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**GOOD GOVERNANCE: A CASE FOR
PATERNALISM OR PERSONAL
RESPONSIBILITY?**

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GOOD GOVERNANCE: A CASE FOR PATERNALISM OR PERSONAL RESPONSIBILITY?

The topic I was given for this paper was: 'Why do we have to rely so heavily on statutory acts to paternalistically ensure integrity and good governance in business?'

That's a pretty heavy title. At first sight it leaves little doubt that it reflects a deeply held concern. The pejorative term "paternalistic" makes it into a rhetorical question, a kind of complaint about something imposed on us from above of the 'this hurts me more than you' and 'its for your own good' variety. On reflection, however, I decided I liked the specification. The absurd mixture of unexplored premises and bald assertion reflects the way we are expected to think about the issues. Worse, it reflects the way laws are made. The reference to "integrity and good governance" is typical of the feel-good bombast we are asked to tolerate, or even propagate, without recognising or being embarrassed by its foolishness.

The question seems to assume that statutes (and by extension regulations) are necessary and that we do have to rely on them. In my opinion we don't have to. In a strict technical sense statutes may only be a part of the choking smog of law, but the title catches the theme. Do we need mandatory rules, rules we can't contract around? Rules enforced by government power irrespective of the prior consent of adult parties?

I suggest that if we keep on as we are, we will increasingly have to rely on statutes. Reliance on detailed mandatory government rules will, of course, crowd out self-reliance and voluntary cooperation.

It may be that humans need a certain quantum of of rules. We are uncomfortable when the conduct of those we must associate with becomes unpredictable beyond a certain threshold. Rules enable us to rely on reasonable consistency. If people are not constrained by social rules, the requirements of good manners, ethical concerns and reputational interests, then binding legal rules will be sought to fill the gap.

The question is whether and when binding legal rules work. And when they do work, do the benefits outweigh the costs?

We tend to forget that similar issues were dealt with by our forebears and that they displayed considerable wisdom. There has been a constructive tension over such issues ever since the first radicals argued that freedom might have value, even freedom to make mistakes, to be wrong.

Some three years ago I delivered for Roderick Deane, at a company law conference, a paper since cited frequently. He was worried about how the Companies Act 1993 would work for directors.

Today I am going to return to the themes of that paper, with the benefit of some hindsight. I want to put the issues into a context which might help us think about ways of stemming the apparently inexorable tide of legalism. It has brought, as Roderick Deane feared, complexity, compliance costs, frustration and alarm, while "integrity and good governance" seems no less in peril.

I will look first at this big picture then hope to illustrate the propositions by examining several small parts of company law where well-meaning attempts have gone seriously wrong. They are good topics for study because they were crafted by people who felt they were alive to the risks of over-regulation. The drafters were trying to reduce the risks of working through employees which would be inherent in any over-sweeping statements of responsibility for directors. The result is serious interference with sensible delegation, that core element of the company solution to the problem of how to organise vast resources and many people.

At the end I consider some solutions. Our forebears would have thought them too obvious to need elaboration, but I fear they will be missing from the earnest efforts now being made to roll back the legal fog. Initiatives to reduce business costs, such as those being promoted by commerce minister John Luxton, may be discredited if they are incomplete. They must also ensure that freedom carries with it the likelihood of suffering the consequences of mistakes.

Recognising regulation

Statutes and regulations can 'regulate' even where there is no official regulator. Closely defined liabilities, prescribed procedures and certifications create a web of 'regulation'. Vague extensions of positive obligations of 'good faith' and 'due diligence' do the same. They can mean to each lawyer and each judge what he or she wants them to mean. The lawyers and the compliance programme peddlers are the regulators just as much as the members of commissions, officers of departments and other inquisitors. Their views about 'reasonable practice' are the standards which determine in retrospect whether you should be punished for some decision.

Tightly confining such regulation was a hard-won and magnificent achievement of the English-speaking world. The English law was that we can do whatever is not expressly forbidden. Immoral conduct which was not illegal had consequences, whether financial, reputational, social, health or otherwise, but there was a realm of conduct into which the law should not intrude. The range of things expressly forbidden was largely to be confined to protecting non-volunteers from tangible harm. It was not a justification for law that the conduct complained of might upset the neighbours or offend princes or priests. This was contrasted with the continental and ecclesiastical view that people as social beings might be prohibited from doing anything 'immoral'.

A corollary of the freedom-favouring view was that we are responsible for how we find ourselves, that we should reap or bear the rewards of successes or failures, of virtue or vice. It was a view that we are not victims of immovable fate or of malevolent devils or spirits. It was not a 'victim' ideology.

Freedom was radical. It was justified by humanists like John Locke. In 1690, he argued that the government does not have proper authority to impose something just because it may improve people's lives. This is a foundation of toleration and of liberal government in general: that there is a private sphere which governments may not invade, even for the obvious benefit of those affected. It was argued in relation to religion, which people then believed was something as fundamental as you could get.

Sadly this pillar of our legal philosophy has vanished, seemingly in a binge of 'progressive' reform lasting a mere decade or so. *The Economist* (20 December 1997) highlights the irony in a discussion of the anti-smoking movement. Anti-smokers:

... believe themselves to be upholding liberal social principles when they traduce them Establishing Locke's principle – the demarcation of a privileged private sphere, where even well-intentioned snoops may not go – was the work of centuries. It should not be relinquished in a puff of smoke.

To paraphrase *The Economist*:

... a goodly share of today's ['corporate governance' and 'stakeholder'] rhetoric is crafted to fudge these principles, or to drown them out with indignant noise.

The founding fathers of the American constitution were apparently not able to cement in the principle for Americans, though a generation ago it might have been thought to be fundamental to our view of law and the proper role of politicians.

The ever-increasing pretensions of lawyers and judges and of the politically active elite which claims to speak for 'the community' are not only a New Zealand phenomenon. Nor is observation of its empirical worthlessness new. As Tacitus pointed out: "When the State is corrupt then the laws are most multiplied." And within a Christian tradition Matthew reminds us:

Alas for you lawyers ... hypocrites! ... you have overlooked the weightier demands of the law, justice, mercy, and good faith. It is these you should have practised ... blind guides! You strain off a midge, yet gulp down a camel! (Matthew 23:23:24).

More prosaically and closer to home, Alan Cameron of the Australian Securities Commission (not a body usually in the forefront of concern about over-regulation) cited the following extracts from a book.

The proposals for new regulations governing the behaviour of company directors which surfaced in 1992, for example, were a perfectly understandable response to mis-management and irresponsibility among business leaders – and those who advised them – during the 1980s. But a desire to clean up the corporate act carries the inherent risk of going too far: the more regulations we impose on company directors and managers, the more we limit their freedom of choice and the more we discourage the operation of individual conscience. As regulations become more numerous and complex, the automatic response is to assume that "if it is not prohibited by the rules, it must be OK."

For people who feel a strong desire to take greater control over their own lives, the appeal of increased regulation of others is obvious: it reduces uncertainty and, because pathways of action are more clearly defined, promises less unpredictability and lesser responsibility. This is a critical moment for us because we may not yet have realised that the difficulty with the pro-regulation mentality is that it will fail, at the deepest level, to satisfy our urge to find a new set of bearings.

Some of you will have heard of Professor Fred Hilmer's team of eminent Australian business people who produced the study on corporate governance entitled *Strictly Boardroom*. It sounded a warning against seeking business salvation through regulation. It is now producing fruit (somewhat stunted and worm-eaten but still recognisable) in Australian attempts to simplify the Corporations Law.

In the United States the drive to attain and maintain relative simplicity in company and commercial law is more a subset of the general anxieties about the legal miasma. Law is seen to be choking the United States. A recent best-seller on this topic is called *The Death of Common Sense*. Apologists for the courts, the legislators and the legal profession counter-attack with claims that

the law must become more expensive, more necessary and more extensive, as modern life becomes more complex.

Our world is not necessarily more complex or more difficult to understand and control and cope with than that of our forebears. It may change faster, but that is an argument against ossifying customs in law. It is misleading to talk about a novel and complex modern world as if speed of communication were a complicating factor. Past generations had most of the investment instruments with which we are familiar, indeed they developed them. If you think of the risks facing investors and business people 100 years ago, our world is vastly simpler. We do not have to place reliance on agents to make decisions for us at vast distances and with communications taking months. We can send and receive documents, verify facts and identities and alter instructions in ways that our forebears would have thought miraculous reducers of business risk. It may be that the only thing vastly more complex about the modern world is its law.

Some of you may have met Professor Richard Epstein, an eminent US legal scholar, whose book *Simple Rules for a Complex World* was developed out of lectures he delivered here in New Zealand at the invitation of the New Zealand Business Roundtable. He recognises that unilateral disarmament will not work. The party or individual who decides not to use lawyers or their complex rules will lose unless the rules generally are made more simple.

If we do not want to be restricted to one-size-fits-all government-approved investments or formulas, then we must accept that there will be losses. They will sometimes be serious. The lessons to be drawn from them will involve individuals resolving to change their conduct in the future, not in the creation of fences 100 metres back from the top of the cliff, instead of 10.

This is not, in a modern welfare state, a harsh conclusion. People who fall over the financial cliffs land softly. Our children will not starve as did those of our Victorian forebears when major investments failed. Our sons and daughters will not be unmarriageable because of parental bankruptcy. They will not be deprived of education and health care. It is indeed ironical that at a time when the consequences of catastrophic business failure are probably less in individual terms than they have ever been, we are bending more and more official effort to minimise or mitigate business failure through regulation.

At the same time our willingness to countenance the rules that reinforce prudent behaviour, savings, care for our families, and so forth are seen as quaint or outdated. Individuals are often more free to gamble, to drink to excess, to have multiple families they cannot support, or to

abandon the care of parents to the state than ever before. Yet we seem obsessed with involving the state in attempting to legislate moral and ethical codes for business where the natural incentives for prudence and good reputation remain as strong as they have ever been, particularly for New Zealanders who went through the aftermath of the 1980s.

Indeed when we adopt a privacy law that enables people to conceal their own justified bad reputations, and establish legislation which allows Employment Court judges to prevent employers (and fellow employees) from visiting the normal pre-agreed sanctions on rude or careless or suspect fellow employees, we have surely entered an 'Alice in Wonderland' world.

What is actually wrong with the law

I was interested to learn that David Goddard, a Chapman Tripp partner who was heavily involved in the Law Commission's draft of the Companies Act, has recently identified where the New Zealand company law exercise went wrong in a paper to be published in the Company and Securities Law Journal. He says that the law tries to prescribe too much because its authors were too unwilling to let people sort out their own preferred arrangements. In short, they failed to recognise that business transactions and participation in companies are voluntary or consensual. In consensual transactions people will sort out what best suits their circumstances for dealing with risks.

He does not reject making it easier for people by providing standard contractual models to agree on, or to be deemed to agree on if nothing else is specified (like the old Table A company constitution). But he bewails the arrogance of the legislators in prohibiting voluntary alternative solutions in so many areas.

It is fascinating that we are having to rediscover early lessons that might have seemed so elementary to the lawyers and legislators of two or three generations ago. We have lost the collective memory of why we favoured freedom and are having to rediscover it.

Over the last decade or so New Zealand has stumbled back toward freedom in many areas of economic policy, out of necessity rather than conviction on the part of many of the politicians involved. But even as we increased some economic freedoms we were busy shutting down others. The so-called Human Rights Act, the Privacy Act, the Companies Act and the mandatory personal grievance remedy in the otherwise liberating Employment Contracts Act all make serious

intrusions on the rights of consenting adults to choose how they will order their lives and their relationships with others. Those acts:

- assume that law ought to be involved as well as (or in place of) moral, social, reputational and natural financial sanctions;
- assume that law can effectively achieve the objects to which it is ostensibly directed;
- ignore costs, in terms of compliance programmes and enforcement costs and the chilling effects on innocent transactions; and
- ignore the loss of credibility for the law as an institution, the loss of an acceptance that it should have reasonable boundaries in a free society, the loss of integrity when it is so plainly anomalous – pursuing some 'moral' causes and ignoring others – and the loss of the trust we should have in legislators when they can be bent to the will of minority enthusiasms.

Good governance: can it be ensured?

To return to our immediate concerns as business people, we know intuitively in our company roles that you can't 'ensure' integrity, or 'ensure' good governance. We know that you can infuse everything you do with respect for those values and objectives. You can make it more likely that the dishonest or the lazy or foolish will be discovered and rooted out (or in this more caring world 'retrained' and 'supported') sooner rather than later, but no system or set of regulations or fashionable set of priorities can 'ensure' integrity and good governance.

However, legislative or regulatory mandates for such worthwhile objectives require that you 'ensure' such things. That priority will carry great deadweight costs. Good corporate governance should rank among a number of objectives or risks to be managed among all the competing objectives. These include returns to shareholders, avoiding waste, encouraging innovation, enhancing job satisfaction and so on. When legislated they usurp rational priority allocations. Among the myriad risks involved in business decisions, the law simply pre-empts normal weightings. It elevates a form of back-covering behaviour designed to demonstrate compliance.

This is not, of course, to argue that wicked people should not be punished for evil deeds. Fraud, theft, dishonest misappropriation and so forth have been the proper concern of laws throughout modern times (since the company began in 1858). But we make a nonsense of the law when we try to use the same threats and apply the same resources in the case of a failure to file notices, or to get a permit, or simple carelessness.

It is easy to see it as ludicrous for directors to face direct personal liability for failure to get a permit before weeding a vegetable patch (which could be required under the words of some district schemes), or failure to prevent an employee disobeying express orders by removing a protective guard on a machine, or failure to stop employees wolf-whistling and the like. But such nonsense is sinister. It corrupts our sense of coincidence of the law with right and wrong. We like to believe that there is a logic to the law and to our relationships with each other. This does not mean that the law can or should pursue every moral misdemeanour, but it certainly should not pursue voluntary conduct on which there is no consensus as to its morality.

Let us examine the new positive law in action in less arcane areas which you might have thought reasonably straightforward and unexceptionable. What does such law mean for business?

Most people don't like lawyers very much – they say, usually with bitter experience, that they cost too much. What does 'too much' mean? It means that they do not think they get value for what they pay: the returns do not justify the cost. And yet, usually, the lawyer will have done the job asked. In reality, the complaint is not so much that lawyers are greedy (though some may be) but the sense of frustration that lawyers are necessary at all.

For the lay person there seem to be endless meaningless hoops that have to be jumped through to accomplish simple transactions – whether buying a house, getting off a wrongly issued parking ticket or obtaining a divorce settlement. So when we complain about lawyers, we are really complaining about the number and complexity of laws, and their consequent cost in time and money.

Ultimately, however, business people pay lawyers and obey the law partly because breaking the law (and being caught) is bad business – not only because of the immediate sanctions, but also because of the consequent bad publicity. But the converse proposition – that complying with the law guarantees good business – is not true. And no one expects that it should be. Investors take the law as a set of minimum expectations. They want their money to be dealt with honestly. They expect not to be defrauded. But if all that their boards do is comply with the law, investors would be sorely disappointed. They expect much more than this. They are looking not simply for the minimum performance required at law, but the best possible performance that will bring them tangible rewards.

So the law's role in ensuring integrity and good governance is necessarily limited. By definition almost, it is not the average requirement but the minimum. But the real concern is that complying

with the law may obstruct the achievement of that best possible performance and so result in bad business.

What do our statutes say about integrity and good governance?

What does the law presently say about the way business should operate? You won't find much that bears directly on good governance in the Companies Act 1993. But the duties assume much about best practice.

Section 128 tells me that the business and affairs of a company "must be managed by, or under the direction or supervision of, the board of the company". "Manage", my dictionary tells me, means to "organise, regulate or be in charge of". This can be true of closely held companies, which make up over 90 percent of the companies in New Zealand, where the shareholders are likely to be directors also. But it is not true of large corporations which account for much economic activity. Similarly "direction" implies that the board should take the initiative for the business direction of the company. And "supervision" suggests close overseeing of the business. The reality of big business – the passive board which adopts a whistleblowing role on management – is not acknowledged.

This picture of the board as a pro-active, hands-on body is emphasised again later in the Companies Act. Section 130 gives the board the power to delegate, but provides that it is responsible for the exercise of that power of delegation:

... unless the board –
(a) believed on reasonable grounds at all times before the exercise of the power that the delegate would exercise the power in conformity with the duties imposed on directors of the company by this Act and the company's constitution; and
(b) has monitored, by means of reasonable methods properly used, the exercise of the power by the delegate.

So the board remains responsible for the direction or supervision of management unless it both believed the delegate would comply with the Act and had objective grounds for that belief. That seems fair enough. You should prudently select your chief executive or financial officer. You should not just gullibly believe wild unfounded statements about their experience. You should have a basis for your reliance.

But section 130 requires you to believe the manager will comply with the statutory duties at all times before the exercise of the power. This requires far more than just

prudent selection of a person with relevant skill and qualifications. It suggests I must never have had a moment's doubt that the person could do the job. It is not enough that I had overcome some such doubt or, more likely, considered that in the context the risk that the manager could not do the job was outweighed by other factors.

It is common sense that I should withdraw authority from a manager I have lost confidence in, and even that I should do so quickly if I have grounds to suspect that he or she is untrustworthy. But on the face of it this rule removes my ability to make an assessment as to the grounds for that suspicion or give a manager an opportunity to make mistakes.

But even if I try to meet my duties under this law, I am snookered by another. In order to replace a manager quickly while complying with employment law, a board of directors would need to have evidence of serious wrongdoing, almost sufficient to sustain a criminal conviction for fraud. If a manager is simply incompetent, a lengthy series of warnings and second chances must be given. In one recent case the Employment Court awarded compensation to a chronically underperforming senior sales executive because it thought the period of two months he had been given in which to improve was insufficient time. If a manager is merely mediocre, it may not be possible to sack him or her at all.

Whatever your opinion about these rules for ordinary employees, they are clearly ludicrous when applied to highly paid senior management. A company may be able to carry the burden of an ordinary dishonest or incompetent employee until the person is finally caught with one hand in the till or engaged in sexual harassment, but treating a senior manager with equivalent laxity could be enough to sink a business. It will certainly be enough to sink a board of directors for breaching their duties to protect their company.

Looking again at section 130, the second requirement is that I "monitor" the delegate by reasonable methods properly used. Again the law, it seems to me, has made the mistake of imposing a positive obligation on boards, rather than setting a narrow restriction on what cannot be done. And it has done this without defining the content of that obligation. I must monitor, but what does monitor mean? Similar questions were asked by the Hilmer working party in *Strictly Boardroom*. They pointed out that there are a number of levels of monitoring. If, for example, a board wishes to review the strength of its brand franchise by asking the chief executive whether the company is adequately maintaining its brands by competitive marketing, service, packaging and the like, a number of responses from the chief executive are possible. For example:

- she might talk about the brand franchise in general terms and outline the policies being followed;
- she might be more specific, referring to data on trends in marketing expenditures for the company relative to others and to market research results;
- she might offer to bring a formal report to the board and have senior marketing executives in attendance for the board to question; or
- the board might get an external review by a marketing expert and an assessment of the brand's value and the management's actions in maintaining and improving it.

What is appropriate for good governance will depend on the function delegated and its importance to the company. I assume that a sensible court would say that "monitoring" can mean different things in different contexts. But what looks reasonable with the benefit of time and hindsight can look very different from a judgment that has to be made quickly if an opportunity is not to be lost. I am told that this obligation to "monitor" is a far cry from the duty which the common law set. At common law, the need for a board to trust its management was recognised. Until recently, provided I did not "abdicate responsibility" altogether, I could trust my managers unless put on notice.¹ If put on notice I would have to make inquiry and satisfy myself that duties were being properly performed. However, there was no positive obligation on me to watch over management's shoulder, and no requirement to try to guess how much watching I must do to satisfy my legal duties.

So company law prevents me from trusting my managers. It requires me to watch over them and to strip them of authority at will if I suspect them to be unreliable. But employment law says that I cannot do so without having climbed through the hoops demanded by the Employment Court.

The other key provision of the Companies Act which governs the relationship between the board and its executives is section 138. Section 138 says I can only rely on reports or advice from the following persons:

(a) an employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned;
 (b) a professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence;
 (c) any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority.

1 Re City Equitable Fire Insurance [1925] Ch 407.

Incidentally it implies that I should rely on a professional adviser over an employee. Reliance on a professional adviser is justified on matters within the person's qualified competence. But reliance on an employee is fraught with difficulty. I am expected to know the personal qualities of my employees. I am placed under a positive obligation to ascertain whether a person is reliable and competent. In addition, how can I give employees a second chance? Gone is the ability for a trial period for employees. At least this time company law and employment law are at one in preventing this, I suppose.

But more difficult is subsection (2), which says that I can only rely on these persons if I have no knowledge that such reliance is unwarranted. What does this mean? It must mean something more than that I have made inquiries to reassure myself if, for example, I have heard whispers suggesting that my financial officer is not up to scratch. That requirement is covered in (b), which states that I must make proper inquiry where the need is indicated by the circumstances. Does it mean I have to be completely certain that the person is up to the job? Or will courts sensibly qualify this obligation so that my duty is just that the outcome of my inquiries if put on notice must, after having balanced up the risks, reassure me?

Here we come to the crux of the issue: I do not know what these positive obligations mean – or what a court will later interpret them to mean. The only prudent response is to oversee and second-guess management.

What's wrong with paternalism?

The beauty of the concept of a company is that it provides a vehicle for a number of private parties to contract with each other to do business. They can more efficiently pool their capital. They can limit the costs of the transactions between them. They can avoid undue risk for the contributors and ensure continuity beyond the lifespan of any particular person. And a key feature of the company is limited liability. It spreads economic risk through a number of willing participants, and it encourages business risk to be taken. The benefit to society as a whole is incalculable. But most new businesses fail. Only a few of today's listed companies existed 30 years ago. But business risk is a prerequisite to innovation and growth.

The investor and his or her associates have an opportunity to set the company's governance structure at the outset. They put in place procedures in the company's constitution or in a shareholder agreement, such as shareholder consultation rights and limits on the board's prerogative, which prescribe the framework under which the company will operate. They can also

come to the company with shared expectations as to how the conventions for monitoring management discretions operate. At this stage, the parties have the freedom to determine the level of expectations, and these will be constrained by market expectations.

Creditors look at the credit risk of the company. They have an opportunity to protect themselves by obtaining security or not extending credit to the company at all. Each participant is a consenting party with the opportunity to opt in or out.

So why should company law need to dictate these standards for us? Who are we protecting and why? Some answer that question by asking why should we care if the minimum standards are set higher than freely contracting parties might choose – doesn't this result in better overall performance?

There are two points to be made in response. First, the law should prescribe minimum standards that are efficient and do not inhibit the key benefit of the corporate form. Investors should be protected from fraud. But, assuming honesty, why does the law protect against incompetence when investors could do so themselves?

The present attitude of the law is summed up for me by the new power of the Registrar in section 385 to prohibit a person from being a director or taking part, directly or indirectly, in the management of the company. If a person has been a director/manager of two or more failed companies, that person has to prove either that mismanagement was not even a partial cause of the failures, or that it would not be "just or equitable" to exercise the prohibition power. In other words, if a company fails, someone must have been at fault and someone should be punished unless the case to the contrary can be proved.

Secondly, the governance model prescribed by the Companies Act would not be problematic if these standards were only a default option, which consenting investors and other stakeholders could opt out of. But we have no ability to negotiate on what level of risk is acceptable. Company law now envisages only one kind of company director. The law has stipulated business practice for all companies, no matter what size, and for all directors, no matter their role on the board. By making it law, we have made an average requirement the minimum.

These so-called minimums can be at odds with good business practice. For example, they take no account of decentralised decision making. And because I do not know how they will be interpreted in the future, conservatism is the only safe option. The cost is not only immediate in the form of

larger legal fees – as the compliance programmes are churned out – but also in a form which is harder to quantify – the losses in efficiency and in transactions which simply do not occur.

But then why do we expect anything different? Lawyers draft laws. Lawyers administer laws. And lawyers judge compliance with laws. But lawyers are peculiarly incapable of understanding the risk/return matrix. They don't need to. Legal business is not made or lost in the way other business can be. Lawyers are not made redundant by a newer product model. Few have experienced being put out of business because someone else undercut them or made a successful risky decision faster, or with less information.

But risk is something investors appreciate. And in the end the law does not have a great deal to do with whether or not an investment succeeds. The risks investors are obviously most concerned about dwarf those that the law tries to confine. The risk that someone else will make a better product tomorrow that will make mine obsolete, that taxes might rise, that supply prices will increase, that a key employee will die, that the currency will depreciate, that consumer confidence might plummet – all these are risks that the law cannot do much about.

Good and bad responses to our present dilemmas

What conclusions can be drawn about our current position – where politicians have been persuaded that lawyers can give us the incentives to maximise profits for our 'stakeholders'? What flows from this lamentable outcome of well-meaning effort?

First, in a lawyer-led economy there will be thousands of expensive lawyer hours spent on interpreting the law. Secondly, as transaction costs may consume nearly 50 percent of all resources in a modern economy, it is not surprising that heavily regulated countries have puny growth rates.²

The Nobel laureate F A Hayek had views that were eclipsed for a time as the children of the 1940s and '50s smothered their own freedoms with a nanny state. Regulatory failure is only to be expected, according to Hayek. Freedom works because in aggregate, and over time, people will

2 The figure comes from North, D C, 'Economic Performance Through Time', American Economic Review, Vol 84 (1994), p359.

know more about their immediate circumstances and requirements, and be able to craft solutions that better fit them, than any number of overbearing, or well-meaning, officials at the centre.

This is not a prescription for people to exercise rights without sanctions. At an individual level many of us make mistakes. Unless someone else has agreed (expressly or implicitly) to meet the costs of those mistakes, we should meet them. Nor is it a prescription for no role for the state. There are many things which can and should be done collectively. Among those is standard setting. At its most simple, the enforcement of honest weights and measures is the paradigm. No law should tell you how much butter or cheese or flour you can offer for sale or buy. But it is perfectly in order for the law to establish the quantities that represent a kilo or a tonne, and to punish those who falsely claim to be dealing in such quantities when they are not.

In company law there is nothing wrong with recording common patterns of rights and expectations in the company, of shareholders from directors and of employees from employers. But equally in voluntary arrangements people should be free to contract for variations. For example many shareholders might be delighted to have the wisdom of a Ron Brierley or a Douglas Myers on their board, even if he was available only sporadically, or took an active part only when serious strategic questions were faced. They might be happy to write the directors' duties to recognise that it was an "attend and respond only when asked or put on inquiry" role. They could have done so until the 1993 Act was passed. We have now lost that freedom.

The likely response of law makers to our predicament is, I fear, to struggle on a case by case basis to examine each rule and to try to think of a better, less costly one. They will feel that by doing so they are rolling back the boundaries of overweening legislation. They may also try to exclude the law and lawyers from areas of conduct. That may work in some areas but I think it will be constantly frustrated by the 'what if?' fears of those who assess law not by its total costs and effects, but instead by the impact of the sad cases they can imagine and would like to avert. Those who can think of some unfortunate who might be protected will block a reform which might make thousands better off.

For this reason I do not see a long-term turning of the tide until we have regained a consciousness of the importance of freedom and the need for humility about the knowledge and analytical skills of the would-be regulator. An understanding of the reasons for letting the costs of bad conduct and failure lie with those who indulge in it or risk it must be re-established. Freedom has a price and it is that actions have consequences. If we want to be free then we need to ensure the free operation of the incentives to choose carefully, to deal with people of proven integrity and good reputation, and to act honestly ourselves. The law should be straightforward enough and cheap enough to

create the right odds that pre-agreed allocations of risk will be enforced. Expected consequences will follow.

A more immediate payoff would come from much more simple reforms. They also are more likely to find favour. Do not change the rules again. Do not labour to find perfect solutions, or absolutely level playing fields. Just allow consenting adults to contract out, to decide for themselves how they want to govern their relationships and their investments. Just try freedom.