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Corporate Governance, Stakeholders, and Corporate Social Responsibility

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An overview

- Gatekeepers & Corporate Scandals
- Corporate Governance, Stakeholders, and CSR Responsibility
- Technology

Shell

Shell Case

- 26 May 2021 - District Court of The Hague*.
  - **Royal Dutch Shell to reduce the CO2 emissions of the entire Shell group by 45% below 2019 levels by 2030**.
  - This 'reduction obligation' concerns **the group's entire energy portfolio and the aggregate volume of all CO2 emissions** (Scope 1, 2, 3) associated with it.
  - The court declared its order to be 'provisionally enforceable'.
  - Class-action lawsuit filed in 2019 by:
    - the Dutch association Milieudefensie/Friends of the Earth Netherlands
    - Four foundations
    - An association
    - A youth organization

*District Court of the Hague, C/09/571932/ha za 19–379, 26 May 2021

Legal basis

- Book 6, Section 162 - Dutch Civil Code (tort of negligence)
  - Liability in the case of a violation of a personal right, a breach of a statutory duty, or, in the variant relied on by the court in this case, a breach of an **unwritten standard** of care characterized as 'proper social conduct'.
  - ➢ When interpreting open-ended norms in domestic law, Dutch law allows a court to take into account standards in international law.
- Court - Unwritten standard of care defined on the basis of:
  - 'the relevant facts and circumstances, the best available science on dangerous climate change and how to manage it' and
  - 'the widespread international consensus that human rights offer protection against the impacts of dangerous climate change and that companies must respect human rights' (para. 4.1.3).
  - Fourteen partially overlapping factors (para. 4.4.2).

Facebook whistle-blower **Frances Haugen**

“Facebook's products harm children, stoke division and weaken our democracy"

“**The company’s leadership** knows how to make Facebook and Instagram safer but won’t make the necessary changes because they have **put their astronomical profits before people**.”

Key Points

- How did we get there?
  - Notion of the Corporate Purpose
  - The evolution of the debate on the Corporate Purpose
- Where are we now
  - Identifying the Key distinguishing characteristics of the contemporary debate.

Corporate Purpose

Operational Purpose (Gesellschaftszweck, object)	Interest of the Company (Gesellschaftsinteresse)

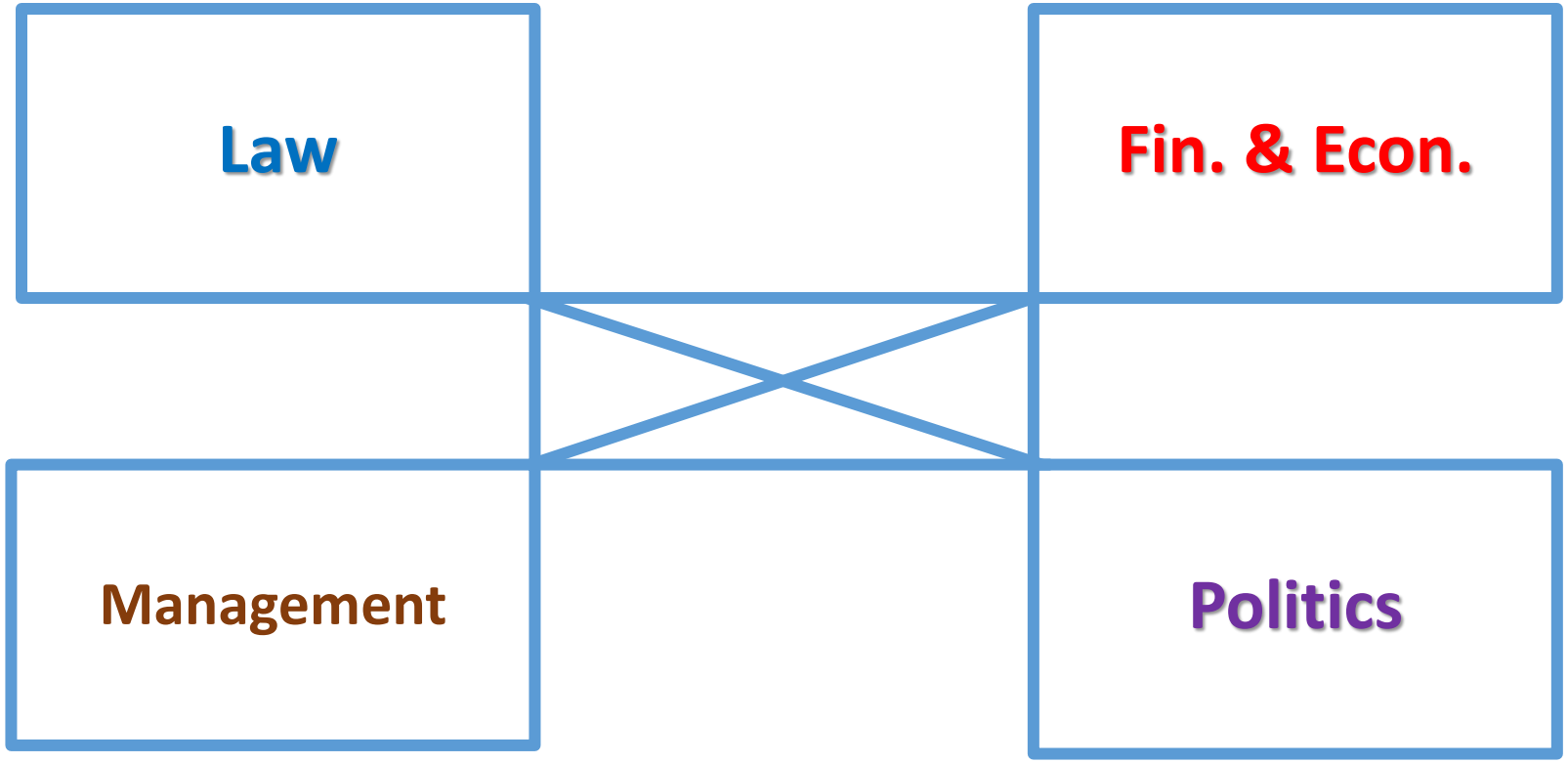
• **Art. 626 OR**
  • Contractual Nature
  • A requirement for the constitution of a corporation
  • Function:
  • Establishing a perimeter for Executives' actions
  • Protecting Shareholders
	• **Art. 717 Abs. 1 OR**
	  • The members of the board of directors […] must […] **safeguard the interests of the company in good faith.**

- **Art. 706 OR Abs. 2.4 OR**

  2. In particular, **challenges may be brought against resolutions which**

     4. transform the company into a non-profit organisation **without the consent of all the shareholders**.

The drivers of Corporate Governance



The Key debates on the Corporate Purpose

- **Legal debate over corporate objective and director duties**:
  - In managing/overseeing the management, whose interests does the law expect directors to take as primary? What are the limits on directorial decision making?
- **Financial & economic debate**:
  - Alternative theories of the firm & governance arrangements & impact on firms
  - What are the alternatives to shareholder value?
- **Management debate & strategy**:
  - Key management challenge: organizing the participants & build a great company.
  - How to build valuable and sustainable firms
- **Political debate**:
  - Social role of large corporations/ obligations imposed on listed (or all) corporations
  - Are current economic arrangements politically legitimate and sustainable?

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The Evolution of the debate

1910s-	1970s-	2010s-
Legal Debate: Interest of the Company	**Econ/Man Debate: Shareholder vs Stakeholder-Value**	**Legal/Political/Fin. Debate: Corporate Purpose**
Germany United States Switzerland	**School of Chicago & Del. Case Law**	**Europe Switzerland United States**

Germany: Institutional Interest of the Company

- Enterprise in itself (Unternehmen an sich)
  - A main point of concern: **Interference from shareholders**
  - **Long-term SHs** (adequate yield on their investment) **vs speculators** (short-term capital gains).
  - The use of **voting rights** by SHs should be limited by the **duty of loyalty** which is tied **to the interest of the corporation**.
  - Interest of the corporation: the measure in **majority-minority conflicts** (on business policies & dividends distribution)
- **To constrain shareholders in a concentrated ownership structure.**

Germany: Corporate Reforms

- 1937 Aktiengesetz
  "to manage the corporation as **the good of the enterprise** and its retinue and the common **wealth of folk and realm demand**."

- § 70 - Codetermination Act – 1976
  Unternehmensinteresse: The **enterprise as a social collective**

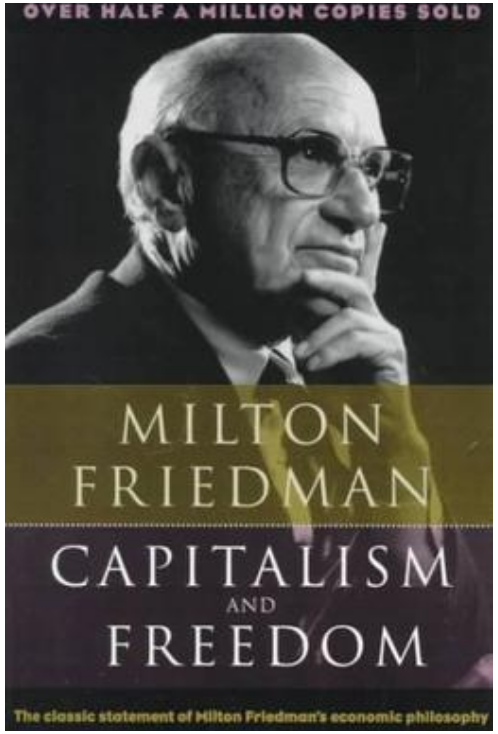
United States

- **Berle**: "[…] [A]ll powers granted to a corporation or to the management of a corporation […] are necessarily and at all times exercisable **only for ratable benefit of all the shareholders as their interest appears** […]"(1931)
- **Dodd**: Not only do "business[es] ha[ve] **responsibilities to the community** but that our corporate managers who control business should voluntarily and without waiting for legal compulsion manage it in such a way as to fulfill those responsibilities."
- Case Law - **Dodge v. Ford Motor Co. (1919)**:
  - "[a] business corporation is organized and carried on **primarily for the profit of the stockholders**. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself […]."

Switzerland - Case Law

- **BGE 100 II 384, 393 E. 4, Federal Supreme Court (1974)**:
  - Shareholder's right to realization of profits is limited by the **extensive discretion of the company** which must also safeguard other interests in addition to the realization of profits
- The board must strive to maximize the value of the corporation, thus the value of the shareholder's participation.
- Limits. The duty to maximize value does not necessarily imply that the board should:
  - **focus on short-term success**;
  - require that the **highest possible dividends be paid**;
  - **neglect** the interests of employees or creditors or even disregard the law.

Milton Friedman:
The birth of Shareholder Primacy



A Friedman doctrine—

The Social Responsibility Of Business Is to Increase Its Profits

Milton Friedman: The birth of Shareholder Primacy

- In his capacity as a corp. executive, the manager is the agent of the individuals who own the corporation. Does he have a **social interest**?
- If yes: he is to act in some way - not in the interest of his employers.
- **He would be spending someone else's money for a social interest:**
  - (i) imposing taxes
  - (ii) deciding how the tax proceeds shall be spent.
- This process raises questions on two levels:
  - Political: Imposing taxes & spending the proceeds are gov. functions.
  - Principal-agent: Distorsion of the Principal Agent

Friedman: The Social Responsibility of Business is to Increase its profits

- In a **free-enterprise, private-property system**, a corporate executive is an employee of the owners of the business.
- He has **a direct responsibility** to his employers:
  - to conduct the business in accordance with their desires, which generally will be to make ***as much money as possible*** while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom.
- In some cases his employers may have a different objective:
  - A group of persons might establish a corporation for an elemosynary purpose--for example, a hospital or a school. The manager of such a corporation will not have money profit as his objectives but the rendering of certain services.
- The key point: in his capacity as a corporate executive, the manager is the agent of the individuals who own the corporation.

Friedman (II): Does the Corporate Executive have a social interest?

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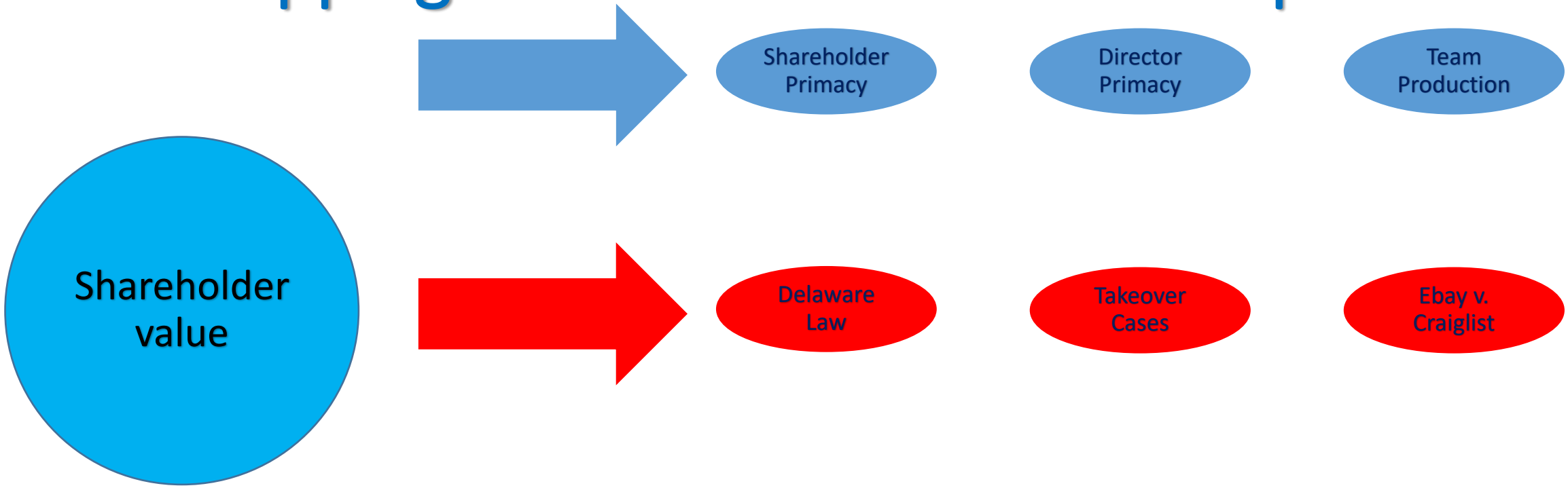
- If yes, he is to act in some way that is not in the interest of his employers:
  - **He does not increase the price of the product** to contribute to the social objective of preventing inflation, **but a price increase would be in the best interests of the corporation**.
  - **He makes expenditures on reducing pollution** beyond the amount that is in the best interests of the corporation to contribute to the social objective of improving the environment.
  - At the expense of corporate profits, **he is to hire "hardcore" unemployed instead of better qualified available workmen** to contribute to the social objective of reducing poverty.
- **The corporate executive would be spending someone else's money for a social interest. His actions in accord with his «social responsibility»**
  - **REDUCE RETURNS TO STOCKHOLDERS, SO HE IS SPENDING THEIR MONEY.**
  - **RAISE THE PRICE TO CUSTOMERS, SO HE IS SPENDING THE CUSTOMERS' MONEY.**
  - **LOWER THE WAGES OF SOME EMPLOYEES, MEANS SPENDING THEIR MONEY.**
- The stockholders or the customers or the employees could separately spend their own money on the particular action if they wished to do so.

Milton Friedman (III): Conclusion

- The executive is:
  - exercising a distinct **"social responsibility"** rather than serving as an agent of the stockholders or the customers or the employees, only if he spends the money in a different way than they would have spent it.
  - But if he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other.
- This process raises questions on two levels:
  - Political: Imposing taxes and spending the proceeds are governmental functions.
  - Principal-agent:
    - The justification for permitting the corporate executive to be selected by the stockholders is that he is an agent serving the interests of his principal. This justification disappears when the corporate executive imposes taxes and spends the proceeds for "social" purposes.
    - He becomes in effect a public employee, a civil servant, even though he remains in name an employee of a private enterprise.

Mapping Milton Friedman's Consequences



REVLON

FORSTMANN LITTLE & CO.

FL

- $ 65 per share
- maintaing employees, etc.

Pantry Pride

- $ 70 per share
- Cutting employees, etc.

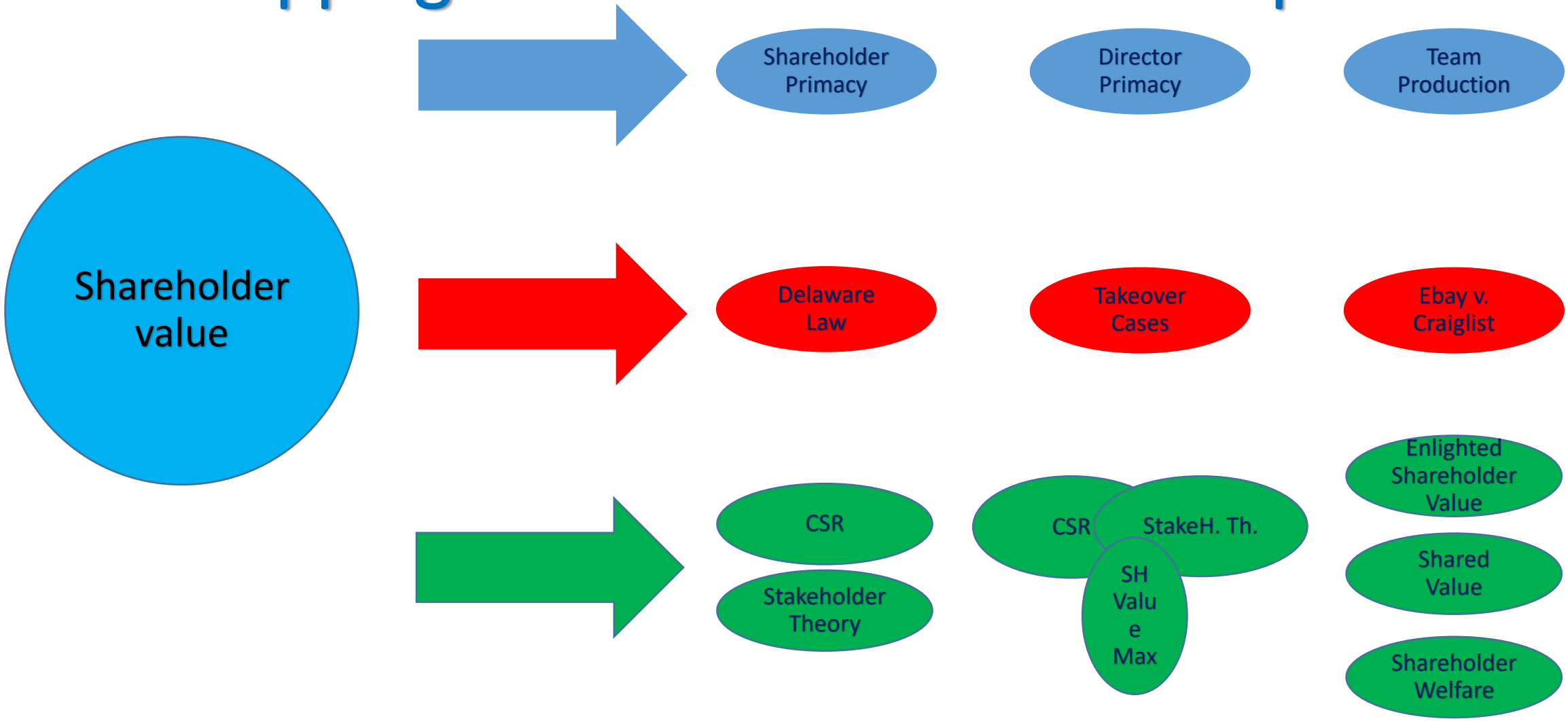
SEAL OF THE SUPREME COURT DELAWARE

In the context of a takeover a fiduciary obligation of directors is to **maximize the immediate stockholder value** by securing the highest price available.

craigslist

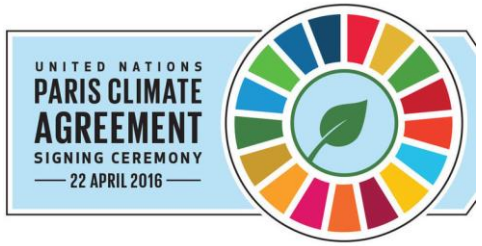
"Directors of a for-profit Delaware corporation cannot deploy a [policy] to defend a business strategy that **openly eschews stockholder wealth maximization** - at least not consistent with the directors' fiduciary duties under Delaware law."

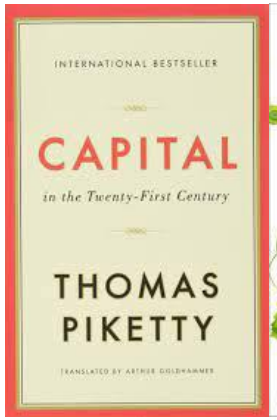
Mapping Milton Friedman's Consequences

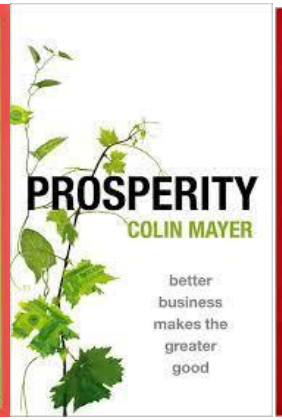


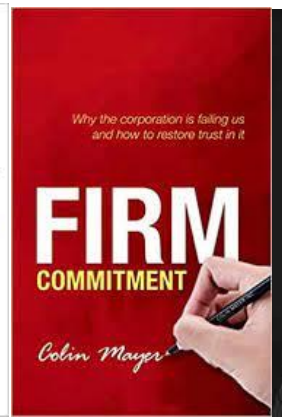

PODEMOS
Asamblea Ciudadana

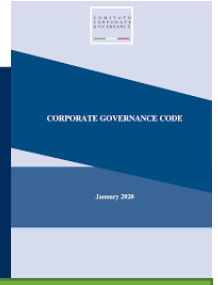

OCCUPY WALL ST











Sustainable Success of the Company

France

Article 1833 (2) Civil Code:

- a company "shall be managed in its "*intérêt social*" (corporate interest), **factoring in the social and environmental issues raised by its business activity**"
- Companies can include a ***"raison d'être"* (central purpose)** in their articles of association.

The emergence of two trends

- A pressure to move away from **Shorterminism**
  - UK Companies Act (see Article 172)
  - Shareholder Rights Directive II (SRD II)

- Embracing **Stakeholderism** & re-discussing the **Corporate Purpose**

Shorterminism

Excessive focus on short-term (and not long-term interests)

Excessive focus of investors on quarterly earnings

No attention to strategy, fundamentals and long-term value creation.

Pressure on Corporation

Expenditures research and development

Investments with positive long-term potential

Threat for development of sust. products or investment

Deliver operational efficiencies

develop human capital

effectively manage the social and environmental risks to their business.

Ownership in Corp. Gov. & Time Horizon

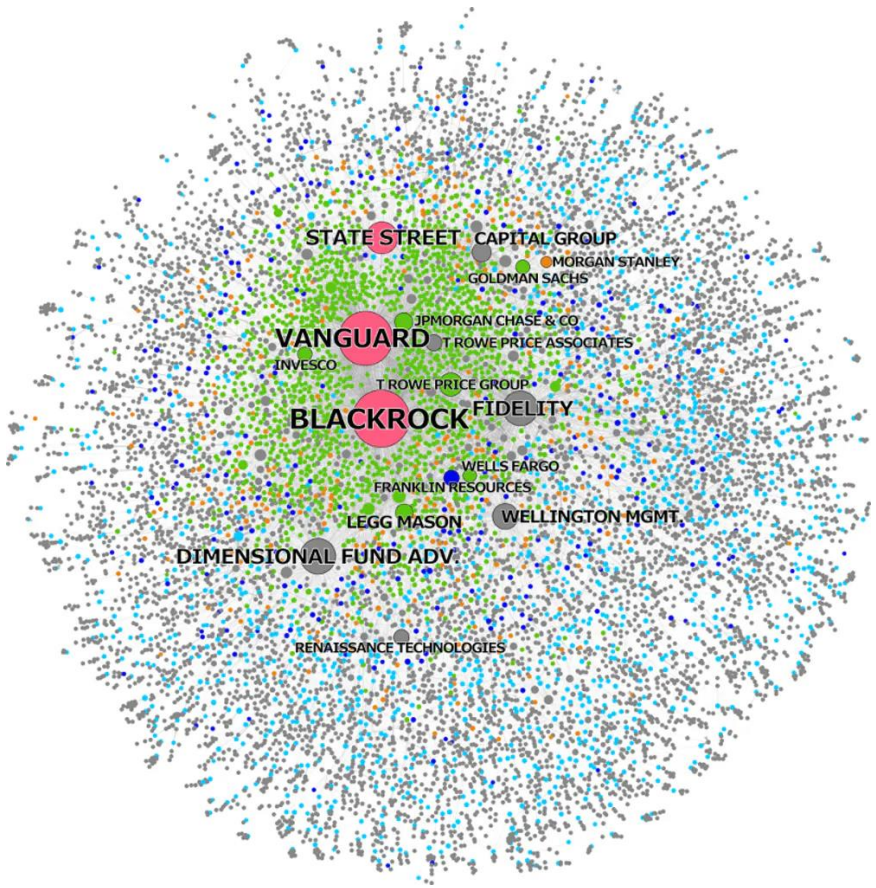
Short (<2 y) → Medium (<5 y) → Long (>10 y)

Financial Investors
- Hedge Funds
- Asset Managers
- Private Investors
- High-Frequency Traders

Strategic Shareholders
- Private Equity
- Institutional Investors

Long-Term Owners
- Founders
- Families
- Foundations
- Coops/Mutual Companies

The rise of Passive Funds



-Total Inflows 2009-2018

Index (Passive) Funds

$ 3.4 trillion

-Total Inflows 2009-2018

Actively Managed Funds

200 billion

Shareholder Activism

A range of activities by one or more shareholders intended to result in some change in the corporation.

- The spectrum of activities:
  - significance of the desired change
  - assertiveness of the investors' activities.
- Aggressive practices:
  - **hedge fund activism** - significant change to the company's strategy, financial structure, management, or board.
- Less aggressive practices:
  - **one-on-one engagements** between shareholders and companies ("say on pay" advisory vote).

UK : Company Act – Section 172
Duty to promote the success of the company

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

(a) the likely consequences of any decision in the long term,

(b) the interests of the company's employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

UK Corporate Governance Code

- **1. BOARD LEADERSHIP AND COMPANY PURPOSE - Principle A.**
- **A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company**, generating value for shareholders and contributing to wider society.
- **5. REMUNERATION – Principle P.**
- P. **Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success**. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy.

Swiss Corporate Governance Code (2016)

"**Sustainable corporate success as the lodestar of sensible CSR**".

"Corporate Governance" as a guiding principle

Corporate governance encompasses all of the principles aimed at safeguarding sustainable company interests. While maintaining decision-making capability and efficiency at the highest level of a company, these principles are intended to guarantee transparency and a healthy balance of management and control.

Duties of the Board of Directors. Article 9

The Board of Directors should be guided by the goal of sustainable corporate development.

Particular features of the compensation system. Article 35

Where the compensation system for persons in executive positions consists of both fixed and variable elements, it should be structured in such a way that the variable component is in reasonable proportion to individual performance on the one hand, and dependent on the sustainable success of the company or a corporate unit on the other.

Italian Corporate Governance Code (2020)

- Definitions:
  - **Sustainable success**: the objective that guides the actions of the board of directors and that consists of creating long-term value for the benefit of the shareholders, taking into account the interests of other stakeholders relevant to the company.
  - Business plan: a plan which defines the company's strategic objectives and the actions to achieve them in line with the chosen level of risk exposure, with the aim of promoting the company's sustainable success (such as defined below).
- Article 1. Principle I - Role of the board of directors
  - The board of directors leads the company by pursuing its sustainable success.
- Article 5. Remuneration - Principle XV
  - The remuneration policy for directors, members of the control body and the top management contributes to the pursuit of the company's sustainable success and takes into account the need to have, retain and motivate people with the competence and professionalism deemed adequate for their role.
- Article 6. Internal control and risk management system – Principle XVIII.
  - The internal control and risk management system consists of a set of rules, procedures and organisational structures for an effective and efficient identification, measurement, management and monitoring of the main risks, aimed at contributing to the sustainable success of the company.

The emergence of two trends

- A pressure to move away from **Shorterminism**

- Embracing **Stakeholderism** & re-discussing the **Corporate Purpose**

The remergence of the debate on the Corporate Purpose

2018 - BlackRock Larry Fink's **letter to CEOs** "Society is demanding that companies, both public and private, **serve a social purpose** [...] **Companies must benefit all of their stakeholders**, including shareholders, employees, customers, and the communities in which they operate."

BR Business Roundtable

August 2019 - Business Roundtable: "Statement on the Purpose of a Corporation." Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country. Generating long-term value for shareholders

In The Business Roundtable's view, **the paramount duty of management and of boards of directors is to the corporation's stockholders**; **the interests of other stakeholders are relevant as a derivative of the duty to stockholders**.

The notion that the board must somehow balance the interests of stockholders against the interests of other stakeholders fundamentally **misconstrues the role of directors**.

It is, moreover, an unworkable notion because it would leave the board with **no criterion for resolving conflicts between interests of stockholders and of other stakeholders or among different groups of stakeholders**.

The remergence of the debate on the Corporate Purpose

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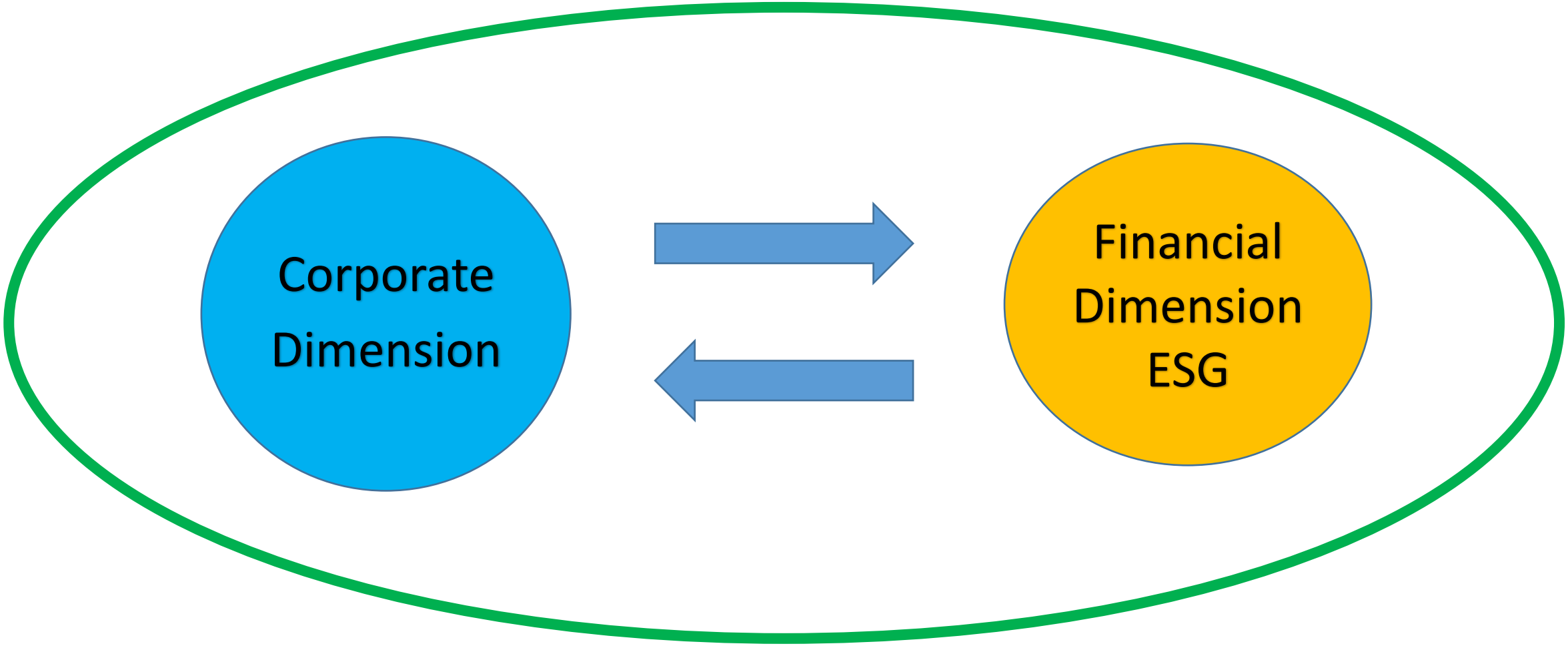
"Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution"
The purpose of a company is to engage all its stakeholders in shared and sustained value creation. In creating such value, a company serves not only its shareholders, but all its stakeholders. A shared commitment to policies and decisions that strengthen the long-term prosperity of a company.

The Dimensions of the Contemporary Debate



Consequences & Possible Areas of Intervention

- **Corporate purpose**
  - Broadening the Corporate Purpose, including stakeholders and heterogeneous interests and goals (Colin Mayer)
  - Would a vague definition really matter?

“offering everyone a better way forward”

Examples of raison d'etre

- Atos (the first to include a central purpose in its articles of association):
  - "help design the future of the information technology space".
- Veolia Environnement: "resourcing the world"
- Carrefour: "becoming the world leader in the food transition for all"
- Total: "supply to as many people as possible a more affordable, more available and cleaner energy"
- Sanofi: "prevent, treat and cure as many patients as possible"
- PSA: "ensure the freedom of movement by providing a safe, sustainable, affordable and enjoyable mobility, for as many people as possible".

Consequences & Possible Areas of Intervention

- **Fiduciary Duties:**
  - Redesigning Fiduciary Duties also taking into account the ESG dimension
  - Does a multiplication of directors' goals (increasing the complexity of their fiduciary duties) decrease their discretion?
- **Enforcement of Directors' Duties:**
  - "to strengthen the enforcement of the directors' duty to act in the interest of the company."; "[a]llow stakeholders (other than shareholders) to bring suits in courts for alleged violations by directors of the duty of care and loyalty."
  - Subverting the reasons underlying the Business Judgement Rule
- **Alligning Compensation with the ESG dimension:**
  - "1. Regulating ability to sell the shares they receive as pay. 2. Making Compulsory the inclusion of non-financial, ESG metrics, linked to a company's sustainability targets, in executive pay scheme."
  - Dilution of Incentives? Which are the relevant and measurable targets?
- **Rethinking Gatekeepers: ESG rating and ESG rating providers**
- **Soft Law: Look at Corporate Governance Codes (Enlightened Shareholder Value)**

Recent Findings on the Limits of Stakeholderism

- Long-term value creation does not imply sustainability
  - Activities substantially harming stakeholders can serve long-term shareholder value
- Corporate leaders have incentives **not** to serve stakeholder interests beyond what would serve shareholder value.
- BRT companies two years after the statement on the corporate purpose:
  - No material changes in stakeholder treatment.
- Stakeholderism brings:
  - More investor deference to corporate leaders, more acceptance of arrangements insulating management from market pressures.
    - **Reduced accountability** that would raise managerial slack, benefitting only managers
    - **Slowering down other more fundamental reforms**

Focus on legal changes and policies constraining and incentivizing companies from OUTSIDE!

Putting Stakeholders first: It's difficult!

- Johnson & Johnson "Credo" in 1943
  - Robert Wood Johnson describes his company's responsibilities in this order: patients/doctors/nurses, customers, business partners, employees, communities, the environment and natural resources, and *then,* after all that, "stockholders should realize a fair return."
- 2019: A judge had ruled against the company, fining it $572 million for its alleged contribution to the opioid crisis in Oklahoma.
- However, the situation shows that
  - (a) companies are increasingly expected to play a positive role in society and take responsibility for the broader effects of their actions and products, and
  - (b) companies are complicated — their actions and words don't line up perfectly. A company can have the right principles on paper but, at times, lose sight of what serving multiple stakeholders really means.

Putting Stakeholders first: It's difficult!

- Amazon: increased burning depends on policies to help industrial agriculture and meat industries, all enabled by a Brazilian president that *wants* to monetize natural capital.
- What responsibility do businesses have to prevent this degradation?
  - Presumably, companies signing a statement like the BRT's wouldn't buy from meat suppliers that burned down the Amazon to create grazing lands.
  - And companies that truly put stakeholders and long-term needs ahead of short-term investors would proactively fight these kinds of devastating policies.
  - In a similar vein, signatories should become loud, vocal advocates for a price on carbon.

Putting Stakeholders first: It's difficult!

- Signatories have fought any action on climate, even while making public statements in support of a price on carbon. This isn't ancient history.
- In the 2018 election, a ballot initiative in Washington state proposed a modest carbon price. Money poured in from fossil fuel interests, including many of the BRT signatories, to defeat the initiative.

Evaluation

Link: https://www.uzh.ch/qmsl/en/LUUCR