

# **EVALUATING AUSTRALIA'S CORPORATE LAW REFORM FROM AN ORGANIZATIONAL THEORY PERSPECTIVE**

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## **Evaluating Australia's corporate law reform from an organizational theory perspective**

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This paper explores the effect that the extensive Corporate Law Economic Reform Program (CLERP) reforms in Australia had on corporate governance compliance and enforcement.

It is not possible to determine the effectiveness of the reforms without first knowing how corporations and corporate actors respond to regulation. Organizational theory is a body of research that helps answer these questions. Unfortunately, organizational theory has many competing theories. A classification scheme is used in this paper to summarize the insights from organizational theory and show that there are really two different competing perspectives of how corporations and corporate actors respond to regulation: the rational open systems perspective and the natural open systems perspective (including the "social theory of the corporation").

The evaluation of the effectiveness of the CLERP reforms depends on which perspective is adopted. The reforms are more effective if the rational open systems perspective is adopted and not as effective if the natural open systems perspective is adopted.

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## Introduction

Australian corporate law has undergone an extended period of reform over the last few decades.<sup>2</sup> The latest set of reforms began in 1997 with the announcement of the Corporate Law Economic Reform Program (CLERP) by the Howard government. The CLERP reforms were motivated by three different concerns: the complexity of Australian corporate law, increasing competitive pressures in the economy from globalization, and a series of high profile Australian corporate governance scandals, including HIH Insurance, One.Tel, Ansett, Pasminco, Centaur, and Harris Scarfe.<sup>3</sup>

Now that the CLERP reforms are almost complete, it is time to take a step back from the reform effort and to evaluate its effectiveness by determining whether the changes are likely to increase corporate governance and compliance in Australia.<sup>4</sup> This paper evaluates the CLERP reforms from the perspective of organizational theory.

The paper is divided into five parts. Part 1 is an introduction to organizational theory. It includes a discussion of the two dominant perspectives in organizational theory (the rational systems perspective and the natural systems perspective) and a discussion of the close relationship between organizational theory and corporate theory. Part 2 explores the application of the rational and natural perspectives to corporate regulation. Part 3 evaluates CLERP using the rational and natural systems perspectives. Part 4

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<sup>2</sup> The corporate law reforms in Australia over the last 30 years have been so extensive that no article can hope to offer any meaningful evaluation of them as a whole. As such, the choice was made in this article to focus only on the most recent set of reforms: The Corporate Law Economic Reform Program (CLERP).

<sup>3</sup> Many commentators have described these corporate governance failures in detail. For example *see* Gerald Acquah-Gaisie, "Toward more effective corporate governance mechanisms" (2005) 18 *Journal of Australian Corporate Law* 1; Jean du Plessis, "Reverberations after the HIH and other recent Australian corporate collapses: The role of ASIC" (2003) 15 *Australian Journal of Corporate Law* 225; Roman Tomasic, "Corporate Collapse, crime and governance – Enron, Anderson and beyond" (2002) 14 *Aus. J. Corp. L.* 183; Michael de Martinis, "Do directors, regulators, and auditors speak, hear, and see no evil? Evidence from the Enron, HIH and One.Tel collapses" (2002) 15 *Aus Jnl Corp Law* 66; [extend list with rest of articles read].

<sup>4</sup> CLERP is not yet completed because CLERP 8 still needs to be legislated.

discusses the differences between the rational and natural perspectives and offers the Layered Approach as a potential way to reconcile the conflicting insights and explains how they relate to the “regulation pyramid” from strategic regulation theory. Part 5 concludes by stating that evaluation of the effectiveness of the CLERP reforms depends on which perspective is adopted. The reforms are more effective if the rational systems perspective is adopted and not as effective if the natural systems perspective is adopted.

## **Part 1 - Organizational Theory and Corporate Theory**

Why use organizational theory to analyze corporate law reforms? Because, whether we realize it or not, all corporate law reform efforts are based on a particular organizational theory or perspective.

The fact that corporate law reform efforts are based on particular corporate theories has been acknowledged for a long time.<sup>5</sup> Corporate theories are theories that support a particular view of the world and the way that corporations fit into that world.<sup>6</sup>

All corporate theories provide answers to the following two questions:

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<sup>5</sup> The relevance of corporate theories on corporate regulation in Australia has been pointed out by Profs. Ian Ramsay, Stephen Bottomley and Katherine Hall. See Ian Ramsay, “Company Law and the Economics of Federalism” 19 Fed. L. Rev. 169 at 202, where he stated: “Theories may flourish and then fade just as legal principles, once embraced by many, decline in significance. *However, because different corporate theories have fundamentally different consequences for the extent of corporate regulation perhaps it is time that each of us involved in company law research, teaching and reform gave more attention to the corporate theory that (either explicitly or implicitly) imbues our work.*” [emphasis added]; See Bottomley *supra* note XX at 204, where he stated: “The broad and basic purpose of examining corporate theory is to develop a framework within which we can assess the values and assumptions that either unite or divide the plethora of cases, reform proposals, legislative amendments and practices that constitute modern corporate law”; See also Hall *supra* note XX, where she stated: “Together with a consideration of cases, statute, policy and practice, theory has a vital role to play in the development of corporate law.” For a complete discussion of corporate theory and the importance of corporate theory on law reform efforts see Michael Cody, *The Corporation is a Social Institution* (2006) (unpublished thesis).

<sup>6</sup> Academic interest in corporate theory in Australia has grown in the last two decades. Australian sources that discuss corporate theory are: Katherine Hall, “The Interior Design of Corporate Law: Why Theory is Vital to the Development of Corporate Law in Australia” (1996) 6Aus Jnl Corp Law 1; Stephen Bottomley, “Taking Corporations Seriously: Some Considerations For Corporate Regulation” (1990) Federal Law Review 203; Roman Tomasic and Stephen Bottomley, *Corporations Law in Australia* (Sydney: Federal

1. What is a corporation? and
2. What is the purpose of corporate law?<sup>7</sup>

The assumption behind this question is that it is necessary to understand the social phenomenon that is being regulated before you can regulate it.<sup>8</sup>

Organizational theory enters this analysis because it is the discipline best suited to answer the first question: What is a corporation? This is because in reality corporations are nothing more than organizations of people. For example, economist Michael Jensen wrote that in order to develop a theory of corporate governance we will need to:

. . . break open the black box called the firm, and this means understanding how organizations and people in them work. In short, we are facing the problem of developing *a viable theory of organization*.<sup>9</sup>

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Press, 1995) at Ch 2; Roman Tomasic, J Jackson and R Woelner, *Corporations Law: Principles, Policy and Process* (Sydney: Butterworths, 1996) at 4-13; S. J. Stoljar, *Groups and Entities: An Inquiry into Corporate Theory* (Canberra: University Press, 1973); and Leicester Webb, *Legal Personality and Political Pluralism* (Melbourne: Melbourne University Press, 1958). Other important Anglo-American sources on corporate theory include: Arthur W. Machen Jr., "Corporate Personality" (1911) 24 Harv L. Rev 253; Frederick Hallis, *Corporate Personality: A Study in Jurisprudence* (London: Oxford University Press, 1930) (the basic starting point for all theories prior to 1930); Roscoe Pound, *Jurisprudence* (St. Paul, Minn: West Publishing Co., 1959); Morton J. Horwitz, "Santa Clara Revisited: The Development of Corporate Theory," (1985-86) 88 W. Virginia Law Review; Gregory A. Mark, "The Personification of the Business Corporation in American Law" (1987) 54 U. Chicago L. Rev. 1441; William W. Bratton Jr., "The New Economic Theory of the Firm: Critical Perspectives from History" (1989) 41 Stanford L. Rev 1471; Mark Hager, "Bodies Politic: The Progressive History of Organizational 'Real Entity' Theory (1988-1989) 50 U. Pitt. L. Rev. 575; David Millon, "Theories of the Corporation" [1990] Duke L.J. 201; Chris Tollefson, "Corporate Constitutional Rights and the Supreme Court of Canada" (1993) 19 Queen's L.J. 309; Robert Yalden, "Competing Theories of the Corporation and their Role in Canadian Business Law" in Anand and Flanagan ed., *The Corporation in the 21<sup>st</sup> Century* (Kingston: Queen's Annual Business Law Symposium, 2003); and Cody *supra* note 4.

<sup>7</sup> The idea that corporate theory answers the question "What is a Corporation?" is shared by John Coates. See John Coates, "State Takeover Statutes and Corporate Theory: The Revival of an Old Debate (1989) 64 NYU L. Rev. 806.

<sup>8</sup> The idea that it is necessary to understand the social reality of corporations in order to develop effective regulation is not a new idea. It was supported by early corporate theorists like Otto Gierke and Frederick Hallis. For an example see Hallis *ibid*. Australian legal academic D.P. Derham has provided a modern view of this argument: "It is necessary for the lawyer and legislator to be informed about human personality, about the nature of groups and their activities, about human purposes whether individual or communal, about the actual relations developed or developing between men in society, for this is the stuff without which law as an applied science has no content or meaning." David Derham, "Theories of Legal Personality" in Leicester Webb, *Legal Personality and Political Pluralism* (Melbourne: Melbourne University Press, 1958) 1 at 11.

<sup>9</sup> Michael Jensen, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems" (1993) *The Journal of Finance* 831. [emphasis added]

Organizational theory is simply the study of how organizations are created, maintained and changed. It attempts to answer questions like: What are organizations? And, how do they respond to change? Organizational theory focuses on two primary relationships: the internal structure of the organizations and the relationship between the organization and its external environment. Sociologist, Neil Fligstein has described the scope of organizational theory in the following way:

Organizational theory is concerned with how the internal organizational structure works to motivate participants and produce outcomes consistent with the goals of those who control the organization. It is also interested in how the world external to an organization effects what is going on inside of a particular organization. Finally, it is concerned with how the internal organization and the external world can effect organizational survival.<sup>10</sup>

Therefore, organizational theory is the perfect discipline to support corporate theory which is simply asking a subset of the questions that organizational theory asks: What are corporations? And, how do corporations respond to change (regulation)? The result of the overlap in the questions posed by corporate law and organizational theory has led to a close historical relationship between corporate law (and corporate theory) and organizational theory as. This relationship is explained in more detail below.

### *Difficulties in Applying Organizational Theory*

Notwithstanding the applicability of organizational theory to corporate law, organizational theory has been vastly underrepresented in modern corporate law literature to date. Why is it that modern Anglo–American corporate law,<sup>11</sup> that is in essence the law of a particular type of organization, has been so uninterested in the broader

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<sup>10</sup> Neil Fligstein, “Organizations: Theoretical Debates and the Scope of Organizational Theory” in Craig Calhoun et al., eds., *International Handbook of Sociology* (London: Sage Press, 2005) at para 5.

<sup>11</sup> The term Anglo-American refers to the following group of countries: the United States, the United Kingdom, Canada, Australia and New Zealand.

developments in the social sciences that relate to how organizations are created, maintained and change?<sup>12</sup> The most likely reason is that it is hard to apply organizational theory because the discipline is has way too many conflicting theories. Just how many theories organizational theories are there? Fligstein has identified at least 23 significant organizational theories.<sup>13</sup> His chart outlining the historical development of those organizational theories is attached as Appendix 1.

The sheer number of theories makes the discipline difficult for everyone to understand. Organizational theorist, W. Richard Scott described the complexity of the discipline in the following way:

The current profusion of multiple competing theoretical perspectives necessarily poses difficult problems for all of us – from beginning student to seasoned scholar – working in the field. . . Suffice it to say that while the existence of multiple paradigms may reduce consensus and support, it may also reflect the complexity of the phenomenon addressed and improve our analytic capacity by providing multiple lenses through which to observe the world.<sup>14</sup>

Scott's argument is that the discipline is complex because the subject matter (human organization) is complex. Therefore, instead of simplifying organizational theory for use by other disciplines,<sup>15</sup> Scott has classified organizational theories into three main perspectives: the rational systems perspective, the natural systems perspective and the

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<sup>12</sup> The exception to this rule is the “Nexus of Contracts” theory of the corporation that is now the dominant theory of the corporation in Anglo-American societies. This theory was based directly on Agency Theory – which was an organizational theory developed by economists in the 1970's.

<sup>13</sup> See Neil Fligstein, “Organizations: Theoretical Debates and the Scope of Organizational Theory” in Craig Calhoun et al., eds., *International Handbook of Sociology* (London: Sage Press, 2005).

<sup>14</sup> See Scott, W. Richard. *Organizations: Rational, Natural and Open Systems*, 5<sup>th</sup> ed. (Toronto: Pearson Education, 2003) at 121.

<sup>15</sup> Neil Fligstein has made the opposite argument. He has argued that organizational theories and economic sociology theories of the economy are too complicated and that they will never be used by policy makers (including regulators) until the theories are simplified. See Fligstein, Neil. *The Architecture of Markets: An Economic Sociology of Twenty-First-Century Capitalist Societies* (Princeton: Princeton University Press, 2001) at xiii and 9.

open system perspective.<sup>16</sup> The perspectives are separated based on their different conceptions of what organizations are. This classification scheme will be used in this article because it is particularly effective at highlighting the differences between organizational theories, making the theories easy to understand and making the theories accessible to people who are not familiar with them.<sup>17</sup> This simplified version of organizational analysis is also particularly useful to show how organizational theory can be used to evaluate corporate law reforms without engaging in too much detailed analysis.<sup>18</sup>

### *Scott's Classification Scheme – The Three Theoretical Perspectives*

Each of Scott's three perspectives is summarized briefly below and included in the Chart attached as Appendix 2.

#### *Rational Systems Perspective*

The rational systems perspective includes organizational theories that view organizations as tools designed to attain specific goals.<sup>19</sup> The perspective defines organizations in the following way:

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<sup>16</sup> His classification scheme is widely used by organizational theorists. Scott's use of the terms "perspective" to refer to these three groups of theories was purposeful: "The term *perspective* is used advisedly since we are dealing in each case not with a single unified model of organizational structure but rather with a number of varying approaches that bear a strong family resemblance." See Scott, *supra* note 14 at 31.

<sup>17</sup> Please note that a tremendous amount of complexity is lost in using this classification system. For a more detailed description of the application of four specific organizational theories to corporate law regulation see Edward Rubin, "The Role and Limits of Legal Regulation of Conflicts of Interest (Part II)" 6 *Theoretical Inquiries L.* 347, where he explores the application of the human relations school, agency theory, systems theory, and institutionalism to corporate regulation.

<sup>18</sup> For a more detailed description of the application of four specific organizational theories to corporate law regulation see Edward Rubin, "The Role and Limits of Legal Regulation of Conflicts of Interest (Part II)" 6 *Theoretical Inquiries L.* 347, where he explores the application of the human relations school, agency theory, systems theory, and institutionalism to corporate regulation.

<sup>19</sup> See Scott *supra* note XX at 33.



Organizations are collectivities oriented to the pursuit of relatively specific goals and exhibiting relatively highly formalized social structures.<sup>20</sup>

This definition illustrates the two structural features of organizations that differentiate organizations from other social groups in the rational systems perspective: goal specificity and a high degree of formalization.<sup>21</sup> Goal specificity refers to the fact that organizations have clear goals that provide “unambiguous criteria for selecting among alternative activities.”<sup>22</sup> The clearer and more ‘specific’ the goals the more successful the organization will be because it can more easily be designed to meet those goals.<sup>23</sup> Formalization refers to the deliberate structuring of the roles and relationships among participants in an organization.<sup>24</sup> Organizations achieve their goals by implementing these formal systems (including laws, regulations and codes of conduct) to increase their chances of attaining their goals.<sup>25</sup>

This perspective tends to view organizations as if they were mechanical devices that operate in specific predetermined ways. Scott describes this belief as follows:

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<sup>20</sup> *Ibid* at 27. Other examples of rational systems definitions of organizations are: Blau and Scott (1962) at 2, where the authors state: “Since the distinctive characteristic of . . . organizations is that they have been formally established for the explicit purposes of achieving certain goals, the term “formal organizations’ is used to designate them”; Adam Etzioni, *Modern Organizations* (Upper Saddle River, N.J.: Prentice Hall, 1964) at 3, where the author states: “Organizations are social units (or human groupings) deliberately constructed to seek specific goals.”; and James March and Herbert Simon, *Organizations* (New York: John Wiley, 1958) at 4, where the authors state: “Organizations are assemblages of interacting human beings and they are the largest assemblages in our society that have anything resembling a central coordinative system. . . The high specificity of structure and coordination within organizations-as contrasted with the diffuse and variable relations among organizations and among unorganized individuals-marks off the individual organization as a sociological unit comparable in significance to the individual organism in biology.”

<sup>21</sup> *Ibid.*

<sup>22</sup> *Ibid.*

<sup>23</sup> For example, Scott writes: “Specific goals not only supply criteria for choosing among alternative activities; they guide decisions about how the organization structure itself is designed. They specify what tasks are to be performed, what kinds of personnel area to be hired, and how resources are to be allocated among participants. The more general or diffuse the goals, the more difficult it is to design a structure to pursue them.” *Ibid* at 34.

<sup>24</sup> *Ibid.* This idea has led to the development of organizational charts, work-flow diagrams and other process mapping technologies.

<sup>25</sup> *Ibid.*

Thus, in a fundamental sense, the organizational structure is viewed as a means, as an instrument, which can be modified as necessary to improve performance.<sup>26</sup>

The appropriate metaphor for this perspective would be that of a clock or other mechanical device. One of the implications of this perspective is that the structure of the organization is more important than its participants. The organizational structure becomes independent of its participants, participants are not required to have any special skills and they are simply slotted into roles as interchangeable parts of the overall machine. The human and individual characteristics of the participants in the organization become irrelevant.<sup>27</sup> Early rational systems theories also did not take into account the effects of the larger social or cultural context on an organization or its structure. They were primarily focused on the internal structure of the organizations.<sup>28</sup> Examples of organizations that fit this perspective are the army and certain government bureaucracies. The best example of a rational systems theory is Frederick Taylor's scientific management theory.<sup>29</sup>

The rational systems definition of an organization is the dominant perspective in organizational theory and in practice among managers of organizations.<sup>30</sup> It is also the dominant perspective in corporate law.<sup>31</sup>

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<sup>26</sup> *Ibid* at 36.

<sup>27</sup> *See ibid* at 37 where he states: "Formalized structures are thus rendered independent of the participation of any particular individual. A related consequence is that it becomes less essential to recruit unusually gifted individuals for key positions. The power and influence of leaders can be determined in part by the definition of their offices and not made to depend on their personal qualities – their charisma."

<sup>28</sup> *See ibid* at 55.

<sup>29</sup> *See* Frederick Taylor, *The Principles of Scientific Management* (New York: Harper, 1911). Other examples of rational systems theories are Weber's bureaucracy theory, Fayol's administrative theory and Simon's decision making theory.

<sup>30</sup> *See* Scott at 25 where he states: "Special attention is accorded here to the [rational systems] definition because it continues to be the dominant perspective in the field, not only in guiding the work of the majority of organizational scholars, but also by being embraced at least implicitly by most real-world managers and other practitioners."

<sup>31</sup> The dominant "nexus of contracts" theory of the corporation is a rational systems theory,

### *Natural Systems Perspective*

The natural systems perspective includes theories that emphasize that organizations are collectivities of human actors and not tools designed to meet specified goals. This perspective emphasizes that organizations are social groups attempting to survive and adapt in their particular circumstances.<sup>32</sup> Organizations are similar to all other types of social groups and, therefore, are subject to the forces that affect all social systems.<sup>33</sup> The perspective defines organizations in the following way:

Organizations are collectivities whose participants are pursuing multiple interests, both disparate and common, but who recognize the value of perpetuating the organization as an important resource. The informal structure of relations that develops among participants is more influential in guiding the behavior of participants than is the formal structure.<sup>34</sup>

This definition recognizes the emphasis of the natural systems perspective that the primary goal of an organization is the survival and maintenance of the organization itself.<sup>35</sup> In direct contrast to the rational systems perspective, this perspective acknowledges that organizations are characterized by goal complexity and informal structures. Goal complexity is the ability of an organization to pursue a multitude of goals at the same time.<sup>36</sup> This perspective also emphasizes that the informal structures (norms, culture, beliefs etc.) of an organization are as important as its formal structures (roles and

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<sup>32</sup> *See Ibid* at 57.

<sup>33</sup> *Ibid* at 28.

<sup>34</sup> *Ibid* at 28.

<sup>35</sup> *Ibid. See also* Alvin Gouldner, "Organizational Analysis" in Robert Merton, Leonard Broom, and Leonard Cotrell, eds., *Sociology Today* (New York: Basic Books, 1959) at 405, where he stated: "The organization, according to this model, strives to survive and to maintain its equilibrium, and this striving may persist even after its explicitly held goals have been successfully attained. This strain toward survival may even on occasion lead to the neglect or distortion of the organization's goals." To illustrate this point, Scott provides the example of the National Foundation for Infantile Paralysis that changed its name and continued on after a cure was found for its disease.

<sup>36</sup> *Ibid.* The classic example of multiple goals is that an organization, in addition to pursuing its stated objective, must also spend time and energy maintaining itself. Other examples include personal goals of participants or goals of specific departments or subgroups within the organization.

responsibilities, rules, codes of conduct etc.). Scott describes the importance of informal structures to this perspective:

Natural systems analysts emphasize that there is more to organizational structure than the prescribed rules, the job descriptions, and the associated regularities in the behavior of participants. Individuals are never merely ‘hired hands’ but bring along their heads and hearts; they enter the organization with individually shaped ideas, expectations, and agendas, and they bring with them distinctive values, interests and abilities.

Expressed through interaction, these factors come together to create a reasonably stable informal structure. One of the most important insights of the natural systems perspective is that the social structure of an organization does not consist of the formal structure plus the idiosyncratic beliefs and behaviors of individual participants but rather of a formal structure and an informal structure: informal life is itself structured and orderly. Participants within formal organizations generate informal norms and behavior patterns: status and power systems, communication networks, sociometric structures and working arrangements.<sup>37</sup>

This perspective tends to view organizations as if they were living organisms. The appropriate metaphor for this perspective would be that of the human body. An example of an organizational type that fits this perspective is the Japanese Keiretsu during the 1980’s.<sup>38</sup> Examples of natural systems theories are Philip Selznick’s early institutional theory, Elton Mayo’s human relations school, and Talcott Parsons model of society.<sup>39</sup>

### *Open Systems Perspective*

Both the rational systems and natural systems perspective tend to view the organization as a closed system separate from its environment with an easily identifiable and stable set of participants.<sup>40</sup> This is considered to be a clear boundary. However, organizations are not closed systems – they are open to and interact with their

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<sup>37</sup> *Ibid* at 59.

<sup>38</sup> In fact, as an example of this, Sony had an internal corporate structure diagram that depicted the organization as a living tree.

<sup>39</sup> For a description of these theories see Scott, *supra* note **Error! Bookmark not defined.** at 61-76.

<sup>40</sup> *Ibid* at 28.

environments.<sup>41</sup> This is the key insight of the open systems perspective. The open systems perspective defines organizations in the following way:

Organizations are congeries of interdependent flows and activities linking shifting conditions of participants embedded in wider material-resource and institutional environments.<sup>42</sup>

Open systems organizations are open to their environments and thus it is often difficult to determine their boundaries. For example, which stakeholders are participants in a corporation? Are creditors participants or are shareholders, managers and workers the only participants? Because of the difficulty of defining boundaries, organizations need to expend resources in order to maintain their boundaries. Open systems also adapt to their environment and become more specialized and complex. This leads to the development of a greater degree of complexity and variability among the different component parts that make up the organization, as those components adapt to deal with circumstances of the specific environments with which they interact.

There is one other important concept associated with the open systems perspective that is relevant to corporate law reforms: the fact that social systems are loosely coupled.<sup>43</sup> The loose coupling of systems refers to the fact that many of the components of a system are only weakly connected to the other components of the system and, as a result, can behave in a fairly autonomous way.<sup>44</sup> In these types of systems it is very difficult to determine cause and effect or predict outcomes. Scott provides the following example of how loose coupling can affect organizations:

Often there is a weak connection between ‘talk’ and ‘action’ in organizations. Executives and managers may talk convincingly about the total quality

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<sup>41</sup> *Ibid.*

<sup>42</sup> *Ibid* at 29.

<sup>43</sup> See Scott, *supra* note **Error! Bookmark not defined.** at 88.

<sup>44</sup> *Ibid*

management (TQM) programs in their organizations, but researchers find little or no evidence of such activities in production and service departments.<sup>45</sup> [footnotes omitted]

The loose coupling of components in systems together with the difficulty in identifying the boundaries around organizations, have caused a dramatic change in the definition of organizations. New definitions focus less on the entity of the organization and more on the processes of the organization.<sup>46</sup> The “nexus of contracts” theory of the corporation is an example of an open systems definition of an organization.

One example of an open systems theory in organizational theory is contingency theory. Contingency theory makes three assumptions about organizations that illustrate the open systems approach. First, there is no single best way to organize. Second, not all methods of organizing are equally effective. Third, the best way to organize depends on the environment in which the organization is situated.<sup>47</sup>

Even though open systems theories were the last of the organizational perspectives to develop, they have “spread rapidly and have had an enormous effect on organizational theory.”<sup>48</sup>

### *The Classification Chart*

By using these three perspectives Scott was able to classify all of the major organizational theories. His classification chart is attached as Appendix 3. In the chart, Scott highlights that organizational theories have historically developed along the following path from simple to more complex theories:

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<sup>45</sup> *Ibid* at 88.

<sup>46</sup> *See ibid* at 100.

<sup>47</sup> *Ibid* at 96. .

<sup>48</sup> *Ibid* at 92.

Stage	Description	Time Period
1.	Rational closed systems models	Turn of century to late 1930's
2.	Natural closed systems models	Late 1930's – 1960's
3.	Rational open system models	1960's – late 1970's
4.	Natural open system models	Late 1970's to present

*The Normative Assumptions Underlying Organizational Theories*

Scott also recognized that the perspectives outlined above differ in their underlying assumptions.<sup>49</sup> The rational systems perspective and the natural systems perspective have different normative assumptions about two important moral and philosophical issues: human nature and the structure of society. He described the different assumptions about human nature in the following way:

*Natural and rational systems theorists base their approaches on differing assumptions about human nature: the interests that guide and the factors that motivate behavior in organizations. Natural system theorists posit a more expansive, social, and motivationally complex actor than do rational system analysts. Also, theorists from the two schools hold differing conceptions of the actual and the proper relation of individual participants to organizations. Rational system theorists argue that only a subset of behaviors of participants are relevant to the organization. Natural system theorists expand the definition of organizationally relevant behavior to include a broader range of an individual's activities and attitudes . . .”<sup>50</sup> [emphasis added]*

Similarly, he described the different assumptions about the structure of society:

*Further, the two approaches are characterized by quite divergent views of the fundamental nature of social systems. These differences are reflected in the contrasting imagery and metaphors employed by the two schools. For the mechanistic model of structure the rational systems perspective, the natural system substitutes an organic model. Rational systems are designed, but natural*

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<sup>49</sup> See *ibid* at 29.

<sup>50</sup> *Ibid.*

systems evolve; the former develop by conscious design, the latter by natural growth . . .”<sup>51</sup> [emphasis added]

These normative assumptions cannot be proven by scientific analysis. They are choices that are made about the way we think the world ‘ought to be’.

Scott goes on to acknowledge that the debate between these competing sets of normative assumptions is a long standing one and that it is not likely to be resolved anytime soon:

*Lest we regard these images of social structure as being of recent vintage, Wolin reminds us that they have a long history in political and social thought. The view of organizations as economic, technological, efficient instruments is associated with the work of such social theorists as Hobbes, Saint-Simon, and Lenin – the precursors of Taylor, Weber, Fayol and Simon. The view of organizations as communitarian, natural, nonrational, organic systems may be traced back to the social theories of Rousseau, Proudhon, Marx, Burke and Durkheim, the intellectual ancestors of Mayo, Barnard, Selznick, Parsons, Gouldner and Bendix. With such lengthy and distinguished pedigrees, it is unlikely that either of these two lines of thought will soon end, or that their differences will be quickly resolved.*<sup>52</sup> [emphasis added, footnotes omitted]

### **Organizational Theory and Corporate Theory are Closely Related**

As stated previously, corporate theories are very closely related to organizational theories. They also have underlying assumptions about human nature and the structure of society and can be classified into two different perspectives based on their assumptions.<sup>53</sup>

The two perspectives in corporate theory that correspond roughly to rational systems perspective and the natural systems perspective have been called “economic” theories and “social” theories, respectively.<sup>54</sup>

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<sup>51</sup> *Ibid* at 80.

<sup>52</sup> *Ibid* at 80.

<sup>53</sup> In fact, I used Scott’s classification of the normative assumptions behind organizational theories to classify all Anglo-American corporate law theories in my thesis. See Michael Cody, *The Corporation is a Social Institution* (2006) (unpublished thesis) at Ch 3.

<sup>54</sup> *Ibid*.



An early example of rational systems perspective or “economic” corporate theory was Managerialism.<sup>55</sup> It was based on the underlying assumptions that humans are economic rational actors and that the individual was the correct unit of analysis in society. It used the “goal specificity” of a rational organization (that of generating a profit for its owners) to justify shareholder primacy.<sup>56</sup>

An early example of a natural or “social” corporate theory is entity theory which saw the corporation as a “living entity”. It was based on the underlying assumptions that human beings are social beings whose behaviour is affected by their surroundings and that groups are valid units of analysis in society.<sup>57</sup>

The link between organizational theory and corporate theory is even clearer in modern times because for the last half-century corporate theories have been directly based on organizational theories. For example, the nexus of contracts theory of the corporation is based on Agency theory which was an open rational systems theory of the firm.<sup>58</sup> Similarly, power coalition theory was purposefully constructed by Lynne Dallas

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<sup>55</sup> Managerialism refers to the corporate theory that was popular in Anglo-American countries between the 1930’s and the 1980’s that was based on Berle and Means’ work that argued that there was a separation of ownership from control in modern corporations and thus there was the need for shareholders to police the behaviour of managers or else they would run companies for their own benefit. *See* Adolph Berle and Gardiner Means, *The Modern Corporation and Private Property* ((New York, Harcourt, Brace & World: 1968).

<sup>56</sup> For a complete discussion of the assumptions underlying Managerialism and other economic theories of the corporation *see ibid.*

<sup>57</sup> For a complete discussion of the assumptions underlying entity theory and other social theories of the corporation *see ibid.* It should be noted that there is an error in most corporate law literature that states that entity theory was supportive of individualism. This mistake seems to stem from Morton Horwitz’s article on the *Santa Clara* decision in the United States, *see* Horwitz *supra* note 6. Nothing could be further from the truth. Entity theory was developed by Otto Gierke specifically in opposition to the individualistic tendencies of the Roman law that was being imported into Germany in the late 1800’s. Entity theory was based on the concept of the German fellowship. For a discussion of the group orientation and assumptions behind entity theory *see* Hager *supra* note 6 and Cody *supra* note

<sup>58</sup> The institutional form of the nexus of contracts theory is based directly on the transaction cost work of Oliver Williamson (*See* William W. Bratton Jr., “The New Economic Theory of the Firm: Critical Perspectives from History” (1989) 41 *Stanford L. Rev* 1471) and the strong form of the theory is based directly on the Agency theory work of Jensen & Meckling and Eugene Fama. (*See* Scott *supra* note 14 and

from the insights offered by resource dependence theory which is an open natural and system theory.<sup>59</sup> In fact, the relationship between organizational theory and corporate theory is so close, that it is possible to classify corporate theories by their similarities to organizational theories using Scott's classification scheme.<sup>60</sup> An illustrative example of this kind of a classification of corporate theories is attached as Appendix 4.

Corporate theories have also developed in the same manner as organizational theories: from rational systems perspectives, to natural systems perspectives, to open rational systems perspectives. The similarities between the development of the theories can be seen by looking at the modified version of Fligstein's historical development chart of organizational theory attached at Appendix 5. The chart has been modified to show the overlay of corporate theories on top of the organizational theories that they are either related to, or based upon.

While the development of the two sets of theories is similar, there are two major differences. First, in the case of corporate theory, development lags behind the advances in organizational theory by about 10-20 years. This time lag is illustrated by the timetable in Appendix 7. Second, as Appendix 7 clearly indicates that the generally accepted versions of corporate theory have not yet developed from an open rational systems perspective to an open natural systems perspective. The dominant nexus of contracts corporate theory is still an open rational systems perspective. This has effects on

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Fischel and Easterbrook, *The Economic Structure of Corporate Law* (Cambridge, Mass: Harvard University Press, 1991.)

<sup>59</sup> See Dallas, Lynn. "Working Towards a New Paradigm" in Lawrence Mitchell, eds., *Progressive Corporate Law* (Boulder: Westview Press, 1995) at 50 where she states: "The power coalition theory . . . combines resource dependency and social construction theories in order to better explain corporate behaviour and to regulate it effectively." The theories that Dallas refers to as 'social construction theories' are theories like Pfeffer's theory. In both Scott's and Fligstein's classification scheme they are referred to as resource dependency theories. Therefore, for the purposes of this paper power coalition theory is built on resource dependency theory.

<sup>60</sup> See Cody (2006) *supra* note 5 at Ch 5.

corporate law reforms that will be made apparent through the discussion of the application of organizational theory to corporate regulation.

## **Part 2 -- The Application of Organizational Theory to Corporate Regulation**

What does this all mean for corporate law reform? It means that, knowingly or not, every corporate law reform proposal or effort is based on a particular organizational theory perspective and thus on a particular view of what organizations are and their role in society. In order to simplify the analysis, this paper assumes that there are only two such perspectives: the open rational systems perspective and the open natural systems perspective.

The rational systems perspectives' approach to corporate regulation has five basic characteristics that flow from its basic assumptions and assertions:

1. A commitment to shareholder primacy,
2. A dedication to formal laws and rules,
3. A focus on the individual and the preference for self-regulation,
4. A reliance on deterrence and criminal sanctions to change unwanted corporate behaviour, and
5. A belief in universal rules leading to a convergence on international standards.

The perspective's commitment to goal specificity explains the regulatory commitment to shareholder primacy because in the rational systems perspective the best run organizations focus on only one goal. In the case of corporations, that goal is to make money for its owners - the shareholders. Formalization supports the reliance on legislation, regulations and codes of conduct when regulating corporations. The assumption that the individual is the only unit of analysis in society supports the belief of

reformers that there are only a few “bad apples” and that the system itself is not broken. The assumption that individuals are rational actors supports the reliance on deterrence, fines, civil penalties and criminal sanctions to change unwanted corporate behavior. Finally, since every rational actor will act in the same way given the same set of circumstances, this assumption also supports the formulation of universal solutions or rules and the convergence of rules among different corporate governance regimes.

Not surprisingly, the natural systems perspectives’ approach to corporate regulation is the exact opposite. It also has five basic characteristics based on its basic assumptions and assertions:

1. Accommodation for stakeholder interests,
2. A focus on corporate culture and norms as a source of unwanted corporate behavior and an interest in organizational change procedures to prevent unwanted behaviour from reoccurring
3. The acknowledgment of the corporation as a system itself and a preference for public regulation,
4. A commitment to informal mechanisms of regulation including conversation, and negotiation, and
5. An acknowledgement that particular solutions are better than universal solutions.

The perspective’s commitment to goal complexity means that organizations can be run for many different reasons and not just for the benefit of shareholders. The perspective tends to support reforms that are more inclusive of other stakeholder interests. The focus on the informal networks within the corporation support a regulatory approach that is focused on changing the culture of an organization through social means. For example, dialogues, relationships or negotiations between the corporation and the regulator. The assumption that the group is a valid unit in society also focuses reform efforts on the

corporation and not on individuals. Under this perspective regulators assume that it order to prevent unwanted behaviour from happening again that corporate culture must be changed. The assumption that human beings are social beings with complex patterns of behaviour acknowledges that behaviour will not change simply because fines or imprisonment is imposed on individuals and that there are systemic issues that are influencing behaviour. It also supports particular solutions that solving problem cases on a case by case basis and not with universal rules.

These basic characteristics of the two perspectives approach to corporate regulation are summarized in the chart in Appendix 8.

Therefore, the two perspectives have opposing views of the type of corporate law and corporate regulation that will result in increased corporate governance and compliance. Unfortunately, not enough studies have been done to determine which is more effective and the studies that have been done have been inconclusive.<sup>61</sup>

### **Part 3 – Evaluation of CLERP**

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<sup>61</sup> For example, the three empirical studies of the effects of the CLERP reforms showed inconclusive evidence that the reforms actually increased corporate governance or compliance. *See* Michelle Welsh, “Eleven Years on – An examination of ASIC’s use of an expanding civil penalty regime” (2004) 17 *Aus Jnl Corp Law* 175, which found that ASIC had not significantly increased its use of the new civil remedies. Helen Bird, David Chow, Jarrod Lenne and Ian Ramsay, “Strategic Regulation and ASIC Enforcement Patterns: Results of an Empirical Study” (June 2005) *Journal of Corporate Law Studies* 191, which concluded that ASIC continues to use criminal sanctions on corporate wrongdoers even though civil penalties and sanctions were made available to it under the CLERP reforms; and Ian Ramsay and Benjamin Saunders, “Litigation by Shareholders and Directors: An Empirical Study of the Australian Statutory Derivative Action” (October 2006) *Journal of Corporate Law Studies* 397, which concluded that the introduction of the statutory derivative shareholder action in Australia had no measurable effect on the number or success rates of derivate actions.

Because the CLERP contained an enormous amount of reforms,<sup>62</sup> the choice has been made to evaluate CLERP by focusing on the intent and purpose of the reforms and relying on a few specific examples of reforms that illustrate the difference between the rational and natural perspectives approaches to corporate regulation.

The CLERP Program was announced in 1997 by Howard's coalition government.<sup>63</sup> It involved a "fundamental review of key areas of regulation which affect business and investment activity."<sup>64</sup> The stated objective of the program was to:

promote business and market activity leading to important economic outcomes including increased employment, by enhancing market efficiency and integrity and investor confidence.<sup>65</sup>

The aim of the program was to simplify and increase flexibility in Australia's corporate law to allow Australian businesses to complete more effectively in the globalizing Asian economy. CLERP was developed in consultation with the business community.

CLERP was carried out using a two step process. The government first issued nine policy papers on various reforms for comment and then it collected comments, drafted and implemented legislation. The nine CLERP policy papers dealt with the following topics:

- |         |  |
|---------|--|
| CLERP 1 | Accounting Standards <sup>66</sup>                       |
| CLERP 2 | Fundraising <sup>67</sup>                                |
| CLERP 3 | Directors' Duties and Corporate Governance <sup>68</sup> |

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<sup>62</sup> The CLERP Policy Reforms document outlines 60 different reforms from changing disclosure laws to facilitating takeover bids. See "Corporate Law Economic Reform Program: Policy Reforms" (AGPS, 1997) at 7-27. Available online at <[www.treasury.gov.au](http://www.treasury.gov.au)>.

<sup>63</sup> See Australian Government, Treasury Office, "CLERP Policy Framework," found online: <http://treasury.gov.au/documnets/267/HTML/docshell.asp?URL=index.asp>.

<sup>64</sup> *Ibid.*

<sup>65</sup> *Ibid.*

<sup>66</sup> Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 1, "Accounting Standards: Building International Opportunities for Australian Business" (Australian Government Publishing Service, 1997). Available online <[www.treasury.gov.au](http://www.treasury.gov.au)>

<sup>67</sup> Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 2, "Fundraising: Capital Raising Initiatives to Build Enterprise and Employment" (Australian Government Publishing Service, 1997). Available online <[www.treasury.gov.au](http://www.treasury.gov.au)>

CLERP 4	Takeovers <sup>69</sup>
CLERP 5	Electronic Commerce <sup>70</sup>
CLERP 6	Financial Markets and Investment Products <sup>71</sup>
CLERP 7	Simplified Lodgements and Compliance <sup>72</sup>
CLERP 8	Cross-Border Insolvency <sup>73</sup>
CLERP 9	Corporate Disclosure <sup>74</sup>

CLERP was implemented through the following legislative steps:

CLERP 1-4	CLERP Act 1999
CLERP 5	[?]
CLERP 6	Financial Services Reform Act 2001
CLERP 7	Corporations Legislation Amendment Act 2003
CLERP 8	Not yet enacted
CLERP 9	CLERP (Audit Reform and Corporate Disclosure) Act 2004

It is too early to determine what the effect of CLERP has been. The empirical studies that have been released to date on its effects have had inconclusive findings.<sup>75</sup> However, this did not stop the government from asserting in the CLERP 9 policy paper that the CLERP reforms have had “a major role in building a strong and vibrant economy.”<sup>76</sup>

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<sup>68</sup> Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 3, “Directors’ Duties and Corporate Governance: Facilitating Innovation and Protecting Investors” (Australian Government Publishing Service, 1997). Available online <[www.treasury.gov.au](http://www.treasury.gov.au)>

<sup>69</sup> Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 6, “Financial Markets and Investment Products: Promoting Competition, financial innovation and investment” (Australian Government Publishing Service, 1997). Available online <[www.treasury.gov.au](http://www.treasury.gov.au)>

<sup>70</sup> Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 5, “Electronic Commerce: Cutting Cybertape – Building Business” (Australian Government Publishing Service, 1997). Available online <[www.treasury.gov.au](http://www.treasury.gov.au)>

<sup>71</sup> Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 4, “Takeovers: Corporate Control: a better environment for productive investment” (Australian Government Publishing Service, 1997). Available online <[www.treasury.gov.au](http://www.treasury.gov.au)>

<sup>72</sup> Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 7, “Simplified Lodgements and Compliance: Streamlining Paperwork under Corporations Law” (Australian Government Publishing Service, 2000). Available online <[www.treasury.gov.au](http://www.treasury.gov.au)>. For a description of these reforms *see* Tom Bostock, “CLERP 7 becomes law: An outline of the Corporations Legislation Amendment Act 2003” (2003) 15 *Aus Jnl Corp Law* 269.

<sup>73</sup> Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 8, “Cross-Border Insolvency: Promoting International Cooperation and Coordination” (Canprint Communications, 2002). Available online <[www.treasury.gov.au](http://www.treasury.gov.au)>

<sup>74</sup> Corporate Law Economic Reform Program, Proposals for Reform: Paper No. 9, “Corporate Disclosure: Strengthening the Financial Reporting Framework” (Canprint Communications, 2002). Available online <[www.treasury.gov.au](http://www.treasury.gov.au)>

<sup>75</sup> *See supra* note 61.

<sup>76</sup> CLERP 9 at iii.

*The Economic Assumptions Underlying the CLERP Program*

CLERP, as its name suggests, was based on neo-classical economic principles.<sup>77</sup> This is not a surprise because all corporate law reforms are based on a corporate theory and the most influential corporate theory in Australia is an economic theory built on neo-classical economic principles: the “nexus of contracts” theory.<sup>78</sup> This theory is also the dominant corporate theory in all other Anglo-American countries including the United States, the United Kingdom and Canada. The dominance of the theory and the law and economics movement in general within corporate law has been commented on by U.S. contractarian scholar Stephen Bainbridge:

Over the last couple of decades, law & economics scholars have mounted a largely successful hostile takeover of the corporate legal academy . . . Law & economics remains the most successful example of intellectual arbitrage in the history of corporate jurisprudence. It is virtually impossible to find serious corporate law scholarship that is not informed by economic analysis. Even those corporate law scholars who reject economic analysis spend most of their time responding to those of us who practice it. . . Perhaps the most telling evidence of the success of law and economics in our field, however, is that many leading corporate law judges and lawyers are now adept at its use. Both judicial opinions and practitioner publications are filled with the jargon of law and economics. This is a claim that no other modern school of jurisprudence can make.<sup>79</sup>

The economic assumptions underlying the CLERP reforms are evident and consistent with both the “nexus of contracts” theory and the rational open systems approach to regulation. It is also interesting to note that the CLERP reforms were run out the Treasurer’s office and not the office of the Attorney General, where the previous corporate law reforms took place.

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<sup>77</sup> John Farrar pointed out the neo-classical underpinnings of CLERP *see* Farrar at

<sup>78</sup> The dominance of the theory in Australia has been highlighted by John Farrar, Stephen Bottomley and Katherine Hall, among others. *see* John Farrar, *Farrar’s Company Law 2ed* (London: Butterworths. 1998) at 7-12; Hall *supra* note 5; and Bottomley *supra* note 5 at 209. For an Austrian critique of the “nexus of contracts” theory *see* David Campbell, “The Role of Monitoring and Morality in Company Law: A Criticism of the Direction of Present Regulation” (1997) *Aus Jnl Corp Law* 343.

<sup>79</sup> Stephen Bainbridge, Stephen M. “Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship (1997) 82 *Cornell L. Rev.* 856.



It is also not surprising then that the major themes of the program only make sense if the rational systems approach is adopted. Those themes include:

1. **Economic Analysis** with its emphasis on efficiency, cost benefit analysis, and a robust market for corporate control,<sup>80</sup>
2. **Reliance on Legislation.** All of the reforms were put in place through legislative acts,<sup>81</sup>
3. **Self-Regulation** which was evidenced in the establishment of the business judgment rule, the rules on fundraising and the investment industry reforms,
4. **Shareholder Primacy** which was evident in the establishment of the statutory derivative shareholder action, and
5. **Convergence on International Standards** which was apparent in the accounting standard reforms.

These themes are evident throughout the policy papers and the legislation. As one example, when announcing the program the government stated that the program would, among other things, “contribute to the efficiency of the economy”.<sup>82</sup>

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<sup>80</sup> For a discussion of the takeover law reforms in the CLERP see Justin Mannolini, “CLERP and takeover law reform – Politics trumping principle?” (1999) 10 *Aus Jnl Corp Law* 193; James Mayanja, “A mandatory bid rule for Australia: an idea whose time has come” (2004) 16 *Aus Jnl Corp Law* 205. The takeover law reforms have appealing features from both the rational systems perspective and the natural systems perspective. From the rational systems perspective the addition of the mandatory bid rule will increase the likelihood of successful hostile takeover bids, therefore increasing the market for corporate control and a robust market for corporate control is an effective way, under this perspective, of increasing corporate governance and compliance by acting as a deterrent on managers to act inefficiently. From the natural systems perspective, the reforms remained particular to Australia. The reforms resisted the temptation to do away with the Australian Takeovers Board. Regardless of the opinion of the desirability of this board it is clearly a unique Australian institution and it was preserved by the reforms.

<sup>81</sup> Australia has a fascination with corporate law legislation. This fascination has been pointed out by numerous commentators. For example, see Andrew Clarke, “Australia’s corporate governance: balancing historic, regional and free trade paradigms” (2005) 18 *Aust Jnl of Corp Law* 103 at 109-112; Stephen Bottomley, “Where did the law go? The delegation of Australian corporate regulation” (2003) 15 *Aust Jnl Corp Law* 105; John Farrar, *Corporate Governance in Australia and New Zealand* (Melbourne: Oxford University Press, 2001) at 6;

<sup>82</sup> *Corporate Law Economic Reform Program* (1998) at iii.

The important thing to realize here is not that the economic assumptions underlying the CLERP program were wrong. It is simply to realize that its preference for economic analysis, self-regulation, convergence, and shareholder primacy are not facts or universal truths. They are simply preferences that are based on a certain set of assumptions and organizational theory shows us that there is an opposite, and equally plausible, set of assumptions.

### *Evaluating some CLERP Reforms*

In order to illustrate the differences in the regulatory approaches between the rational and natural systems perspectives, four particular reforms from CLERP will be evaluated for the potential to increase corporate governance and compliance: Auditing standards, the business judgment rule, the shareholder derivative action and the addition of civil penalties for breaches of the duty of care.

### *Accounting Standards – Convergence with International Standards*

CLERP 1 identified the harmonization of Australian accounting standards with international standards as its “ultimate objective” and it established the AASB to accomplish this task.<sup>83</sup>

From a rational systems perspective this reform has a high likelihood of increasing corporate governance convergence and compliance because the best way to change a corporation under this perspective is to change its formalized structure. This is accomplished by changing the laws, rules and codes that apply to it. Accounting standards are a good example of such formalized rules. Similarly, by adopting

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<sup>83</sup> See Clerp 1 *supra* note 66 at 1.

international standards corporate governance is increased because it allows the accounting rules to become universal.<sup>84</sup>

From a natural systems perspectives these reforms are not likely to increase corporate governance and compliance. The focus on accounting rules ignores the fact that the major corporate collapses were more about fraud and dishonesty and not deficient rules.<sup>85</sup> As such, programs to change the acceptability of dishonesty in corporate culture would be more effective. Similarly, the convergence of accounting standards with international standards is not, in and of itself, a guarantee that corporate governance will increase, those international standards may prove to be unsuitable for some or all of Australia's listed companies. A more detailed look into what standards would rectify specific Australian issues would have been more appropriate than the push to simply harmonize.

### *The Business Judgment Rule – Self-Regulation*

CLERP also created a statutory version of the business judgment rule.<sup>86</sup> This rule allows directors and officers of the corporation a 'due diligence' defence for any

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<sup>84</sup> For an article supporting the convergence of Australian corporate law with international standards see Paul von Nessen, "Corporate Governance Convergence in Australia: Converging with international developments" (2003) 15 Aus Jnl Corp Law 190.

<sup>85</sup> For a discussion of the role that dishonesty played in the corporate governance failures of the late 1990's see Kath Hall, "The Psychology of Corporate Dishonesty" (2006) 19 Aus Jnl Corp Law 268, where the author argues that regulators need to understand the psychological nature of dishonesty and how it impacts corporations before they begin to regulate it. On page 286 the author wrote: "When we understand dishonesty as a process as well as a behaviour, we have a new perspective through which to consider how regulation can influence corporate decision-making. In believing that behaviour can be restricted and good behaviour cultivated, we need conceptual and empirical tools to craft and evaluate interventions. In particular it is important to understand the relevance of psychology if we are to have any success in reducing the levels of corporate dishonesty."

<sup>86</sup> Section 180(2) and (3) of the Corporations Act. For a description of the business judgment rule see Robert Baxt, Ian Ramsay and Geof Stapledon, "Corporate Governance in Australia: The Evolving Legal Framework and Empirical Evidence" in Low Chee Keong, *Corporate Governance: An Asia-Pacific Critique* (Hong Kong: Sweet & Maxwell, 2002) at 162-195.

decisions made provided that they acted for a proper purpose, informed themselves and believed they were acting in the best interests of the corporation.<sup>87</sup> This reform is a good example of the self-regulation theme of the reforms. The idea is that business people will be protected from being second guessed by courts and shareholders provided that they act reasonably in the circumstances.

From an rational systems perspective this reform is likely to increase corporate governance because it provides a measure of protection to directors to take reasonable business risks while running the company. The will lead to more competitive businesses in Australia. In the absence of the business judgment rule directors' decisions would be subject to too much scrutiny. Also, since the corporation is a private entity it is not appropriate to have the government or the courts interfering in its day to day operations.

From a natural systems perspective this reform is not likely to increase corporate governance or compliance. In fact, it will have the opposite effect because it exempts the most important decision making function within corporations from any kind of regulatory scrutiny. Corprations are not simply private entities they impact on our societies and, as such, they should be subject to regulatory oversight. The business judgment rule is an example of deregulation more than it is an example of self-regulation.

### *The Statutory Derivative Action – Shareholder Primacy*

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<sup>87</sup> Section 180(2).

CLERP creating a statutory derivative shareholder action where shareholder's can sue on behalf of the company.<sup>88</sup> This action is a method by which shareholders can police corporate managers.

From a rational systems perspective this reform is likely to increase corporate governance and compliance because shareholders take over some of the regulatory burden. Since shareholders are the owners of the company, they are the correct ones to have the statutory action.

From a natural systems perspective this reform is not likely to increase corporate governance because it is only for the benefit of shareholders. The natural systems perspective insight that corporations have goal complexity acknowledges that there are many different constituents in the corporation all legitimately pursuing different goals. To focus all of the power and responsibility in one particular group is counter to the good governance of the corporation as a whole. The derivative action is an example of this type of regulation. Natural systems theory would propose instead that the derivative action, if it is required, be open to a wider group of stakeholders and not just shareholders.<sup>89</sup>

### *Civil Penalties in Addition to Criminal Penalties*

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<sup>88</sup> Part 2F.1A of the Corporations Act (2001). For a description of this action and the results of its introduction see Ramsay and Saunders *supra* note 61. For a general description of the action see Robert Baxt, Ian Ramsay and Geof Stapledon, "Corporate Governance in Australia: The Evolving Legal Framework and Empirical Evidence" in Low Chee Keong, ed., *Corporate Governance: An Asia-Pacific Critique* (Hong Kong: Sweet & Maxwell, 2002) at 194-199.

<sup>89</sup> For the argument that directors already owe a duty to all stakeholders in the Australian Corporations Act see James McConvill, "Directors' duties to shareholders: A reform proposal based on three false assumptions" (2005) 18 *Aus Jnl Corp Law* 88.

CLERP also added civil sanctions to replace criminal sanctions when the duty of care is breached.<sup>90</sup>

From a rational systems perspective this change is not likely to increase corporate governance and compliance. Increased compliance is achieved through enforcement and the imposition of sanctions. If there is a choice between civil and criminal sanctions the criminal sanctions will be preferred because they will act as a larger deterrent for the unwanted behaviour.

From a natural systems perspective this reform is likely to increase corporate governance and compliance because it increases the number of tools in the regulators toolbox to increase compliance. This change also recognizes that changing the formal rules (the law) does not necessarily mean that behaviour within the corporation will change. In order to change behaviour within corporations it is necessary to change corporate culture and norms. Regulators in North America are beginning to recognize this. For example, the U.S. Securities and Exchange Commission has recently stated that its goal in enforcement is to change the long-term behaviour of corporations.<sup>91</sup> In furtherance of this goal, it has recently begun experimenting with the practice of Reform Undertakings.<sup>92</sup> This practice recognizes that monetary penalties alone are not enough to change corporate culture. Instead, under a Reform Undertaking, a corporation enters into a settlement agreement with the SEC whereby the corporation hires an approved third party to oversee its compliance procedures and policies for a period of time.<sup>93</sup> This approach has a number of advantages over traditional enforcement, the most important of

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<sup>90</sup> For a description of these provisions *see* the studies outlined in note 61.

<sup>91</sup> *See* Christie Ford, "Toward a New Model for Securities Law" (2005) 57 *Administrative Law Review* 757 at 758.

<sup>92</sup> For a description of Reform Undertakings *see Ibid* at 797 to 806.

<sup>93</sup> *See Ibid* at 759-760.

which is that the focus is on changing behaviour. Christie Ford had argued that the Reform Undertakings approach of the SEC could lead to a new paradigm of enforcement in securities law.<sup>94</sup> In Australia, ASIC has the power to accept enforcement undertakings.<sup>95</sup> These are similar to reform undertakings except that instead of agreeing to “do” something, the regulated entity agrees with ASIC not to do certain actions.

Overall, the reforms evaluated above are generally more effective if the rational systems perspective is adopted and less effective if the natural systems perspective is adopted.

#### **Part 4 - What to do with the Two Competing Perspectives?**

Given that the assumptions of the two perspectives are opposites, how do you reconcile their approaches?

##### *The Corporation is VERY, VERY Complex*

The first step to achieving that lies in recognizing that corporations, social organizations and the social world are very, very complex places. The truth is that we really do not fully understand what is going on, either within corporations, organizations or society – regardless of what you hear otherwise. To illustrate the amazing complexity of social systems it is useful to examine the systems classification scheme that was developed by Boulden during the 1950’s as part of his work on systems theory.<sup>96</sup> Systems theory was based on the observation that the sciences and social sciences were

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<sup>94</sup> *Ibid.*

<sup>95</sup> This power is located in section 93A of the ASIC Act. For a description of enforceable undertakings in Australia see Marina Nehme, “Enforceable Undertakings in Australia and Beyond” (2005) 18 Aus Jnl Corp Law 70.

<sup>96</sup> Scott uses Boulden’s chart to illustrate the complexity of organizations see Scott supra note **Error! Bookmark not defined.** at 82.

increasingly becoming compartmentalized and that key concepts in any one science could have relevance across a number of other disciplines. In particular, systems theorists pointed out that:

[M]ost important entities studied by scientists – nuclear particles, atoms, molecules, cells, organisms, ecological communities, groups, organizations, societies, solar systems- are all subsumable under the general rubric of system.<sup>97</sup>

A system is simply a combination of parts that are interrelated.<sup>98</sup> Boulden's systems classification chart (Appendix 6) identifies nine levels of systems in increasing complexity divided into three general types: physical systems, organic systems and human and social systems. Progressing from level 1 to 8 the systems become more complex and the relationships among the various parts become more loosely coupled, or in other words, there is more free choice or random variation in the system. As system complexity increases the system ceases to act mechanically. Level 7 is a human being or a system capable of free choice. Level 8 is the most complicated system that we are aware of. It is level 7 systems interacting with each other. Obviously, it becomes very difficult to predict behavior or understand how changes occur in a level 8 system. Level 9 is simply systems we have not yet identified. Scott explains the increasing complexity of the systems and the characteristics of each general type in the following way:

The parts of which all systems are composed vary from simple to complex, from stable to variable, and from nonreactive to reactive to the changes in the system to which they belong. As we move from mechanical through organic to social systems, the parts of which each system are composed become more complex and variable. In addition, relations among the parts vary from one type of system to another. . .In mechanistic systems, the interdependence among parts is such that their behaviour is highly constrained and limited. The structure is relatively rigid, and the system of relations determinant. In organic systems, the connections among the interdependent parts are somewhat less constrained, allowing for more flexibility of response. In social systems, such as groups and organizations, the

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<sup>97</sup>*Ibid* at 82.

<sup>98</sup> *Ibid* at 83.



connections among the interacting parts are relatively loose; less constraint is placed on the behaviour of one element by the condition of others. *Social organizations, in contrast with physical or mechanical structures are complex and loosely coupled systems.*<sup>99</sup> [Emphasis added]

This systems chart offers an important insight into corporations and corporate law. The corporation is a social organization of human beings that are interacting with each other. That makes it a level 8 system: A very complex system. As such, we should be skeptical theories that attempt to explain all of the behaviour in a corporation with one concept. For example, the rational choice theory of economics. As we progress our general understanding of our social world, we should expect our theories and conceptions of organizations (and corporations) to become more complex as well. They should ‘move up’ the systems chart. In this regard, complexity is a good thing. Constantly striving for simplicity of analysis when dealing with complex systems is a recipe for misunderstanding what is going on. Currently, we have theories that are able to explain social systems with level 4 understanding. Therefore, we truly do not completely understand how social organizations function yet. But, it does not mean that our theories are not useful. We just have to use them only for the purposes for which they are useful (explaining small portions of the more complex system) and not accept them as universal theories of understanding.

Therefore, our corporate law, the law which governs one of our most important social institutions, needs to be complex, not simple. This argument has been made by Fiona Patfield who believes that we have to resigned ourselves to the complexity of corporate law:

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<sup>99</sup> *Ibid.*

Company law is complex because it is concerned with the structuring and organization of economic power. . .If we want our company law to play any sensible role at all then we must resign ourselves to the fact of its conceptual complexity. Laws about complex subjects in complex societies should be so otherwise they run the risk of becoming entirely marginal and irrelevant to those matters which they purport to govern.<sup>100</sup>

Complex does not mean unclear. Law can be clear without having to be simple. Patfield also describes this:

The fact that corporate law may not be able to be simplified without losing much of its legitimacy does not mean that it cannot be clear. Considerable confusion seems to exist between the concepts of simplification and clarity. They are not the same thing; attempting to simplify a complex area of law will not lead to clarity; but clarity should make a complex area of law simpler to use.<sup>101</sup>

### *Scott's Layered Approach*

Because of the complexity of corporations, as of yet, no single theory or perspective explains the functioning of an entire human social system. Therefore, it is premature to choose one, over all others, as the theory that explains corporations the best. In fact, Scott argues that each theory is particularly good at explaining a certain type of organization or a certain aspect of organizations. The result is that the most complete analysis that we can currently make of a corporation is to use more than one organizational theory. This is completely acceptable. It recognizes the limitations of our theories. Scott refers to this as a "Layered Approach".<sup>102</sup> Unfortunately, because of the dominance of the "nexus of contracts" theory of the firm natural systems theories approach to regulation has been vastly underused in Anglo-American countries.

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<sup>100</sup> Fiona Patfield, "Challenges for Company Law", in Fiona Patfield, ed., *Perspectives of Company Law: Law 1* (London: Kluwer Law Interational, 1995) at 3.

<sup>101</sup> *Ibid* at 4.

<sup>102</sup> This layered approach is discussed later in Chapters 6 and 7.

## *The Regulation Pyramid*

The Layered Approach when applied to corporate law and corporate regulation looks remarkably similar to Strategic Regulation theory's "Regulation Pyramid".<sup>103</sup> The basic concept of the regulation pyramid is that sanctions should increase as contraventions of the law become more serious. Strategic regulation theory was legislated into reality in Australia with the 1999 CLERP which instituted a regulatory pyramid with three levels of sanctions: civil remedies, civil penalties and criminal penalties.<sup>104</sup>

The interpretation of the regulation pyramid is enhanced if we understand the different levels of the pyramid as relating to different conceptions of the corporation. For example, if we acknowledge that the activities that are going on at the bottom of the pyramid in the self-regulation category are related to the natural systems perspective – then those activities need to be focused on the social and human aspects of the corporation. The market participants being regulated at this level are the "good performers." They generally want to comply with the laws, would like to engage in conversation and probably will not respond well to a command and control approach to regulation. Therefore, it would not be sufficient to adopt the economic approach of deregulation at that level that which justifies the regulator withdrawing from regulation

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<sup>103</sup> Strategic regulation theory is associated with the work of Braithwaite and Ayres. See J. Braithwaite, *To Punish and Persuade: Enforcement of Coal Mine Safety* (New York: State University Press, 1985); I. Ayres and J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (New York: Oxford University Press, 1992). For a description of the applicability of strategic regulation theory to Australian corporate law see Vicky Comino, "High Court relegates strategic regulation and pyramidal enforcement to insignificance" (2005) 19 *Aus Jnl Corp Law* 48.

<sup>104</sup> This pyramid was first suggested in the Cooney Committee Report which advocated the adoption of a regulation pyramid with three levels of penalties. See Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* at 190-191. Vicky Comino has noted that before the 1999 CLERP Amendments there was only two levels to the regulation pyramid in Australia because the regulator was forced to choose between pursuing civil penalties or criminal penalties and could not treat them as mutually exclusive. See Comino.

activities and allowing corporations to self-regulate or to follow the advice of commentators who advocate an adversarial stance to regulation with the regulator actively pursuing criminal and civil sanctions against all transgressors.<sup>105</sup> Deregulation at this level would be disastrous because under the natural systems perspective this informal level of activity in the corporation is the most important. Therefore, self-regulation can only occur at this level if there is an ongoing dialogue, negotiation and interaction between the regulator and the regulated. The focus of the regulator at this step of the pyramid is on changing corporate cultures to ensure that they are consistent with the purpose and objectives of the regulation. The activities here would include guidance and training and not the promulgation of laws or rules. As an illustration, it would not be sufficient to pass a law saying all corporations must have a code of conduct (deregulation). Instead, the regulator should require each company to have a code of conduct and it should be engaged with the corporations to negotiate and dialogue over the content of those codes.<sup>106</sup> This model of regulation has been referred to as a “conversational model of regulation.”<sup>107</sup> This requires a more active regulator. Although, this activity is not necessarily focused on monitoring for early detection of

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<sup>105</sup> For an example of an article advocating this aggressive stance to regulation see Gerald Acquah-Gaisie, “Enhancing Corporate Accountability in Australia” (2000) *Aus Jnl of Corp Law* 139.

<sup>106</sup> This kind of actions by regulators is unusual in Anglo-American countries. For a discussion of this see Angus Corbett, “Self-Regulation, CLERP and Financial Markets: A Missed Opportunity for Innovative Regulatory Reform” 22(2) *UNSW Law Journal* 506. However, this kind of regulatory activity is prevalent in other countries, most notably Japan. In Japan, the METI (the Ministry of the Economy, Trade and Industry) uses the practice of Administrative Guidance to regulate corporations. Administrative Guidance refers to the ability of government agencies in Japan to direct market participants by issuing policy statements, having informal conversations etc. even though the ministry may be acting in an area for which it has no legislative authority. Sociologist, Chalmers Johnson identified administrative guidance as one of the unique institutional features of the Japanese economy that contributed to the “Japanese Miracle” in the 1980’s. For a description of administrative guidance see Johnson, Chalmers. *MITI and the Japanese Miracle* (Stanford: Stanford University Press, 1982).

<sup>107</sup> See Julia Black, *Rules and Regulators* (Clarendon Press, 1997) at 37-38.

corporate failures as advocated by some.<sup>108</sup> Instead, it is activity focussed on creating corporate cultures with internal control mechanisms that will ensure that they will not collapse.

Similarly, the activities going on at the top of the pyramid are relating to the rational systems perspective. These are the market participants who are the “bad guys” and they probably will not change their behaviour as the result of a conversation or training exercise. Here the economic theories of rules, deterrence and fines make a lot of sense.

The main idea of the regulation pyramid is to give the regulator a menu of options to use when dealing with its regulatees. Corporations are complex places. In order to ensure behaviour does not reoccur in the future it may be necessary, depending on the particular circumstances, to punish a few bad apples, change corporate culture, or both. In order to do that the regulator needs to understand both aspects of the corporation and have regulatory tools available to deal with those issues.

## **Part 5 - Conclusion**

This article showed the usefulness of organizational theory in evaluating and understanding the assumptions behind corporate law reforms. It showed that all corporate law reforms are, knowingly or not, based on a particular corporate theory and in turn on a particular perspective from organizational theory. This is because it is

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<sup>108</sup> See Jean du Plessis, “Reverberations after the HIH and other recent corporate collapses: The role of ASIC” (2003) 15 Australian Journal of Corporate Law 225 at 245, where he commends ASIC for its efforts after the HIH collapse and suggests that “the challenges for ASIC now will be to play a far more active role, not in assuring that corporate collapses do not occur in the future, but to ensure that signs of corporate collapses are detected at the earliest possible time.”

impossible to approach the question of how to regulate a corporation without having first answered the question: What is a corporation.

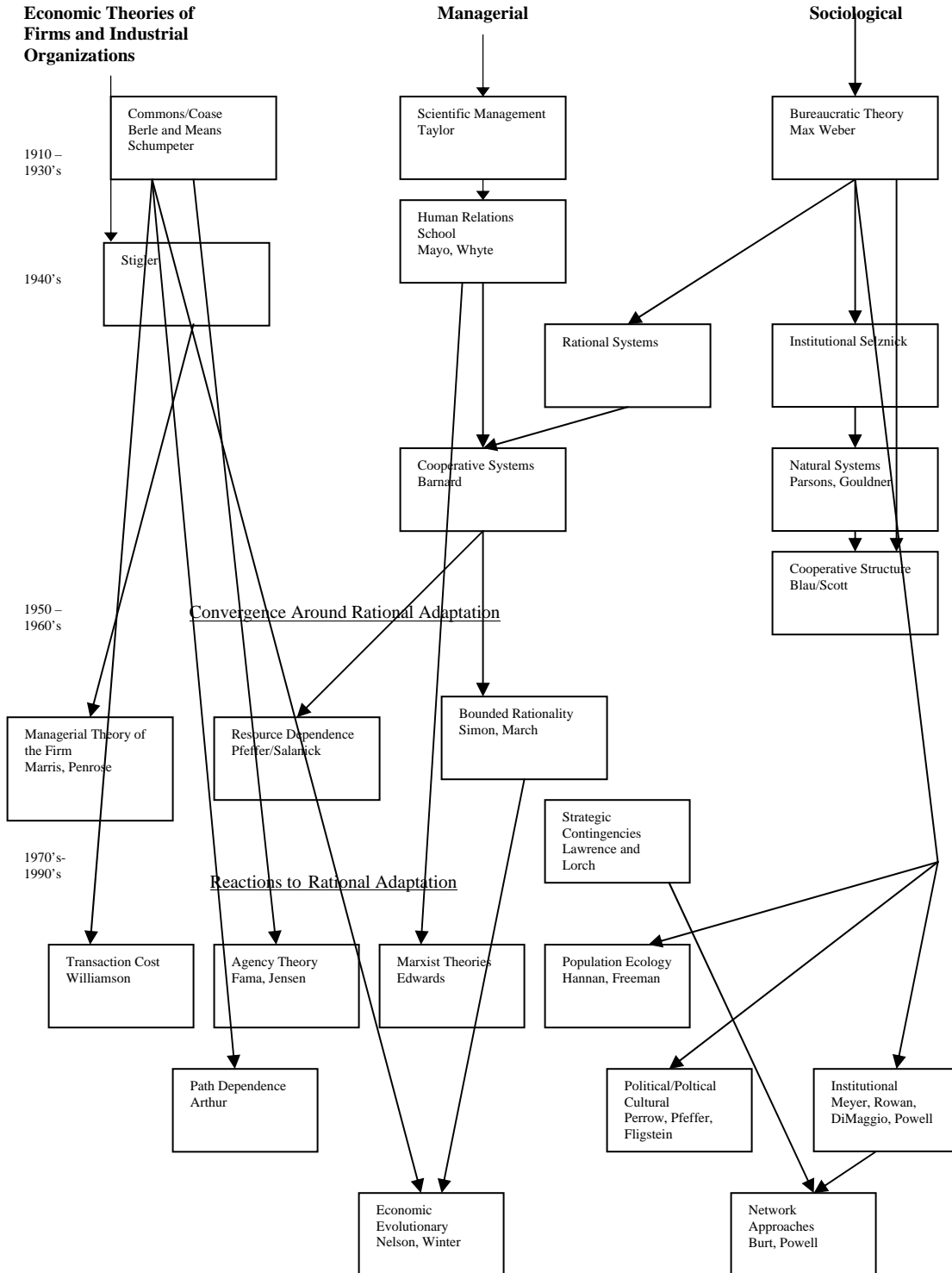
The two dominant perspectives in organizational theory were then outlined: the rational systems perspective and the natural systems perspective and the CLERP reforms were evaluated using these two perspectives. The evaluation of the effectiveness of the CLERP reforms depends on which organizational theory perspective is adopted. The specific reforms that were evaluated were generally more effective at increasing corporate governance and compliance if the rational open systems perspective is adopted and not as effective if the natural open systems perspective is adopted.

A caution was offered that the best regulatory approach is most likely going to be a combination of both of the perspectives. This is because the corporation is a very, very complex phenomenon and no single theory can completely explain it. A suggestion was made that the natural systems approach to regulation is better suited to the lower part of the strategic regulation “pyramid” and the rational systems approach is better suited to the upper part.

After the CLERP reforms Australian corporate law and regulation is probably now too focused on the rational systems approach to regulation and it could probably use some balance.

# APPENDIX 1

## A HISTORY OF ORGANIZATIONAL THEORY



## APPENDIX 2

### DEFINITION OF ORGANIZATION WITHIN RATIONAL, NATURAL AND OPEN THEORETICAL PERSPECTIVES

	<b>Rational Systems</b>	<b>Natural Systems</b>	<b>Open Systems</b>
<b>Definition of Organization</b>	“Organizations are collectivities oriented to the pursuit of relatively specific goals and exhibiting relatively highly formalized social structures.”	“Organizations are collectivities whose participants are pursuing multiple interests, both disparate and common, but who recognize the value of perpetuating the organization as an important resource. The informal structure of relations that develops among participants is more influential in guiding the behavior of participants than is the formal structure.”	“Organizations are congeries of interdependent flows and activities linking shifting conditions of participants embedded in wider material-resource and institutional environments.”
<b>Characteristics of Organizations</b>	<p><u>Primary</u></p> <ul style="list-style-type: none"> <li>• Goal specificity</li> <li>• Formalization</li> </ul> <p><u>Other</u></p> <ul style="list-style-type: none"> <li>• Rationality</li> <li>• Overriding principles (universal application)</li> <li>• Scientific Analysis</li> <li>• Technical expertise</li> <li>• Structure more important than people</li> <li>• People are interchangeable</li> </ul>	<p><u>Primary</u></p> <ul style="list-style-type: none"> <li>• Survival and maintenance</li> <li>• Goal complexity</li> <li>• Informal structures</li> </ul> <p><u>Other</u></p> <ul style="list-style-type: none"> <li>• Social collective of people</li> <li>• Adaptable (half-open, half-closed)</li> <li>• Hard to replicate</li> <li>• No universal principles</li> <li>• Behaviour rather than structure</li> </ul>	<p><u>Primary</u></p> <ul style="list-style-type: none"> <li>• ‘Open’ to its environment</li> <li>• Boundary maintenance</li> <li>• Loosely coupled parts</li> <li>• High variability and complexity of sub-parts</li> <li>• Hierarchy of systems</li> </ul> <p><u>Other</u></p> <ul style="list-style-type: none"> <li>• Adaptable</li> <li>• Interdependency within and between organizations</li> <li>• Information flows</li> <li>• Focus on process and not on structure</li> </ul>
<b>Metaphor</b>	Dry, cold mechanical Clock Blue Print	Living Organism Human Body	Family Social group State Society
<b>Example Organization(s)</b>	Government Army Abstract corporation	Japanese <i>Kieretsu</i> (circa 1980’s) Family Social Clubs	Joint ventures Relational contracting Strategic alliances

Authors: Julian Dierkes, Maclean Brodie, Takeshi Hamamura, Soohyun Jung, Rachael Qi Zhang, Estelli Reyes, and Michael Cody.



### APPENDIX 3

#### DOMINANT THEORETICAL MODELS AND REPRESENTATIVE THEORISTS:

#### SCOTT'S LAYERED MODEL

Levels of Analysis	Closed Systems Models		Open Systems Models	
	1900-1930 Rational Models	1930-1960 Natural Models	1960-1970 Rational Models	1970- Natural Models
<b>Social Psychological</b>	Scientific Management Taylor (1911)	Human Relations Whyte (1959)	Bounded Rationality March and Simon (1958)	Organizing Weick (1969)
	Decision Making Simon (1945)			
<b>Structural</b>	Bureaucratic Theory Weber (1968 trans)	Cooperative Systems Barnard (1938)	Contingency Theory Lawrence and Lorsch (1967)	Sociotechnical Systems Miller and Rice (1967)
	Administrative Theory Fayol (1919)	Human Relations Mayo (1945)	Comparative Structure Woodward (1965) Pugh et al. (1969) Blau (1970)	
		Conflict Models Gouldner (1954)		
<b>Ecological</b>			Transaction Cost Williamson (1975)	Organizational Ecology Hannan and Freeman (1977)
			Agency Theory Jensen & Meckling (1976)	Resource Dependence Pfeffer and Salancik (1978)
			Knowledge-based Nanaka and Takeuchi (1995)	Institutional Theory Selznick (1949) Meyer and Rowan (1977) DiMaggio and Powell (1983)

Source: W. Richard Scott, *Organizations: Rational, Natural and Open System, 5<sup>th</sup> ed.* (Toronto: Pearson Education, 2003) at 108.

Note: This chart has been modified to include additional theories that are relevant to corporate theory. Scott's original chart included representative theories only.

## APPENDIX 4

### CLASSIFICATION OF CORPORATE THEORIES USING SCOTT'S SYSTEM

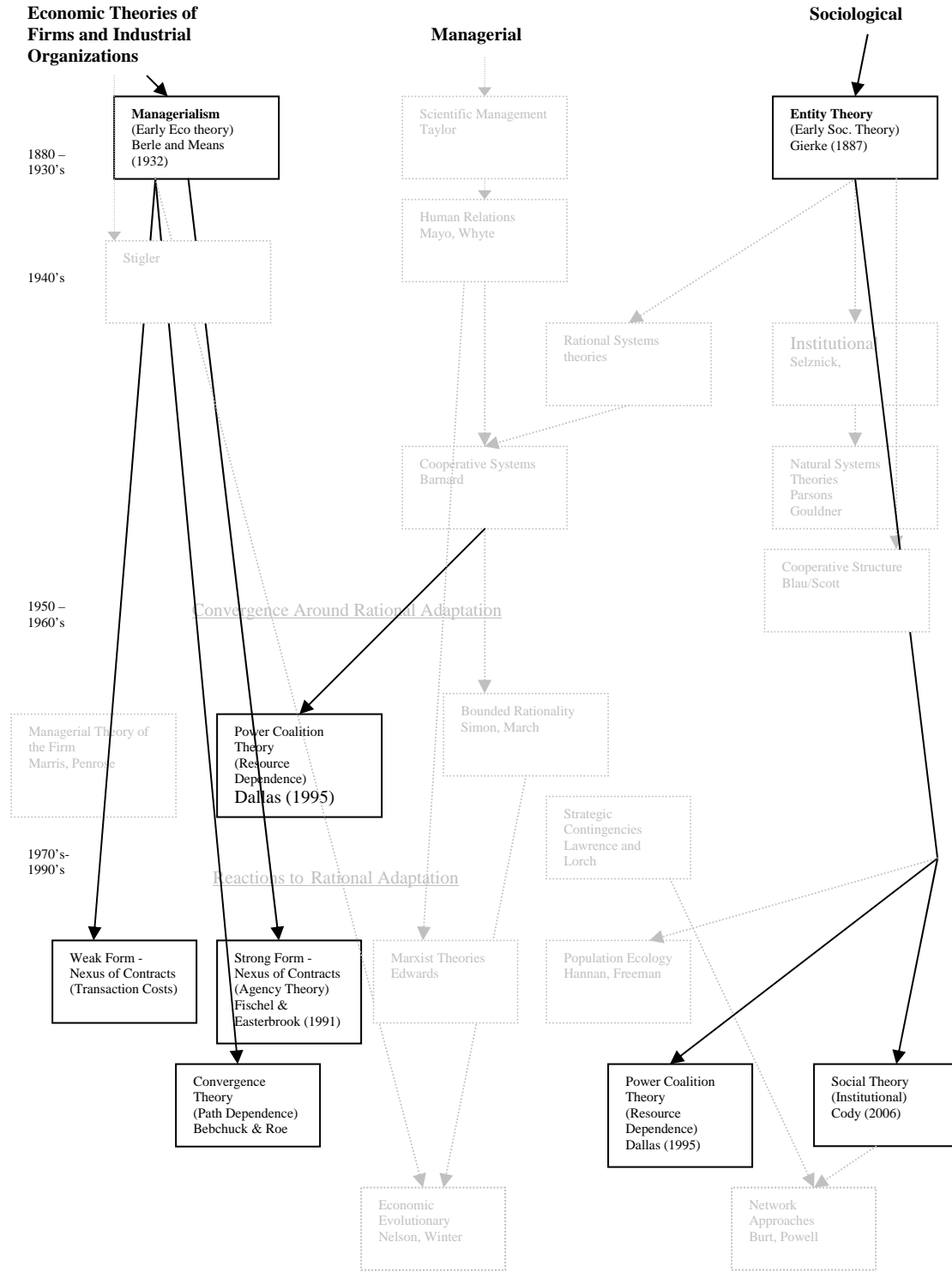
Levels of Analysis	Closed Systems Models		Open Systems Models	
	1880-1970 Rational Models	1880-1930 Natural Models	1960-1970 Rational Models	1985- Natural Models
<b>Social Psychological</b>				
<b>Structural</b>	Contractual Theory Morawetz (1882)	Entity Theory Gierke (1887)		
	Bracket Theory Ihring (???)	Representation Theory Freund (1897)		
	Managerialism (Berle and Means)	Early Sociological Theory Hallis (1930)		
		Early Stakeholder Theory Dodd (1932)		
<b>Ecological</b>			“Nexus of Contracts” -Weak Form (Transaction Costs) (?) [Look to Bratton]	
			Nexus of Contracts – Strong Form (Agency Theory) Jensen & Meckling (1976) Fischel & Easterbrook (1991)	Power Coalition Theory (Resource Dependency) Dallas (1985)
			Team Production Theory (Labor Economics) Blair & Stout (1995)	Social Theory (Institutionalism) Cody (2006)
			Socio-Economics (Socio-economics) Dallas (2005)	

Source: Adapted from W. Richard Scott, *Organizations: Rational, Natural and Open System, 5<sup>th</sup> ed.* (Toronto: Pearson Education, 2003) at 108.

Note: This chart has been modified to include only corporate theories.

# APPENDIX 5

## A HISTORY OF THE LINK BETWEEN ORGANIZATIONAL THEORY AND CORPORATE THEORY



## APPENDIX 6

### BOULDING'S SYSTEM TYPES

Level of System	Type of System	Title	Description	Example(s)
1	Physical	Frameworks	Systems comprising static structures	Arrangement of atoms in a crystal of the anatomy of an animal
2	Physical	Clockworks	Simple dynamic systems with predetermined motions	Clock The solar system
3	Physical	Cybernetic Systems	Systems capable of self-regulation based on a throughput of resources from their environment	Thermostat
4	Organic	Open Systems	Systems capable of self-maintenance based on a throughput of resources from their environment	Living Cell
5	Organic	Blue-Printed Growth Systems	Systems that reproduce not by duplication but by the production of seeds or eggs containing pre-programmed instructions for development	Acorn-oak system Egg-chicken system
6	Organic	Internal-Image Systems	Systems capable of a detailed awareness of the environment in which information is received and organized into an image or knowledge structure of the environment as a whole	Animals
7	Human and Social	Symbol-Processing Systems	Systems that possess self-consciousness and so are capable of using language	Human beings
8	Human and Social	Social Systems	Multicephalus systems comprising actors functioning at level 7 who share a common social order and culture	Social organizations
9		Transcendental Systems	Systems composed of the absolutes and inescapable unknowables	We have not identified them yet.

Source: Adapted from W. Richard Scott, *Organizations: Rational, Natural and Open Systems* (New Jersey: Upper River Saddle, 2003) at 84.

## APPENDIX 7

### THE “THREE” STAGES IN THE DEVELOPMENT OF CORPORATE THEORY

<b>Stage</b>	<b>Description</b>	<b>Organizational Theory Time Period</b>	<b>Corporate Theory Time Period</b>	<b>Example Corporate Theories</b>
1.	Rational closed systems models	Turn of century to late 1930's	1880's – 1970's	Contractual Theory Managerialism
2.	Natural closed systems models	Late 1930's – 1960's	1880's – 1930's	Entity Theory
3.	Rational open system models	1960's – late 1970's	1980's - present	“Nexus of Contracts” Theory
4.	Natural open system models	Late 1970's to present	Not yet accepted Dallas (1985)	Power Coalition Theory

## APPENDIX 8

### THE RATIONAL AND NATURAL PERSPECTIVES APPROACH TO CORPORATE REGULATION

<b>Rational Systems Perspective</b>		<b>Natural Systems Perspective</b>	
<u>Assertion or Assumption</u>	<u>Regulatory Characteristic</u>	<u>Assertion or Assumption</u>	<u>Regulatory Characteristic</u>
<u>Goal Specificity</u>	<u>Shareholder Primacy</u>	<u>Goal Complexity</u>	<u>Stakeholder interests</u>
Formalization	Reliance on legislation, regulations and codes of conduct	Informal structures	Reliance on dialogue, conversation, interaction and negotiation
Individual as Unit of Analysis	A “few bad apples” Focus on Individual punishment and deterrence  Preference for self-regulation	Corporation as Unit of Analysis	Acknowledgement of importance of corporate culture on behaviour  Preference for public regulation.
Rational Actors	Criminal sanctions and penalties to change behaviour	Social Actors	Organizational change efforts to change behavior
	Universal rules and convergence on international standards.		Particular rules, flexibility and national or regional solutions.