own interests are concerned, it even attempts to dominate the state...The law of corporations, accordingly, might well be considered as a potential constitutional law for the new economic state, while business practice is increasingly assuming the aspect of economic statesmanship.<sup>39</sup>

Yet, it is widely acknowledged that there are benefits to nation states in which such corporations operate.<sup>40</sup> These include the introduction of new products, new technology and skills and new industry. Nation states need, therefore, to ensure that the activities of international corporations bring the maximum net benefits to their residents. States have reacted in varying ways to this need. Many have implemented antitrust laws in an effort to control such companies. The difficulty, however, with many of these provisions, is that such attempts are often marred by inconsistencies. On the one hand, nation states seek to regulate the effects of multinationals, but on the other, condone their activities.

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<sup>37</sup> Eisenberg, note 25, at 8.

<sup>38</sup> For an empirical analysis of corporate ownership in Australia, see Ian Ramsay and Mark Blair, 'Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies'. Paper presented at the National Corporate Law Teachers Conference (Brisbane, 1993).

<sup>39</sup> Berle and Means, note 17, at 357.

<sup>40</sup> Mira Wilkins, "The Internationalisation of the Corporation - The Case of Oil" in Ke Lindgren, HH Mason and BLJ Gordon, *The Corporation and Australian Society* (Sydney: Law Book Co, 1974), at 290. There are, of course, some limits upon the powers of multinationals. Most, for instance, are forced in practice to locate their primary operations in one of the advanced industrial countries. See Tom Hadden, *Company Law and Capitalism* (London: Weidenfeld and Nicolson, 1972), at 450.

Rousseau believed that it is natural and inevitable that all associations are, in turn, composed of smaller associations. There are, however, dangers in this. In the *Social Contract*, he claimed that:

Partial associations and intriguing groups disadvantage the whole. There should be no subsidiary groups within the whole if the general will is to be expressed. If such groups do exist, they should be as large as possible and of equal power to one another.<sup>41</sup>

The implication of this is that democracy cannot tolerate monopolies, because there is no means of balancing their power and influence (*'they should be of equal power'*). This, of course, accords with Stokes's analysis that monopolies are one way in which corporations defy traditional ideas of control in the private sector. This need for equality of power is also reflected in Rousseau's statement that, 'It is one of the most important functions of government to prevent extreme inequality of fortunes...by depriving all men of the means to accumulate it.'<sup>42</sup> To Rousseau, inequality of power by groups or individuals within the association would lead to the distortion of power, and hence, of the general will. If we use this analogy, the regulation of multinational corporations can only occur effectively on an international level:

The will of the State, though general in relation to its own members, is no longer so in relation to other States and their members but becomes, for them, a particular and individual will, which has its rule of justice in the law of nature...In such a case, the great city of the world becomes the body politic, whose general will is always the law of nature, and of which the different States and people are individual members. From these distinctions applied to each political society and its members, are derived the most certain and universal rules, by which we can judge whether a government is good or bad, and in general of the morality of all human actions.<sup>43</sup>

The regulation of multinational corporations will remain haphazard on a national level because individual states will condemn or condone the operations of such associations as such operations are perceived to be for or against the objective good of the State. However, the good of individual states can only be a particular will in relation to the objective good of the international association. This parallels the conclusion reached by Wedderburn:

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<sup>41</sup> SC II: iv.

<sup>42</sup> SC II: iv.

<sup>43</sup> 'Discourse on Political Economy', at 253

The final question is set within a paradox. Each of us must find our own way. But none of our societies now *can* stand alone. Each is part of an economic order which is rapidly being internationalized. Each faces transnational enterprises, multinational groups of companies, and world-wide capital markets which easily transcend frontiers and escape the legal jurisdictions of nation states. History threatens to reduce national governments:

to the status of parish councils in dealing with the large corporations which will span the world...

How are we to define, still less enforce, the obligations of transnational corporate management? To whom and for what ends are *they* trustees? How will we-or the global businessmen themselves-identify the 'good citizen' in *international* business?<sup>44</sup>

Similarly, Hadden argues that effective control over multinationals can only come with the development of international legal controls over the operation of these companies, and similarly, the development of trade union organisation on an international level 'so that the power of the multi-national capital may be met by that of multi-national labour and multi-national government'.<sup>45</sup>

## Conclusion

Rousseau's theory emphasises the significance of acknowledging the legitimate hierarchy of interest: 'The interests of the group must take precedence over the interests of the individual; and the interests of the larger group (the state or, in turn, the international community) must take precedence over the interests of the particular association (the company). Such a classification runs counter to the traditional liberal conception of rights and obligations whereby the individual is of paramount concern and the limitations placed by the state upon individual freedom must be justified.

There can be little doubt that both national and international communities perceive the desirability of a wider conception of corporate responsibility. The division of ownership and management within the corporation that has occurred in the twentieth century, and the empirical evidence of the detriment that can result from an untrammelled corporate pursuit of profit, have been influential in the reassessment of corporate social accountability. Specifically, many people have questioned the conventional view that a company's sole or primary aim is necessarily profit maximisation and that management has little, if any obligation beyond that owed to shareholders. Managers are, in consequence, increasingly required to couple their economic, and often political power

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<sup>44</sup> Wedderburn, note 16, at 29.

<sup>45</sup> Hadden, note 40, at 452.

with social responsibility.<sup>46</sup> Yet, the ability of managers to 'serve two masters' - the shareholder and the wider community - may well be in conflict:

Corporate executives are discovering that their institutional systems of response were designed for simpler eras, when the relevant theatre of operation was the local community and not the greater world, cross-continental communication took weeks, not split seconds, and society had a predictable, hierarchical order, not the chaotic diversity of mass democracy. Neither public bureaucratic agencies nor private pyramidal organizations were created to cope with the welter of contemporary problems that are global in nature: issues of the environment, international cooperation and competition, and cultural diversity and conflict.<sup>47</sup>

This quote, like Rousseau's theory, emphasizes the complexity of interests created within and around corporations. It may not be possible for managers to acknowledge all the interests created by the corporation. Schwartz argues that:

Corporation law should be able to provide the context in which corporate managers solve problems. The foreseeable short term presents a host of social issues. How far beyond the legal minimum should managers devote resources to protect the environment? To what extent should corporate managers devote corporate resources to create opportunities for disadvantaged minorities beyond those programs required by law? Should corporations decline economic opportunities in foreign countries whose political or social policies are hostile to our own? Must corporations continue their operations in communities that depend upon them and not take advantage of cost-saving opportunities to do business elsewhere? What accommodations should the corporation make to the abandoned communities? To what extent may managers resist takeovers or disaggregations that promise great gains to shareholders in the interest of long-term continuity of the system?

This brief catalogue hardly exhausts the list of social demands and issues that will confront corporate managers, but it may help to articulate some of the issues against which a concept of corporate purpose and powers will apply.<sup>48</sup>

In Rousseau's theory, as management is directly responsible to the shareholder, it could not pursue socially responsible policies in the face of hostile shareholder reaction. In addition, Rousseau, though acknowledging the desirability of the fact that good citizenship should, in the hierarchy of interests, take precedence, also recognises that the shareholder is likely to be lured by private interests into neglecting that duty. Therefore, it is for the wider association, the state, to ensure that socially desirable policies are pursued. As Martin notes, extrinsic control (law) must step in where intrinsic control

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<sup>46</sup> See, for instance, the corporate reforms suggested by George P Brockway in *The End of Economic Man* (New York: WW Norton & Co, 1993), at 291-295.

<sup>47</sup> O'Toole, note 34, at 4.

<sup>48</sup> Schwartz, note 1, at 522.

(conscience) has failed.<sup>49</sup> The problem is not solved, according to Rousseau, by, for instance, by increasing, for instance, worker or consumer participation in management, unless those individuals become members of the corporation.<sup>50</sup> Only membership of the association can ensure that corporate interests are acknowledged. This argument assumes, of course, that the state perceives it to be in its own interests to regulate such behaviour. It is possible, as has been discussed, for economists to argue that the largely unregulated pursuit of profit by corporations is, in fact, in the community interest. This would ignore, however, the large body of community discontent with the current regulatory system. This seems to bear out Martin's argument that, as the community finds the means to satisfy its needs for survival, it moves up a hierarchy of more esoteric responsibilities, reflecting the esoteric interests of the collective of individuals.<sup>51</sup> Even if one were to accept the economic point of view, it has been argued that the current workings of the market place create too many 'short-term pressures for short-term, narrow, focused results.' Sales and profits must increase each quarter or the stockmarket will 'punish' the corporation by reducing rewards for management and threatening them with takeover.<sup>52</sup>

Our received legal model, however, has been slow to impose, let alone enforce, social responsibility upon corporations. Liberal assumptions regarding obligation, punishment and enforcement have stood in the way of any expansion of corporate responsibility. Ultimately, however, as technology and communication continue to grow, the imposition of corporate social responsibility may be executed legitimately and most effectively, by the international community.<sup>53</sup>

In this analysis, of course, it must be acknowledged that Rousseau's own limitations upon the operation of democracy may make such changes impossible. On a state level, a truly Rousseauan model would hold, firstly, that corporations should not exist at all, given their inherent tendency to subvert the general will; and secondly, that our nation state is simply too large to allow for true, direct democracy. This problem is even more important in the case of an international community. I do not believe, however, on a theoretical level, that these problems negate the insights to be gained from the theory.

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<sup>49</sup> Martin, note 33, at 6.

<sup>50</sup> For instance, those schemes where employees are given share owning schemes without voting rights or improved conditions for collective bargaining would be insufficient.

<sup>51</sup> Martin, note 33, at 12.

<sup>52</sup> P Jones, 'Sanctions, Incentives and Corporate Behaviour', (1985) 27 *Calif Management R*, at 128.

<sup>53</sup> See, for instance, the discussion by Tom Hadden as to the EEC and regulation of the company, note 40, at 453-4.



The Rousseauan model is valuable for its identification of interests and the potential barriers to change. On a more practical level, many of Rousseau's arguments against the possibility of democracy outside small 'city states' were predicated upon existing technology and communications. Certainly, with the advent of computerisation and improved communication links, there is the possibility of a directly democratic community.

## CHAPTER 11

### OVERCOMING THE 'CHAOTIC AND ILLOGICAL MUDDLE'

Much of the literature in the area of Australian corporate law reveals dissatisfaction with our current regulatory scheme. Despite extensive (and ongoing) legislative reforms,<sup>1</sup> the scheme continues to be criticised as costly, complex and largely inefficient in regulating corporate abuse.<sup>2</sup> Recently, Michael Lavarch responded to some of these criticisms in the following way:

The 1980s was a decade of deregulation and debt. Growth in private debt during the decade averaged 17% per annum. It was also a period of pronounced corporate malpractice and significant change in corporate regulation.

It is often argued that the response by Government and regulators to the 1980s corporate malpractice was characterised by a systems failure of regulation rather than a wholesale failure of substantive law. There is much to this argument....

Although faults in the regulatory framework were the primary impetus for reform, the need to remove inadequacies in certain areas of the substantive law also acted as a catalyst. Substantive law reform has taken place in relation to public fundraising, licensing of investment advisers, insider trading, mandatory accounting standards, directors' duties, related party transactions, insolvency law, the introduction of a mandatory trade plus 5 days settlement regime for the Australian Stock Exchange (ASX) and the legislation for the establishment of a central electronic clearing house for equity transactions.

With a satisfactory regulatory framework already established, future directions for reform will focus on improving and simplifying current corporate law so as to satisfy the twin policy goals of enhancing business performance and providing investor protection.....

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<sup>1</sup> See the recent substantive law reforms contained in the *Corporate Law Reform Act 1994* (Cth).

<sup>2</sup> In addition to those critical writings discussed in Chapter 1, see John H Farrar, 'Corporate governance, business judgement and the professionalism of directors', (1993) 6 *CBLJ* 1; Bob Austin, 'Directors duties go overboard', (1993) *ABM* 139; Andrew Rogers, 'What are we trying to achieve by the Corporations Law?', (1992) 6 *CLQ* 15; R Baxt, 'The battle for law reform in the area of corporate law continues', 20 (1992) *Aus Bus LR* 336; John H Farrar, 'Report on modernising Australian Corporations Law', (1992) 89 *Bus Council Bull*, 13; Interview: 'Corporate Culture on the Move', (1992) 8 *Co Dir* 18.

Equally important is the recognition that the constant of change which has occurred in corporate regulation in the last number of years is of itself a source of uncertainty for corporate Australia. We must therefore take care when determining whether to proceed with any particular reforms.<sup>3</sup>

Whilst applauding the government's desire to simplify the law, I would suggest that, on the basis of the arguments presented in this thesis, these statements appear to be overly optimistic. Firstly, I would suggest that the virtual torrent of legislation that has been enacted in recent years in the area of corporate regulation has resulted from the fact that the model of the corporation that we have inherited rests on a number of assumptions and values that are no longer appropriate. I agree that the constant changes made to corporate regulation in recent years have been destabilising and largely counterproductive to business. These constant changes are inevitable, however, until we challenge the underlying assumptions and inadequacies of our traditional corporate model.

My second response to the statements made by Michael Lavarch is that, despite his apparent complacency, I would suggest that a satisfactory regulatory framework has not been established. Many substantive reforms that have taken place are to be applauded. Some aspects of the law reveal, however, outdated ideas that are no longer appropriate. The recent decision in *AWA Ltd. v. Daniels t/a Deloitte Haskins and Sells and Ors* (1992) 10 ACLC 933, is evidence, I believe, of this problem.

My third response is that the inadequacies of the regulatory framework can be seen as a hangover from ideas of the limited state and laissez-faire economics. In determining what our contemporary values and assumptions about corporations are, we need to look closely at the expectations and demands of the wider society in regard to corporate conduct.

My final response is to question whether 'the twin policy goals of enhancing business performance and providing investor protection' can, indeed, both be satisfied. To some extent, investor protection will demand that risk-taking be restricted. In this thesis, I have sought to show that there is a need to identify competing tensions and to understand that these tensions may not be reconcilable. The society must choose which interests and goals it values most at any particular point in time.

In this thesis, I have argued that our ideas of what a corporation is and how it should be governed have been largely constructed by liberal theory. The corporation and its regulation, then, are not absolutes, but social and historical constructs which we are free to reject or modify as we see fit. By examining the ways in which the values and

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<sup>3</sup> Michael Lavarch, 'The Government's Approach to Corporate Law Reform', (1994) 4 *AJCL* 1.

assumptions of liberalism are made explicit in corporate law; then by comparing the traditional model of corporate law with that based upon Rousseau's social contract theory, I have sought to show that many of the assumptions and values underlying corporate law are no longer valid. Merely 'patching up' the existing model is insufficient. What is needed is a complete re-evaluation of the corporation and its place in our society.<sup>4</sup>

This argument makes at least two assumptions: the first is that Rousseau's theory is contrary to traditional liberalism and the second is that traditional liberalism no longer adequately reflects contemporary values. I have based this first assumption on certain key differences between liberalism (as it is derived from Hobbes and Locke) and Rousseau's theory. In particular, liberal theory assumes individuals to be at the apex of the hierarchy of social rights and duties; associations to be artificial entities; society to be inherently hostile and competitive; and inequalities of wealth and or power to be beyond the proper concern of the state where they occur in the so-called 'private' sphere or where they are the outcome of commercial competition. In contrast, Rousseau's theory is based upon the beliefs that the group is at the apex of the hierarchy of social rights and duties; that associations are natural and inevitable entities; that society offers the possibility of moral development to the individual; and that the primary purpose of government is to control gross inequalities of wealth and power. Looking at these contrasting theories in this light tends to collapse the two assumptions underlying this argument into one because, to a considerable degree, these contrasting assumptions between liberalism and Rousseau's theory also reflect the contrast between legal liberalism and critical legal theory:

According to liberal legalism, the inevitability of the individual's material separation from the 'other', entails, first and foremost, an existential state of highly desirable and much valued freedom; because the individual is *separate* from the other, he is free of the other...

This existential condition of freedom in turn entails the liberal's conception of value. Because we are all free and we are each equally free, we should be treated by our government as free and as equally free...

Because of the dominance of liberalism in this culture, we might think of autonomy as the "official" liberal value entailed by the physical, material condition of inevitable separation from the other: separation from the other entails my freedom from him, and that in turn entails my political right to autonomy...

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<sup>4</sup> Similarly, despite the general approbation for the government's objective of the simplification of the *Corporations Law*, Keturah Whitford in 'The year that was - An overview of Corporate Law, 1993', (1994) 4 *AJCL* 35, expresses concern that the opportunity to rationalise the *Corporations Law* will be lost if a piecemeal approach to reform, rather than a focus upon the purpose of provisions, is adopted.

[On the other hand the according to the critical theorist] what the material state of separation existentially entails is not a perpetual celebration of autonomy, but rather, a perpetual longing for community, or attachment, or unification or *connection*, ...The separate individual lives in a state of perpetual dread not of annihilation by the other, but of the alienation, loneliness, and existential isolation that this material separation from the other imposes upon him.<sup>5</sup>

Throughout this thesis, I have attempted to reveal the ways in which corporate law is based upon ideas of individualism and the inherently limited view of obligation these ideas necessarily entail. The philosophical influence of Hobbes and Locke on the law may be seen in Blackstone. Published in 1765, *The Commentaries* provided that the main objective of society 'was to protect individuals in the enjoyment of those absolute rights' over both person and property. The right to be free was absolute in the 'primary and strictest sense', such freedom being to act 'as one thinks fit, without any restraint or control', to exercise the 'faculty of free will'. The purpose of the law, then, was to guarantee the right of personal security, the right of personal liberty, and the right of private property'.<sup>6</sup> These ideas culminated in the environment of laissez-faire liberalism that flowered in nineteenth century England. The company, no more immune to these ideas than other aspects of commercial law, such as contract, reflects the spirit of Hobbes and Locke. Their assumptions and values may be seen to underlie or to justify the characteristic features of the company: the contractual determination of rights and obligations within the company, the share as freely alienable private property, suffrage attaching to share ownership, the separate entity doctrine and limited liability.

The adoption of these ideas has meant that our idea of corporations and their regulation has had a thoroughly individualistic focus. Our concern has been with the rights and duties of individuals within and affected by corporations, rather than with the function, the responsibilities and the rights of the groups themselves. This focus is not, of necessity, inevitable, nor is it, in the modern context, necessarily appropriate. I have sought to show this by comparing the traditional model with the Rousseauan model in the context of the formation, internal governance and external functioning of the company.

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<sup>5</sup> Robin West, 'Jurisprudence and Gender' 55 *U Ch Rev* 1 (1988) reproduced in D Kelly Weisberg (ed), *Feminist Legal Theory Foundations* (Philadelphia: Temple University Press, 1993), at 77. The literature on the critical studies movement is voluminous. See Duncan Kennedy and Karl E Klare, 'A bibliography of critical legal studies' (1984) 94 *Yale L J* 461. On the application of critical legal studies to the corporation, see Christopher Stanley, 'Corporate personality and capitalist relations: a critical analysis of the artifice of company law', (1988) 19 *Camb L R* 97; Robert A Black, Rosalie S Kreider and Mark Sullivan, 'Critical legal studies, economic realism and the theory of the firm', (1988) 43 *U Miami LR* 343; Alan David, 'A critical legal look at corporate practice' (1987) 37 *JLE* 315.

<sup>6</sup> W Blackstone, *Commentaries on the Laws of England* (New York: Garland, 1978), at 123-129.

In the context of the transition from the unincorporated to the incorporated state, a development analogous to the 'state of nature' to the political state, I argued that judicial regulation has traditionally been ad hoc. Regulation has sought to reconcile the competing tensions of encouraging risk-taking entrepreneurial activity by promoters and ensuring fairness to individual company members or third parties. In the context of the contract of association, I argued that Rousseau's conception of this original contract is predicated upon a model in which the group is at the apex in a hierarchy of social rights and obligations. The corporate contract of association bears some resemblance to Rousseau's model, such as the mutuality of associative rights and obligations; the principle of majority rule; the freedom to tailor the form and governance of the association to the special needs of the group; and the mutability of the original contract. This model of rights and duties is confounded, however, by ideas of individualism and the limited state. In particular, the good of the individual is placed above the interest of the group by the proprietary analysis of associative rights and the linkage of suffrage to share ownership. These influences have rendered the corporate contract unacceptable in many circumstances, particularly where oppressive conduct results.

I proceeded then to consider the corporate division of power as it is defined by the contract of association. I argued that the reason for the wealth of litigation in this area is the lack of a coherent statement of the corporate division of power, the lack of effective control by shareholders over management and the failure of prospective corporate members to examine their needs and expectations critically before deciding on the most appropriate constitutional form for the corporation.

From this point, I turned to examine the internal regulation of the company in more detail. Corporate law has traditionally restricted minority rights and remedies by the doctrinal rule that shareholders can vote in self-interest; by the policy of non-interference by the courts in so-called 'internal company matters' and by the adoption of the separate entity doctrine. I argued that, for effective control of a delinquent majority, courts must be prepared to play an active regulatory role; and that the statement of legitimate majority acts should be more coherent and less ambiguous than it currently is.

I then proceeded to consider the rights and duties of directors. The tension between directors' pursuit of self-interest and the need to promote the interests of the group as a whole has been a constant issue in company law. Liberalism has failed to recognise and accommodate these tensions in any coherent way. This problem has been compounded by a lack of effective control by shareholders. I used Rousseau's theory in this context to argue for a clearer exposition of directors' status and duties and a more democratic structure to the company internally.

From this point, I turned to consider the problems posed by the operation of corporations in the wider social environment. I argued that the liberal conception of rights and duties and the importance of individual freedom have meant that regulation has proceeded, in the main, upon the assumptions that it is impractical and/or unjust to impose group liability for legal wrongs. In this context, I argued that Rousseau's theory suggests the possibility of, and the necessary conditions for, group liability. Yet, part of the problem in this area may stem from the existence of corporations: as Rousseau would have termed them, 'partial associations' which exist within the wider association of the State. This view seems to be shared by some commentators. For instance, observing that all the harmful conduct discussed in the case studies in *Stains on a White Collar* were instrumental, rather than expressive, Grabosky and Sutton ask:

Are corporations inherently criminogenic? Is there something about the structure of a company which allows for responsibility to be diffused throughout an organization so that blame for harmful acts or omissions cannot be 'sheeted home' to any individual? Social psychologists have long been aware of 'risky shift' phenomenon, where decision-makers tend to be less cautious when acting in groups than when alone. Psychologists have used the term 'group think' to refer to over-optimism, lack of vigilance, pressures toward uniformity, avoidance of controversy and the unwillingness to question weak arguments which may contribute to grossly miscalculated decisions in some organisations.

To be sure, the culture of a corporation may be conducive to cutting corners or to 'achieving results at any cost'. It may also be the case that the experience of working within an organization can insulate one from the world outside - to the extent that workers, consumers or the public at large become dehumanised. It is a long way from the boardroom table to the coal face or factory floor.<sup>7</sup>

Finally, I considered the role of the company in the wider social environment in more general terms. Here, I considered the effect of the belief in ethical egoism so prevalent in the nineteenth century and the way in which this limited corporate duty to the pursuit of profit. Perhaps in this area, more than in any other, dissatisfaction with the traditional economic model of the corporation is most prevalent.

The tensions between what is best for the group and what is best for the society of groups, and between the structure of that society and the process of its growth, express a still deeper and more general struggle between a politics of particularism and one of universalism.

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Peter Grabosky and Adam Sutton, (eds.) *Stains on a White Collar* (Sydney: Hutchinson, 1989), at 238-239.

...The community needs to remain a particular group, yet it must also become a universal one. Thus, we rediscover on the larger screen of politics the same predicament of a universality at once desired and forbidden so characteristic of human love, the same irreconcilability of the universal and the particular that holds all human thought and life in its grip. It is this disharmony, diminished but never undone, that makes politics incapable of ever fully redressing the imperfections of existence and of reaching the ideal in history.<sup>8</sup>

Most fundamentally, then, liberalism has forced corporate regulation to focus upon the activities, the rights and the obligations of individuals within groups, whilst concealing the operations of the groups themselves. To a large extent, this has led to a confusion among the very different interests created by the corporate form. Rousseau's theory, on the other hand, assumes the possibility of, and suggests the necessary conditions for, group rights and responsibilities. In many ways, the theory is more in accordance with contemporary ideas of the organisational and psychological operation of group entities than liberalism can ever be:

Liberal society is involved in the paradoxes of a mode of association that denies both community and immanent order and is therefore best described by the doctrine of private interest. But postliberal, traditionalistic, and revolutionary socialist society are all obsessed, in different ways, with the reconciliation of freedom and community. This alliance is part of a broader responsibility; the sense of a latent or natural order in social life must be harmonized with the capacity to let the will remake social arrangements.<sup>9</sup>

My analysis of the development of corporate regulation shows that, despite attempts by the judiciary and the legislature to alleviate some of the injustices and wrongs caused by corporate entities (both to their own membership and to the wider society) many of the problems of corporate regulation remain. This is, I suggest, because reform has largely been concerned to 'patch up' the existing scheme. Much of the current scheme of regulation, therefore, continues to be based upon liberal assumptions and values that are often incompatible with contemporary ideas of justice. In particular, these ideas have led to a lack of control by shareholders over management; and in turn, a lack of control by the State over corporations.

In prophetic words written in 1916, Harold Laski claimed:

A corporation is simply an organised body of men acting as a unit, and with a will that has become unified through the singleness of their purpose. We assume its reality. We act upon that assumption. Are we not justified in the event?

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<sup>8</sup> Roberto Mangabeira Unger, *Law in Modern Society* (New York: The Free Press, 1976), at 289.

<sup>9</sup> Id, at 286.



After all, our legal theories will and must be judged by their applicability to the facts they endeavour to resume. It is clear enough that unless we treat the personality of our group persons as real and apply the fact of that reality throughout the whole realm of the law, what we call justice will, in truth, be no more than a chaotic and illogical muddle.<sup>10</sup>

What is needed is a comprehensive overhaul of corporate regulation, based upon the way corporations are now, in all their diversity, rather than the way they were a hundred or so years ago. We need a scheme that is based upon contemporary ideas of social rights and obligations. This is not to say that such an overhaul could be achieved without considerable opposition. Despite the readily apparent shortcomings of the traditional economic model of the corporation, that model still has many long standing adherents and support both in the community and, in the academic context, particularly from the law and economics movement.

From a policy perspective, Rousseau's model provides, I believe, some valuable insights into the shortcomings of our current scheme: in particular, the failure to tailor our associative contract to the particular needs and expectations of corporate members; the failure to distinguish clearly among the interests created by the corporation; the failures both to define the functions and duties of directors and to establish an effective mechanism for shareholder control; the dangers of shareholder passivity and the necessity for the State to ensure that corporations cannot operate outside contemporary legal and ethical norms. Until we address such issues, our scheme of corporate regulation is likely to remain highly complex, extremely costly and largely ineffective.

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<sup>10</sup> Harold Laski, 'Do associations have personalities?' in Michael Curtis (ed) *The Nature of Politics* (New York: Avon Books, 1962), 121, at 123.

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