

SMEs AND CORPORATE GOVERNANCE: POLITICS, RESOURCES AND TRICKLE-DOWN EFFECTS

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Dr AD Clarke

For Session Topic: Corporate Governance Issues for SMEs

This paper proceeds on the basis that SMEs are the forgotten stakeholders in the fair and efficient management of Australian corporate governance. This is principally because the 'corporate governance market' is essentially aimed at listed and other public companies. It is assumed that rules, norms and best practice will somehow magically trickle down to SMEs, but neither resources or practical guidance are offered for multi-tasking managers of SMEs. It is only by default that the system of corporate governance takes into account the interests of SMEs. The CLERPs, for example, have affected SMEs disproportionately as their key personnel are stretched to providing compliance and monitoring, in addition to maintaining the ongoing management of firms.

The current approach is both politically unfair and economically inefficient. Legislators need to re-imagine the contemporary nature and architecture of SMEs; in this way, corporate governance can be refigured so as to better reflect the particularities of, and challenges faced by, Australia's huge array of SMEs.

This paper is in five parts. First it briefly examines differing definitions of SMEs. It then considers three key matters that inform the architecture and operation of corporate governance in Australia: politics, resources, and so-called 'trickle-down' effects. The final part contains suggestions for re-examining Australian corporate governance so as to make it more relevant to, and appropriate for, SMEs.

INDEX

1. RE-MAPPING SMEs	3-8
<i>1.1 Fluidity and inexactitude</i>	
<i>1.2 Back to the future</i>	
<i>1.3 Promulgating the false legacy of Salomon's case</i>	
2. POLITICS	9-15
<i>2.1 The law and politics debate in corporate governance</i>	
<i>2.2 The 'statutory fetish'</i>	
<i>2.3 Compliance fatigue</i>	
3. RESOURCES	15-25
<i>3.1 Governance by box ticking</i>	
<i>3.2 Disengagement by management</i>	
<i>3.3 The orthodoxy of agency costs</i>	
<i>3.4 Resource based politics</i>	
4. TRICKLE-DOWN EFFECTS	26-28
<i>4.1 US Reaganomics</i>	
<i>4.2 'Rolls Royce' governance</i>	
<i>4.3 The outer reaches of the privatized economy and regulatory exuberance</i>	
5. SOME CONCLUSIONS	29-31

1. RE-MAPPING SMEs

1.1 Fluidity and inexactitude

In this part of the paper we briefly examine differing definitions of SMEs. Domestically, it is the fact there is no term of art for the SME concept. As John Farrar notes¹, the traits that make up an SME are quite disparate. They include the fact that in 1996 to 1997 there were over one million of them in Australia, and they employ 3.5 million people. These businesses:

‘Accounted for 97 percent of all private sector business and more than fifty per cent of all private sector employment. Small and medium-sized enterprises (SMEs) have distinct corporate governance needs.’²

The core or irreducible nature of SMEs is difficult to locate, but there are facets that are invariably common to them: family ownership and management, a lack of strict separation between owners and managers, and the management of particular family issues, include dispute resolution and succession planning.³

This can make for difficulties in a complex corporate governance environment because SMEs face particular obstacles in order to proscribe their boundaries and the correlative application of relevant corporate governance regulation and policy. This is further complicated in Australia by the distinction in the *Corporations Act 2001* (Cth) between

¹ John Farrar, *Corporate Governance: Theories, Principles, and Practice*, (2nd ed.), 2005, OUP, Chapter 30.

² Farrar, above n 1, 402.

³ C. Romano and K. Smyrnios, ‘Family Business Survey Findings,’ in *Family Business*, BLEC, Sydney, 1996, p.1.

small and large proprietary companies.⁴ Further there is no international benchmark or template for determining an SME. This can be seen as a particular problem for SMEs.

Alternatively, it can be characterized as another part of the large ‘convergence and persistence’ debate occurring across the broader spectrum of corporate governance. This debate has recently been thoroughly canvassed by Mark Roe and Jeffrey Gordon.⁵ Their thesis is that the very nature of firms and models of corporate governance is under intense scrutiny, as the shareholder models of Australia, the US and the UK compete for supremacy with stakeholder models (from, for instance, Germany and Japan). There are two main theories at play that are explored in their book. One is the case of the ‘convergence optimists’⁶ most notably advocated by Henry Hansmann and Reinier Kraakman.⁷ As Jeffrey Gordon and Mark Roe observe,

‘Their most optimistic claim is that societies can converge on the shareholder model for its efficiency properties while maintaining very diverse conceptions of the good society.’⁸

This is simply a less explicit, and perhaps more politically astute, means of pronouncing their ‘end of (corporate law) history’ thesis. The other approach is the ‘systemic persistence’⁹ thesis, put forward by Lucien Bebchuk and Mark Roe.¹⁰ It is predicated on the basis that:

⁴ Phillip Lipton and Abe Herzberg, *Understanding Company Law*, Law Book Company (12th ed. 2004), 71.

⁵ Jeffrey N. Gordon and Mark J. Roe, (eds) *Convergence and Persistence in Corporate Governance*, 2004.

⁶ Jeffrey N Gordon and Mark J Roe, ‘Introduction’ in *Convergence and Persistence in Corporate Governance*, 1-32, 9 (Jeffrey N. Gordon and Mark J. Roe eds., 2004).

⁷ Henry Hansmann and Reinier Kraakman, ‘The End of History for Corporate Law,’ in *Convergence and Persistence in Corporate governance*, 33-68 (Jeffrey N. Gordon and Mark J. Roe eds., 2004).

⁸ Gordon and Roe, above note 6, at 9.

⁹ Gordon and Roe, above note 6, at 11.

‘They are less certain whether a consensus has yet emerged on the value of a shareholder-oriented system. Although they seem to share the view (with Hansmann and Kraakman) that such a system is economically appealing, its purported advantages are not so clear that national elites, both corporate and political, thus far feel compelled to adopt it.’¹¹

That such fluidity exists in terms of the corporate governance models themselves maps the same form of uncertain terrain that SMEs are currently having to navigate.

1.2 Back to the future

The discourse of Anglo-US corporate law has been to promote the contract between firm and shareholder:

‘The written law comes to represent the idea or ideal whereby original and image, real and imagined, inside and outside, conscious and unconscious, society and nature, take their places within the tradition.’¹²

Salomon’s case in 1897¹³ has solidified and codified the corporation as an entity reserved for the contractual space taken by the firm and its shareholders. The case involved simple cluster of facts: the case involved a successful boot manufacturer run as a sole tradership by Mr Salomon. He set up a company and sold the business to the company for thirty nine thousand pounds worth of consideration. Payment was by means of a mixture of shares, cash and discharge of debt. As a result, Mr Salomon held 20,001 of 20,007 issued

¹⁰ Lucian Arye Bebchuk and Mark J. Roe, ‘A theory of path dependence in corporate ownership and governance’, in *Convergence and Persistence in Corporate Governance*, 69-113 (Jeffrey N. Gordon and Mark J. Roe eds., 2004).

¹¹ Gordon and Roe, above note 6, at 13.

¹² Peter Goodrich, ‘Contractions: Rousseau in the Year Two Thousand,’ in Anthony Carty (ed) *Post-Modern Law: Enlightenment, Revolution and the Death of Man*, Edinburgh University Press, Edinburgh, 1990, 40-70, 64.

¹³ *Salomon v Salomon & Co Ltd* [1897] AC 22.

shares in the company. His five sons and wife held one share each ‘as nominee for Salomon, so that Salomon & Co Ltd was in reality a “one man” company.’¹⁴ The legal precedent of the case is also simple:

‘As long as the necessary formalities of incorporation are satisfied, a new entity comes into existence that is separate and distinct from its directors and shareholders. This is so whether the company has a large number of shareholders or is, as in Salomon’s case, a company managed and controlled by one person.’¹⁵

Its effect is rather different in terms of the unexpected and long shadows that the case has cast. As Redmond notes of *Salomon’s* case, ‘in many respects it marks the beginning of modern company law.’¹⁶ In this way, the case has been as influential in the realm of company law and governance as has the famous case of *Donoghue v Stevenson*¹⁷ in tort law. For Paul Redmond it ‘is perhaps the most famous company law decision’¹⁸ provided by a court anywhere in the Anglo-US world.

The point of immediate relevance is that *Salomon’s* case was based squarely on what we might call an SME factual scenario and since then its *ratio decidendi* has been applied in an *essentially undifferentiated manner* to both SMEs and large companies.

¹⁴ Lipton & Herzberg, above n 4, 29.

¹⁵ Lipton & Herzberg above n 4, 28.

¹⁶ Paul Redmond, *Company and Securities Law: Commentary and Materials*, (4th ed., 2005) 158.

¹⁷ *Donoghue v Stevenson* [1932] AC 562.

¹⁸ Redmond, above n 16, 158.

1.3 Promulgating the false legacy of Salomon's case

Salomons' case has homogenized the forms and meanings of the language available,¹⁹ in terms of the Anglo-US debate of the firm. It has codified and made standard, the language and terms to be adopted. It appears to characterize the debate as one of common sense²⁰ and as entirely rational²¹ and part of 'a conventionally regulated network.'²² The firm may consist of bundle of contracts, but all other contracts pale alongside the set of contracts traditionally regulated by the Articles of Association: firm to shareholder and shareholder to shareholder. Discourse is also intimately connected to the exercise within society of power:

'How discourses are structured in a given order of discourse, and how structurings change over time, are determined by changing relationships of power at the level of the social institution or of the society. Power at these levels includes the capacity to control orders of discourse.'²³

The particular point of continuing relevance from *Salomon's* case is that the company in question is a classic example of an SME and the particular problems faced by SMEs. It involved a family firm going from an unincorporated form to incorporated status; financial difficulty and family fallout arose as a result. If *Salomon's* case gave rise to modern company law, we can see that SMEs were there at the genesis of company law. *Salomon's* case was not complex litigation involving a listed or public company, but an everyday instance of the challenges faced by SMEs. The case marks the first great

¹⁹ Fairclough, Norman, *Language and Power*, Longman Group UK Ltd, Harlow, 1989, 61.

²⁰ Fairclough, above n 19, 2-4.

²¹ Peter Goodrich, *Legal Discourse: Studies in Linguistics, Rhetoric and Legal Analysis*, Macmillan Press, London, 1987, 15.

²² Goodrich, above n 21, 42.

²³ Fairclough, above n 19, 30.

instance of the separation of owners and managers, which is, or has become, the classical paradigm of the Anglo-US firm. The oft forgotten point is that separation between owners and managers is a function of large, disparately owned firms, not SMEs. The journey of corporations law in Australia has proceeded firmly on this axis: separation of function *in public companies*. In this way, it has doubly removed itself from its modern origins as spelt out in Salomon's case. Is it therefore high time that the development of Australia's corporate law returns, at least in some respects, to its modern point of development and *again* takes into account the SME perspective? The facts of the 1897 Salomon's case remain as pertinent 108 years later, for SMEs, but their pertinence to large, public companies has been much more tenuous.

This *de facto* approach that equates shareholders with the company, however, has resonance elsewhere, notably in the UK and US. It is in line with 'the traditional approach of Anglo Australian Corporate Law' which as John Farrar notes, is one

'Of persistent equivocation between treating the corporation as a separate legal person and equation of the corporation with its shareholders.'²⁴

The outcome of this chain of logic is that the corporate governance term, 'stakeholder,' has been largely synonymous with the corporate law term, 'shareholder.'

The undifferentiated application of corporate governance principles to SMEs as if they were simply and exclusively generic companies, marks the need for a new chapter in

²⁴John Farrar, 'Frankenstein Incorporated or a Fools' Parliament? Revisiting the Concept of a Corporation on Corporate Governance', 1998, 10, *Bond Law Review*, 142 at 143.

political regulation and corporate law in Australia. There are three main reasons for this asymmetry which we shall now briefly examine.

2. POLITICS

2.1 The law and politics debate in corporate governance

Mark Roe argues that a pre-condition for effective corporate governance is the state of the background society; in particular that there is a deal of political stability and social peace. This is his ‘peace as predicate’ theory:

‘Before a nation can produce, it must achieve social peace. The proposition is obvious, but has thus far not been widely used to understand corporate institutions. To build large institutions, particularly those in which ownership separates from control, a society must achieve not only key economic, legal and technological preconditions, but political pre-conditions as well, namely a particular kind of social peace.’²⁵

As a result, there is no escaping the influence of other, and arguably richer, narratives than law in the corporate governance debate. As John Farrar notes, corporate governance is too important a subject to be left to lawyers alone:²⁶

‘By its nature it is interdisciplinary and ultimately must be practical as well as theoretical. Good corporate governance does not guarantee good performance but its absence usually indicates present or future problems.’²⁷

²⁵ Mark J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact*, Oxford University Press, New York, 2003, 13.

²⁶ Farrar above n 1, xxvi.

²⁷ Farrar, above n 1, xxvi.

Additionally, an amorphous and crucial set of influences is likely to get sidelined if we focus too closely on law. These include the underlying cultural, economic and political values relevant to each country. These influences play a vital role in the emergent legal arrangement. At a basic level, research has been conducted to illustrate how national cultural arrangements, in particular, impact on how business is conducted.²⁸ In the governance context, Jonathon Charkham has noted that:

‘No system [of corporate governance]....can be understood without first looking at the salient features of the particular society in which it developed. Everyone is to some extent imprisoned by their history, social, political, and economic. The way we think and the assumptions we bring to bear are not the product of an emotional spasm but the consequence of a long historical development which touches us throughout our lives without our understanding it.’²⁹

The political influences are not mere left-right debates. The political context sets the whole tone for the corporate governance architecture. As Mark Roe argues, and was discussed earlier, the key is ‘peace as predicate.’³⁰ A basic agreed level of social and political engagement applies and forms the bedrock of the provision. Additionally, the rules of the game are such that the players consent to the game via a prescribed set of basic principles and understandings.³¹

²⁸ Trompenaars, F., *Riding the Waves of Culture*, 2nd ed., McGraw-Hill, New York, 1998.

²⁹ Jonathon Charkham *Keeping Good Governance: A Study of Corporate Governance in Five Countries*, Oxford University Press, Oxford, 1994, 1.

³⁰ Roe, above n 25.

³¹ Masahiko Aoki *The Co-operative Game Theory of the Firm*, Oxford: Clarendon Press, 1984.

2.2 The 'statutory fetish'

Despite the fact that the stated aim of Australia's legislators has been to simplify the corporate law area through the single prism of law and economic theory, the results have been, in effect, the opposite. The approach to Australia's corporations law development has been subject to criticism as being too complex because it has been dominated by statutes and by a black letter law, rule based methodology, rather than a principles-based approach. Ian Ramsay has referred to the fact we endure in the 'age of statutes' and that corporate law, in particular, 'has been dominated by statutes since its earliest days.'³² Paul Finn observes the predilection to statutes as some form of peculiar national obsession; Australians 'were born to statutes'³³ in the form of adopting legislation based on UK legislation as the 'mother country,' and by adopting a statutory solution to every gap, slip or twist discernible in the common law. As Finn observes, 'from the time of white settlement our country and our laws were built largely under the umbrella of local statutes.'³⁴

Stephen Bottomley has referred to the fact that:

'The statutory fetish of Australian corporate law reformers has enjoyed increasing levels of satisfaction in the last four decades.'³⁵

³² Ian Ramsay, 'Corporate Law in the Age of Statutes,' (1992) 14 *Sydney LR* 474.

³³ Paul Finn, 'Statutes and the Common Law,' (1992) 22 *WALR* 7-30, 8.

³⁴ Finn, above n 33, 7

³⁵ Stephen Bottomley, 'Where did the law go? The delegation of Australian corporate regulation', *Australian Journal of Corporate Law*, (15) 2003.

Bottomley refers to the Corporations Act 2001 (Cth) as ‘dwarfing’ other Acts with its more than 2000 sections. Australian corporate law has suffered from ‘statutory blow-out.’³⁶ For example, the current laws have been described as:

‘Too cumbersome, having been added to year after year by amendments which make it more and more difficult to discern a clear message underpinning the legislation, and to provide a clear message to the courts in deciding cases that are brought before them.’³⁷

It has given rise to several sources of rules and technical information that are out of proportion to the size and scope of the market it serves. The sheer scale and output of Australia’s corporate law has caused unnecessary complexity at the corporate governance level. The same issue has been discussed in relation to Australia’s tax laws. Richard Krever notes, for example, that:

‘“Simplification” has been the mantra of tax reformers and tax deformers since the late 1950s and has been frequently cited as a rationale for tax changes in the closing years of the twentieth century and the opening years of the twenty-first.’³⁸

Despite this explicit aim, the achievement of simplicity has proved elusive in this domain and in the corporate context. As Krever notes:

‘Measured against almost any test of simplicity, the Australian income tax law fails abysmally. While the costs of tax administration incurred by government are not high by international standards, study after study shows the tax system imposes higher compliance costs on taxpayers than virtually all other income tax

³⁶ Bottomley, above n 35.

³⁷ Robert Baxt, ‘The necessity for appropriate reform’ in *Collapse Incorporated: Tales, Safeguards and Responsibilities of Corporate Australia*, CCH Australia Limited, Sydney, 2001, 325- 352, 329.

³⁸ Richard Krever, ‘Taming Complexity in Australian Income Tax,’ *The Sydney Law Review*, Vol 25, no. 4, 467-505, 467.

systems and taxpayers almost universally believe the law to be too complex. The legislation may well be both the largest in the world in terms of sheer volume and among the most difficult to read and comprehend.’³⁹

The issue of identifying the framework of corporate governance is difficult because of the maze-like structure of corporate law. As has been noted,

‘Practitioners in the field of Corporations Law- and in the business world generally- must find keeping abreast of the significant amendments to the law in this field close to a full-time pre-occupation.’⁴⁰

2.3 Compliance fatigue

Justice Michael Kirby referred in 1997 to the ‘complexity, unintelligibility and inefficiency of Australia’s national regulation of corporations.’⁴¹ Eight years and several CLERPs later, there are no signs of the compliance fatigue abating.

The point is that corporate governance is not functioning particularly well for any stakeholder group, but most particularly disadvantages SMEs. Its complex verbosity leads prominent ex-regulators (returning to work as lawyers) to express sentiments such as the following:

‘One of the expectations that’s changed is the expectation that disclosure will be comprehensive and timely, and that puts a lot of pressure on business. Sometimes business finds it difficult to reconcile that expectation with the commercial interests of the company and I know that’s a complicated area where the lawyers

³⁹ Krever, above n 38, 467-468.

⁴⁰ Judy Benson, ‘Book Review’ of the book *CLERP and the New Corporations Law* (2nd ed) by A Black, T Bostock, G Golding, D Healy, Butterworths, Sydney, 2000, at ABLR Vol. 29, April 2001, 181.

⁴¹ Justice Michael Kirby, ‘Corporate governance, corporate law and global forces’ in Ramsay, I., (ed.) *Corporate Governance and the Duties of Directors*, The Centre for Corporate Law and Securities Regulation, Melbourne, 1997, 49-57, 55.

very often get involved. I've had first-hand experience of that as a regulator. I'm sure I'll have some ongoing role. On the general governance side, it's a question of bedding down the governance guidelines and reviewing those principles to see if they've worked well. There may be areas where they're not yet optimal and need refinement.'⁴²

This free-ranging contribution highlights that corporate governance has provided difficulties for companies in terms of application and practice, and a boon for lawyers and other professionals in terms of advice given and reassurance provided. An example of this is provided by John Sartori's recent analysis of employee share ownership schemes (ESOPs) in Australian workplaces. As Sartori notes, 'on 25 February 2004, the government announced that it has set a target of doubling ESOPs in workplaces by 2009,'⁴³ from the current 5.5% of employees to 11%.⁴⁴ The irony is that at the same time, a report published by the House of Representatives Standing Committee on Employment, Education and Workplace Relations concluded that 'the current corporate law and taxation arrangements are restricting the spread of ESOPs.'⁴⁵

Little wonder that company boards complain of the complexity inherent in the law. The practical point is that here again Australian governance provisions are not providing a simple and accessible template for business. There is an inevitable translation effect where firms seeking advice are required to employ a range of specialists in accounting, law, financial planning and superannuation, just to be able to navigate the legislative rapids in this vital issue. This complexity leads to very practical shortcomings. For

⁴² David Knott, former Chair of the Australian Securities and Investment Commission, *The Australian Financial Review*, 'Knott keen to help boards with corporate governance' 16 January, 2004, 3.

⁴³ John Sartori, 'Employee share ownership plans- issues confronting ASX listed companies,' (2005) 23 C&SLJ 71-104, 71.

⁴⁴ Sartori, above n 43, 71.

⁴⁵ Sartori, above n 43, 71.

example, studies have shown that Australia lags behind in the area of ESOPs which is increasingly seen as a vital economic and human resource incentive in other nations.

As Hugh Morgan, Chair of the Business Council of Australia memorably puts it, there is too much ‘lead in the saddle bag’⁴⁶ in terms of our corporate governance arrangements. Australia possesses, what Morgan refers to, as an onerous regulatory environment; he cites the fact our Corporations Act is 660 pages as opposed to 90 pages in New Zealand. This means, as Morgan puts it, that ‘John Citizen does not understand it.’ Morgan colourfully confirms that Australia’s current approach to corporate governance is a recurring cycle of legislation and legal advice, interacting poorly with disaffected managers. Managers are in turn burdened with expensive ‘translation’ effects in which they are forced to seek expensive compliance and risk management advice. This is the scenario painted for large firms; these problems are simply magnified for SMEs.

3. RESOURCES

3.1 Governance by box ticking

The resource implications of corporate governance compliance are far more marked for SMEs. With smaller revenue bases, and less specialization and expertise at their disposal, the compliance demands of corporate governance will invariably require ‘frontline’ managers to divert from their mainstream roles. As John Farrar notes:

⁴⁶ Hugh Morgan interviewed on the ABC’s *Lateline* referring to a survey by Access Economics, 11 August, 2005.

‘Corporate governance regimes are normally drafted with larger listed public companies in mind and do not meet the needs of smaller companies. The cost of compliance with such regimes far exceeds the benefit. There is need to cater expressly for the governance needs of smaller companies.’⁴⁷

The reason for this lack of specific or quantifiable benefit for SMEs, goes back to the fact that the central thrust of company law and corporate governance is to retain the contractual distance between management and the owners. Where there is a great deal of overlap between the two such that the structure is more akin to a partnership, the reports by managers are essentially going to be themselves as owners.

These resource implications and the concept of box ticking were alluded to in the early 1990s by the UK Cadbury Report. These dangers have been exacerbated in Australia due to the rule-bound complexity of our system and the accompanying disengagement by managers.

3.2 Disengagement by management

Despite the likely further deepening of US influence on Australia’s model of corporate governance as a result of the Australia-US Free Trade Agreement (AUSFTA), there is something of a crisis of belief in the efficacy of the present system. This lack of belief stems from the critical governance facilitators and front-line ‘consumers’, namely the management of Australian corporations. Recent reports have cited surveys in which ‘only one company surveyed in a poll of 200 thought the new [ASX] corporate

⁴⁷ Farrar, above n 1, 402.

governance guidelines would improve their financial performance.’⁴⁸ Further, ‘only 43 per cent believed the guidelines would improve their corporate governance standards.’⁴⁹ Part of the reason for this malaise is that:

‘Companies have been forced to increase their compliance budgets by 11 percent to meet the new corporate governance regime, according to the Chartered Secretaries Australia (CSA).’⁵⁰

There is, as a consequence, a diminished engagement with, and regard for, the corporate governance etiquettes, descriptors and rules. The oft-repeated dangers of governance by box-ticking, rather than by mutually reinforcing practice, appears to be an emerging orthodoxy of Australian governance.⁵¹ As Newman notes:

‘The ASX guidelines were introduced to restore investor confidence following a string of company collapses in Australia and overseas and were designed to complement the federal Government’s CLERP 9 corporate law reforms. But these have been criticized by businesses fearful they will encourage the tick-a-box approach to corporate governance.’⁵²

The discourse alluded to by Newman produces both misunderstanding and economic inefficiency. It is a narrative that ignores the CSA conclusion that there is in fact ‘a linkage between good corporate governance, improved investor confidence and improved

⁴⁸ Geoffrey Newman, ‘Firms still don’t believe in good governance,’ *The Australian* (Sydney) Friday, 17 December, 2004, 22.

⁴⁹ Newman, above n 48.

⁵⁰ Newman, above n 48.

⁵¹ The concept of ‘box ticking’ is widely used as a critique of over-zealous and under-thought regulation. See, for example, the reported response of Australian universities to current reforms to higher education funding and quality assurance; *The Australian* (Sydney) Higher Education Supplement, ‘VCs tick off ‘tick a box’ process,’ Wednesday 27 April, 2005, 32.

⁵² Newman, above n 48.

share market performance.’⁵³ However this message is not being adopted in boardrooms because the perspective there is that the system is too complex. A recent, resigning, high profile director has listed the following factors as underlining his decision because they ‘made life harder’⁵⁴ for directors:

‘CLERP 9 amendments to the Corporations Law, ASX Best Practice Guidelines, International Financial Reporting Standards, Initiatives from the Australian Competition and Consumer Commission and industrial manslaughter changes.’⁵⁵

The argument here is not about the complexity of each of the five measures or their exact nature as mandatory or voluntary, but the sheer number of new measures being rolled out and having to be considered and mastered by boards. The issue of complexity is not isolated to the various layers⁵⁶ that make up Australian corporate governance. In particular, it afflicts the inner sanctum of corporate governance: its statutory element.

Despite these concerns arising from business people, and clearly their doubts are driven in part by self interest, academic commentators are calling for more regulation and, specifically, more mandated regulation. In this vein, Entcho Raykovski calls for the widening of the continuous disclosure rules ‘via the Corporations Act 2001 (Cth) and the Listing Rules of the Australian Stock Exchange.’⁵⁷ He also advocates in relation to the ASX the:

⁵³ Newman, above n 48.

⁵⁴ *The Australian* (Sydney), ‘Business Big Shot’, 30 March 2005, 20

⁵⁵ Above n 54, reporting the business commitments of Keith De Lacy.

⁵⁶ John Farrar identifies four discrete levels of corporate governance sources. These are first- legal regulation, second- Stock Exchange Listing Requirements and Statements of Accounting Practice, third- Codes of conduct, Guidelines, and Statements of Best Practice, and fourth- Business ethics, per Farrar, above n 8, 4.

⁵⁷ Entcho Raykovski, ‘Continuous Disclosure: Has Regulation Enhanced the Australian Securities Market?’ (2004) 30 Mon LR 269-302, 269.

‘Continual external supervision of its activities and the adoption of a policy to provide reasons for its decisions, even though it may not be required to provide these by law. This will guarantee transparency in its operations and will maintain the integrity of the market.’⁵⁸

This idea involves a further watchdog policing ‘the regulatory functions’⁵⁹ of the current financial watchdog. Raykovski is a keen advocate of a further raft of rules with greater reach and ‘substantive operation’ and a broadening and deepening of the mandatory framework.⁶⁰ This proposed matrix of super dependent bodies would simply make the Australian corporate governance output ever more complex and challenging for business and other stakeholders. Raykovski’s rationale for ratcheting up regulatory levels is due to the ‘tendency of investors to act irrationally and the incentives for management to ‘hide’ certain information.’⁶¹ This leads to his claim that what is needed is to ‘clearly require a system of mandated continuous disclosure.’⁶² Whilst stock markets can display irrational exuberance,⁶³ and asymmetric information⁶⁴ can be an exacerbating factor, Raykovski promotes these to generic and widespread features of the financial markets. What of the alternative view that the market operate efficiently and generally within a given set of bounds or rules? This raises Masahiko Aoki’s thesis that firms, and by extension, governance systems, are predicated on rules of the game.⁶⁵

⁵⁸ Raykovski, above n 57, 268.

⁵⁹ Raykovski, above n 57, 268.

⁶⁰ Raykovski, above n 57, 302.

⁶¹ Raykovski, above n 57, 302.

⁶² Raykovski, above n 57, 302.

⁶³ Robert J. Shiller, *Irrational Exuberance and the New Financial Order: Risk in the 21st Century*, Princeton University Press, New Jersey, 2000.

⁶⁴ Joseph Stiglitz, Joseph, *Globalisation and its Discontents*, Penguin Books, London, 2002.

⁶⁵ Masahiko Aoki, ‘Institutional Complementarities between Organizational Architecture and Corporate governance’, RIETI, January 8-9, 2003.

<http://www.rieti.go.jp/en/events/03010801/pdf/Aoki.pdf>

The alternative view to Raykovski's is that generally the market is economically efficient and legally compliant and the cases of misfeasance and fraud are essentially emblematic of the few 'bad apple' cases syndrome, rather than evidence of systemic malfunction. Certainly this more limited thesis has been advanced in response to the US *Sarbanes-Oxley Act* of 2002. Doug Branson notes that of the sixteen thousand five hundred companies filing periodic reports with the SEC at June 30, 2002, less than twenty of them were involved in what he calls the US 'year of our corporate governance discontent.'⁶⁶ Whilst the few companies involved- including WorldCom, Tyco, Adelphia Communications, and Enron, generated a deal of bad news and marketplace moral panic, their number relative to the market was miniscule. Branson's conclusion is that they represented a statistical 'aberration,'⁶⁷ and yet they gave rise to, and were the impetus for, far reaching legislative change in the form of the *Sarbanes-Oxley Act*, 2001.⁶⁸

3.3 The orthodoxy of agency costs

The genesis of the agency costs phenomenon lies in the work of Berle and Means and their 'classic text'⁶⁹ of 1932, *The Modern Corporation and Private Property*. Their thesis was that:

⁶⁶ Doug Branson, Conference paper, 'Enron and Its Aftermath,' International Conference on Governance and Regulation: Challenges and Prospects,' Kuala Lumpur, Malaysia, 5-6 March, 2003.

⁶⁷ Branson, above n 66.

⁶⁸ For a summary of the *Sarbanes-Oxley Act* see http://www.aicpa.org/info/sarbanes_oxley_summary.htm

⁶⁹ David Uren, *The Transparent Corporation: Managing Demands for Disclosure*, Allen & Unwin, Sydney, 2003, 135.

‘Ownership and control had become separated in America as corporations grew too large and complex to be controlled by the single dominant entrepreneurial families, such as the Rockefellers, Carnegies and Fords, on whom modern American industry was founded.’⁷⁰

In essence, managerialist corporations had replaced entrepreneurial fiefdoms. This separation can be characterized in two ways. First it can be viewed as ‘an efficient arrangement for the division of labour between professional managers and investors/risk bearers to create wealth together.’⁷¹ Alternatively, the very fact of separation of owner and manager creates issues of distance and potential miscommunication and hence, an agency problem. Treating the separation of ownership and control ‘as a problem to be resolved.... has, however, been the main theme of the corporate governance literature.’⁷²

The shareholders, as principals, are separate from their agents, the managers. There will often be a ‘misalignment of interests’⁷³ between the two groups because of the differing, postmodern perspectives they bring to bear in how the firm operates. Race Matthews notes that ‘the basic agency dilemma’ is a ‘core problem’ ‘because individuals are, by nature, inclined to opportunism and the pursuit of their own self-interest.’⁷⁴ As John Donahue notes in relation to the agency issue, it marks a ‘difficulty in all but the simplest relationships, of ensuring that the principal is faithfully served, and the agent is

⁷⁰ Uren, above n 69, 135.

⁷¹ On Kit Tam, *The Development of Corporate Governance in China*, Edward Elgar Publishing Ltd, Cheltenham, 1999, 23.

⁷² On Kit Tam, above n 71, 23.

⁷³ On Kit Tam, above n 71, 25.

⁷⁴ Race Matthews, ‘The Mondragon worker co-operatives and their lessons for Australia,’ in Gollan, P. & Patmore, G., (eds), *Partnership at Work: the challenge of employee democracy, Labor Essays 2003*, Pluto Press, Melbourne, 2003, 151-164, 159.

fairly compensated.’⁷⁵ Masahiko Aoki describes the agency cost phenomenon in the following terms:

‘Agency theory casts the economic interaction of agents (in the generic sense) in a certain domain of the economy as a principal-agent relationship. Then it inquires into what type of self-enforceable (incentive compatible) arrangement can be established as a second-best response to environmental and incentive constraints when information asymmetry exists between the principal and the agent.’⁷⁶

The problem for SMEs is that agency theory, whilst acutely relevant for large firms, is largely otiose for them. This arises directly from their architectural premise: the less than separate notion of managers from owners. The problem with agency theory and, indeed, with other corporate governance modeling devices such as moral hazard theory and remuneration policy which seeks to better align the two disparate groups, is that they hold very little traction for SMEs. Nevertheless, these theories have, and continue to form, the bedrock thinking of legislators and regulators.

3.4 Resource based politics

In a small corporate market, large firms have a disproportionate power to lobby the government and sway public opinion. In such a market, in blunt terms, it assists big business to keep small businesses, small.

⁷⁵ John D. Donahue, *The Privatisation Decision: Public Ends, Private Means*, Basic Books, 1989, 38.

⁷⁶ Masahiko Aoki, *Towards a comparative institutional analysis*, Massachusetts Institute of Technology, Cambridge, Massachusetts, 2001, 18.

Effective political lobbying requires deep pockets and excellent contacts; the extent of big business lobbying power cannot be under-estimated.⁷⁷ This is a good example of ‘interest group politics’ giving rise to ‘rule-driven path dependence’⁷⁸ in corporate governance. As Lucien Bebchuk and Mark Roe note,

‘A country’s initial pattern of corporate structures influences the power that various interest groups have in the process producing corporate rules. If the initial pattern provides one group of players with relatively more wealth and power, this group would have a better chance to have corporate rules that it favors down the road. Positional advantages inside firms will be translated into positional advantages in a country’s politics. And this effect on corporate rules will reinforce the initial patterns of ownership structure. For example, once a country has rules that favor professional managers and protect diffused ownership structure, these managers will have more political power and this power will in turn increase the likelihood that the country would continue to have such rules.’⁷⁹

Bebchuk and Roe’s thesis suggest that there is a powerful centrifugal political and governance force which favors, in a mutually reinforcing pattern, the hegemony of the biggest and richest firms within an industrial society.

A good example of this theory in action is the recent political imbroglio concerning the possible removal of unfair dismissal laws for small business. In the year 2000, Breen Creighton and Andrew Stewart referred to the fact that:

‘Recently, the Howard Government has strongly argued the case for a further exclusion that would effectively exempt small businesses (those with 15 or less

⁷⁷ Mark J. Roe, ‘The Inevitable Instability of American Corporate Governance,’ 1 *CGLR*, 2005, 1-19, at 16.

⁷⁸ Bebchuk & Roe, above n 10, 71.

⁷⁹ Bebchuk & Roe, above n 10, 71.

employees) from the operation of the unfair dismissal provisions’⁸⁰ [of the *Workplace Relations Act, 1996* (Cth.).]

What has happened since is a good example of ‘bracket creep.’ The proposal of, as yet unseen legislation, was rumored in 2004 to increase the threshold to 20 employees. Then, more recently, it was raised to 100 (as attested to in the Commonwealth Government’s advertising campaign). More recently still, it has taken on the potential to become an apparently unlimited concept, such that it will apply to all businesses, whatever their size. This is a clear case of the asymmetric political resources available to large businesses. They can use the legal disadvantage test to argue that their rights and liabilities on this point should be no different to the perceived advantage afforded SMEs.

The chief (contested) substantive argument is that removal of such unfair dismissal rights for workers will create employment. The original argument was that these changes would assist job creation in small firms. As Creighton and Stewart note:

‘The rationale for this is said to be that unfair dismissal laws hinder *job creation in small enterprises*, with the government quoting a claim from small business groups that the exemption would create “at least 50,000 new jobs.” There is in fact no proven link between unfair dismissal laws and unemployment levels; and even if there were, there would still be a powerful case on grounds of both equity *and* efficiency for laws of general application which protect workers against the arbitrary or unnecessary deprivation of their livelihood, regardless of the size of their employer.’⁸¹

⁸⁰ Breen Creighton and Andrew Stewart, *Labour Law: an Introduction*, The Federation Press, Sydney, 3rd ed, 2000, 319.

⁸¹ Creighton and Stewart, above n. 80, 320.

On the basis of this critique, SMEs without worker protection enjoyed by larger firms, become the site for particular forms of unfairness in the workplace. Creighton and Stewart are supported in these findings by more recent research.⁸²

Subtly, however, the argument has shifted to *all* firms as flagged recently by the Federal Treasurer, Mr Costello where he opined it was conceivable that the removal apply universally within the Australian corporate context. What began as an (arguable) stimulant for small business has been effectively claimed by large business.⁸³ This effectively further locks in the systemic asymmetries between small and large business.

As referred to earlier, the Government's own recent whole page advertisements in national daily broadsheets illustrates the point. Buried at the foot of column three of four columns is the following:

'Laws introduced in 1993 which govern some aspects of unfair dismissal have not worked. They have cost jobs and continue to make employers reluctant to take on more workers. For this reason, businesses in the federal system with up to 100 employees will be exempted from those provisions to generate more jobs in small and medium businesses, the engine room of the Australian economy.'⁸⁴

⁸² David Uren, 'Study debunks PM's unfair dismissal claims,' *The Australian (Sydney)*, 11 August, 2005, 25. Uren reports that 'unfair dismissal laws have little effect on employment and do not impose onerous costs on small business. These explosive findings emerge from the most comprehensive research conducted into hiring-and-firing costs.'

⁸³ Bebhuk and Roe, above n 10, 71.

⁸⁴ Australian Government, 'More Jobs, Higher Wages, A Stronger Economy,' *The Weekend Australian (Sydney)*, July 9-10, 2005, 6.

This short paragraph is loaded. It sheets home responsibility for ‘the problem to be fixed’ to a previous Labor government, and to twelve year old legislation passed under that former government’s watch.

This episode continues the notion of the inexact nature of SMEs. At the size of 100 employees, this is really beginning to blur the lines between ‘small’ and ‘large’ firms. Five years ago it was 15 or less employees; now it has ‘magic-ed’ to 100 or less. The approach becomes an undifferentiated one that naturally favors large firms. This pattern is repeated in law reform and the CLERP program, subject to some minor ameliorating effects,⁸⁵ and in respect of corporate governance changes generally. Large firms are inherently advantaged in this current argument because of economies of scale; they employ more workers, so they can potentially create more employment in a more liberalized employment market. In key components of law reform and market adjustment, large firms can claim competitive advantage over their SME counterparts.

4. TRICKLE-DOWN EFFECTS

4.1 US Reaganomics

As with so much of our contemporary political language which is dominated by US-Anglo concepts, so too is the case with corporate governance. The term ‘trickle down’

⁸⁵ Lipton & Herzberg, above n 4, 71-72.

was classic Reaganomics in the 1980s. It stood broadly for the argument that if tax rates were reduced for the wealthy, the theory was that the wealth this created would cascade down through the economy to the most vulnerable, both in work and without. This was a form of market driven welfare; unlocking the potential of the wealthy elite would generate benevolent solutions for all. This theory has found resonance in a western world dominated by concepts of privatization and downsizing the role of government.

4.2 ‘Rolls Royce’ governance

The concept of trickle down can be applied to corporate governance provision in Australia. Indeed, it has been the underlying principle behind the regulatory provision: the approach has been to make rules for the biggest and best resourced, where they are road tested and refined, and this translates into an easier compliance passage for SMEs. Rather than acknowledging compliance fatigue, this model suggests that small firms will be advantaged by adopting already refined working methodologies. This is an optimistic view. Corporate governance appears to be generating its own internal market as one series of reforms simply grafts onto previous efforts.

Even the largest firms with excellent resources struggle; for example ‘the head of ING, one of Europe’s largest financial institutions has warned of “regulation fatigue” as banks and insurers struggle to apply a wave of new rules.’⁸⁶ If large firms are suffering from overload, then SMEs, by definition smaller and poorer, but invariably subject to the same compliance requirements, suffer doubly. This phenomenon in the Australian financial

⁸⁶ Peter Thal Larsen, ‘Burden of rules inducing burnout,’ *The Australian* (Sydney), 16 August 2005, 24.

industry context has recently been referred to as ‘ “Rolls-Royce” governance.’⁸⁷ As Geoffrey Newman reports,

‘Governance professionals have attacked the prudential regulator’s “Rolls-Royce” solution to corporate governance for banks and insurers, saying it is far too costly for small firms. Chartered Secretaries Australia, the peak body for corporate governance professional, warned the Australian Prudential Regulation Authority’s draft proposals would have a “very harsh impact” on small companies. “APRA’s proposed ‘Rolls-Royce’ solution may be appropriate for the big end of town, but for a host of smaller operators- such as community banks, friendly societies and trustees of superannuation funds- it is overkill,’ CSA chief executive Tim Sheehy said. “In reality, many small companies simply do not have the workflow or resources to justify appointing a dedicated internal auditor either on a full or part-time basis and rely on their external auditor to perform this function.’⁸⁸

There are several points to note, but in particular the themes raised are both international and cross industry boundaries. The Anglo-US global corporate market has become more compliance driven. This is what Ian Ayres and John Braithwaite call an example of ‘command regulation.’⁸⁹ At the epi-centre of this new approach is the *Sarbanes-Oxley Act 2002* (US). It has dramatically increased compliance costs for US and foreign firms. Its approach has filtered through to key elements of recent Australian corporate governance, such as CLERP 9.

⁸⁷ Geoffrey Newman, ‘ “Rolls-Royce” governance too costly for minis,’ *The Australian* (Sydney), 16 August 2005, 22.

⁸⁸ Newman, above n. 87, 22.

⁸⁹ Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, Oxford University Press, New York, 1992, 39.

4.3 The outer reaches of the privatized economy and regulatory exuberance

As noted earlier, Australia suffers from an irrational mind set to legislate despite the long running Government campaign of economic reform and simplification. There appears to be a direct correlation between the degree that a country embraces the concept of privatization, with the degree it then regulates. It is as if there is an anxiety on the part of government to control the remaining elements of the once totally (and publicly) controlled domain. Privatisation is sold to citizens as an economic fix or palliative to economic and political problems. One of the prices paid by the firm or industry in order to cross over into private ownership is to accept the ongoing scrutiny and strictures of the empowered regulator. The current debate concerning the terms and conditions of the post-privatized Telstra reflect this regulatory zeal. These super forms of firm, such as Telstra and Qantas, bear little or no resemblance to SMEs, who are but unwitting victims of the regulatory zeal.

5. SOME CONCLUSIONS

It is axiomatic but essential that Australia's corporate governance provision begins to address the needs of SMEs. Australia's corporate governance is overwhelmingly predicated on problems of contract; this supports the separation of owners and managers model. Contract is used to control the relationship between managers and shareholders *inter se*. Insider trading and controlling executive pay are all part of the contractual control of distant owners and managers. As Mark Roe argues, the first of the core

instabilities of American corporate governance is this unassailable gap between owners and managers:

‘The separation of ownership from control- distant and diffuse stockholders own while concentrated management controls- a separation that creates not only great inefficiencies but also big recurring breakdowns. In every decade since World War II we’ve faced a fundamental large firm problem. Each emanated from this fundamental instability.’⁹⁰

The critical point is that it is a large firm problem, not an SME dilemma. Australia has closely tracked this post War narrative with its own sporadic outbreaks of large firm problems. SMEs have been caught up in the regulatory moral panics that have inevitably followed in their wake.

The following approaches are worth exploring to avoid the continued over-burdening system for SMEs:

- A principles based approach to corporate governance provision, rather than a rule driven, minutiae obsessed orthodoxy. That is, less legal influence and more credence given to cultural imperatives, economic theory and political constructs that inform and shape corporate governance.
- A two step governance system; one for large firms and one for SMEs. That is, a governance arrangement better attuned to the market place which it serves. The hallmarks of the Australian market need to be explicitly acknowledged in this project: a relatively small capital market, and a market in which there is a gulf between the large listed companies and the rest. This binary divide should provide

⁹⁰ Roe above n 77, 1.

opportunities for simple, principle based governance for SMEs that can ‘weave’ its way up to large firms, rather than a continuation of the trickle down approach from large firms to SMEs.

- Specific and simple SME governance arrangements that reflect their particular form and architecture. These forms include the predominance of family based firms with a strong crossover between managers and owners. This provision would recognize the largely fictional notion of separation that is, in fact, more apposite for large and listed firms.
- The possibilities of recognizing a form of hybrid partnership- company arrangement for SMEs.⁹¹ This can be achieved by a separate set of rules, or by specific legislation that recognizes that at the margins, the partnership form and the corporate model do in fact overlap. Rather than the complex set of rules that are theoretically applicable, but badly fitted in practice to SMEs, there should be a differentiated approach that is informed by the basic, but imperative notion, of differential architecture. The domain occupied by SMEs is unique: not part of amorphous arrangement which bundles all firms together in an apparently unproblematic way.

These suggestions are in no way exhaustive, but beginning to address them would ameliorate some of the key concerns for Australia’s SMEs. If SMEs are indeed the engine room of Australian commerce, it would be salient to finally recognize their distinct needs and interests in an increasingly competitive environment.

Dr Andrew Clarke.

⁹¹ Farrar, above n 1, 412 referring to US provision for ‘a kind of incorporated limited partnership.’