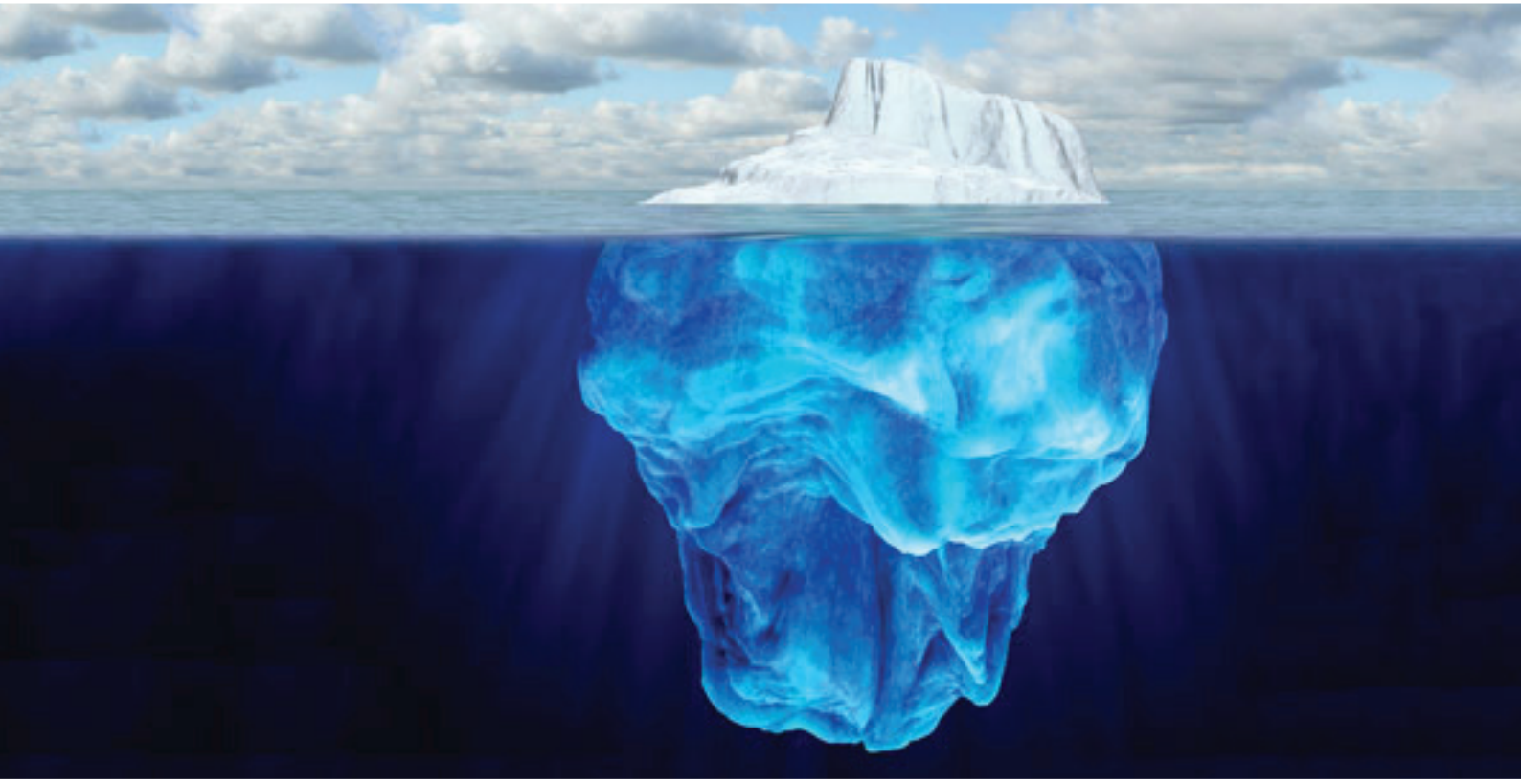
A Pocket Guide to Corporate Governance



Edited by

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I: Introduction to Corporate Governance[1]

Objective of this Guide

The objective of this publication is to provide civil society organisations and responsible businesses with the following:

- A concise overview of corporate governance in the UK and EU;
- An analysis of its relevance to key streams of civil society concern, namely sustainability, inequality, and business and human rights;
- An overview of potential corporate governance models; and
- References to further reading.

What is corporate governance?

Corporate governance may be simply defined as "the exercise of power over corporate entities".[2] Or it may be more fulsomely described as the procedures and processes according to which a business is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making[3]. Corporate governance also gives a structure through which the objectives of the company are set, and the means of attaining those objectives, and monitoring performance are determined[4].

This definition clearly recognises the importance of groups other than shareholders, but in practice shareholders often dominate because they have a stronger voice and their ability to enforce their rights is more clearly defined.

It is now generally accepted that strong corporate governance helps a company to be sustainable in the long-term, although there are widely diverging views on what it means to have good governance. Many corporations have greater turnover than the GDP of several countries. Wal-Mart has revenue that is nearly equal to the GDP of Norway and only 500 transnational corporations control roughly 80 percent of world trade. Given their dominant position in economic system, the way these corporations are governed is essential for either positive or negative change of the system as a whole, depending on the chosen stewardship.

How are corporate governance and company law relevant to social justice?

The current default is to regulate corporate behaviour through external regulations, such as environmental law, human rights standards, tax laws, accounting norms, etc. While these external regulations are crucial to mitigate acute environmental and social problems, such as water pollution and worksite safety standards, they are often criticised for being bureaucratic, complicated, expensive to monitor and enforce, adversarial, stifling innovation and ineffective at addressing root causes[7].

Furthermore, they do not necessarily encourage companies to consider in a meaningful way whether their business activities could be structured so as to completely eliminate potential harm, or conversely to contribute positively to the welfare of workers, the communities in which they operate, and societal welfare.

Corporate governance is therefore relevant to many critical social issues, such as:

Inequality:

Publicly listed companies award compensation packages heavily weighted towards stock options, which increases inequality both within companies and across society.This effect extends further to firms' relationships with suppliers and drives the exploitation of workers throughout value chains, for example in off-shore manufacturing sites.

Sustainability:

Companies face tremendous pressure from investors to justify investments to improve sustainability that do not pay off in the short-term.

Poverty:

The financial crisis showed that existing checks and balances in how companies were being run failed to create sound business practices, leading to a large number of corporate and personal bankruptcies, entrenched unemployment, mortgage defaults, pervasive poverty and reduced opportunities.

Reforming the corporate governance framework offers an opportunity to complement existing regulation that seeks to promote responsible corporate behaviour. Responsible corporate governance offers the possibility of forging a vision for business that sees corporations providing benefits to the communities in which they are situated and creative solutions to the complex challenges we face that cannot be addressed by governments or civil society alone, such as climate change.

Revisioning corporate governance is not an alternative to the regulation of externalities, like pollution and waste. It rather enhances regulation by reducing the pressure on companies to blindly prioritise short-term profits. It is essential for a change of our economic system as whole. Additionally, the eventual formulation and recognition of a new understanding of the purpose of the corporation will create a space for a discussion on the regulation of externalities.

Let's start at the beginning: the corporation

Common myths about the corporation

Current corporate governance rules rely on several misguided beliefs. This section will address the myths to get them out of the way, and the following section will give an overview of what the law *actually* says.

Myth #1:	Fact:
Shareholders own corporations.	Shareholders do not *own* corporations, which are independent legal entities. Shareholders only own shares of stock, which give shareholders certain rights in the company, such as the right to receive dividends and to vote on certain matters. In law, corporations are legal persons or entities, which means they have an independent personality and cannot be owned by anyone. Shareholders own their shares, which give them certain organisational, control and economic rights in relation to the company. This means the shareholders' relationship with the company is analogous to the relationship between the company and other stakeholders, including employees, creditors and bondholders. Treating a corporation as a legal person means that the corporation has certain rights and obligations, including especially the rights to own property, enter contracts, and be held accountable in its own name for any harm it causes to others[8]. It is important to be clear that the idea of shareholders as 'owners' is fundamentally incompatible with the corporation as we know it today. Right now, the financial risk to investors when they buy shares is limited to the amount of money that they have invested in the corporation. If a corporation was owned by its shareholders, they could be held financially responsible for any wrongdoing or money owned by the company (as is the case for other forms of companies, such as sole proprietorships and partnerships).

Myth #2:	Fact:
Boards of directors have a legal duty to maximize shareholder value by focusing on short-term stock price and quarterly returns.	Directors have a duty to act in the best interests of the company. Depending on the jurisdiction, this might be worded as a duty to act in the best long-term interests of the corporation (Canada) or of its members (UK). Certain investors have very short-term time horizons (e.g. hedge funds) whereas others are interested in long-term returns (e.g. pension funds and sovereign wealth funds). Focusing only on quarterly earnings may lead a company to make decisions that will have a negative impact on the future health of the firm, e.g. laying off workers or failing to invest in research and development. It is therefore impossible to conclude that maximizing short-term profits is in the interests of all investors. Directors may instead choose to invest in innovation, research and development, employee training, improvements to sustainability or other areas that will ensure the long-term vitality of the firm.

Myth#3:	Fact:
Directors are the agents of shareholders.	It is often said that directors are the 'agents' of shareholders; this is not true under the company law of any jurisdiction[9]. Directors have a duty to act in the best interests of the company. While shareholders should and normally will benefit from a company's success, directors do not as a matter of law act on behalf of shareholders.

Myth #4:	Fact:
Shareholders have special rights because they invest capital in the company.	Only the first round of shareholders invest capital in a company. When a private company decides to list on a stock exchange, they issue shares and those investors inject capital into the firm. However, when the initial investors resell their shares on secondary markets, the sale proceeds go to the seller, not to the company. As a result, the prioritisation of all shareholders cannot meaningfully be justified by pointing to their investment in the firm as it is only those who participated in the initial public offering (IPO) who invested directly in the company.

Myth #5:	Fact:
The interests of shareholders should be prioritised because they are the 'residual claimants', meaning that they have the sole remaining claim on the company's cash flows after the deduction of preceding agents' claims (e.g. wages, outstanding debts and tax) and therefore also bear the residual risk.	This claim is hotly debated, with many legal scholars arguing that employees are also residual claimants because they invest time and money to acquire special skills of benefit to a specific company[10]. When a company goes bankrupt, employees must invest in retraining and finding new employment. Furthermore, many stakeholder groups are dependent upon, or affected by, company decisions either because their contracts are incomplete or because they are not in a contractual relationship with the corporation at all, and so have no opportunity to protect their interests[11]. In short, shareholders do have a claim on the proceeds of the firm but the legal significance of this claim should not be overstated.

What is the purpose of the corporation?

The purpose of the corporation is whatever its founders wish it to be, as long as it is legal. Thus, it might be to make innovative products, develop cutting edge technology, build a spaceship, create the next penicillin, foster a great working environment for employees, or one of many other objectives. A corporation may also decide to maximise profits and share price - the key here is that it is a permitted objective, not one that is required by law. The law has essentially left a vacuum allowing companies to decide what their purpose should be, and the principle of maximising shareholder value has expanded to fit the vacuum for a variety of reasons that will be explored below. Very few conventional companies have been founded with the narrow objective to maximise shareholder value; shareholder value is rather a result of a successful strategy to implement company's purpose to address specific societal need.

The purpose of the corporation is important because if we believe that it is to maximise profits, we will have very different expectations for corporate behaviour than if we have collectively decided that business has a different role in society, such as to balance fair returns with the interests of various stakeholders.

What is the problem with the current corporate governance model?

Conventional economists argue that publicly traded companies suffer from an incentive problem: the people who run companies (management) are different from the people who 'own' the company (shareholders) or who are otherwise affected by its success or failure (stakeholders). To fix this perceived problem, various mechanisms are used to try to align the interests of management with shareholders, such as stock-based executive pay. In other words, companies often make stock options a very significant part of executive pay in an effort to ensure that management makes decisions that benefit shareholders.

This approach is deeply problematic for several reasons, including:

1 In law, shareholders are not the owners of corporations.

2 Focusing on the interests of shareholders translates in practice to an excessive focus on short-term returns and share price at the expense of investment in long-term innovation, good jobs, and sustainability.

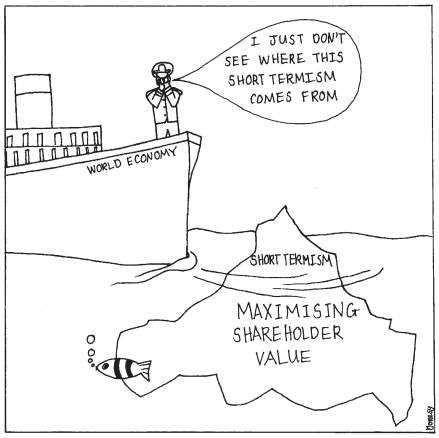
3 The current model often creates a business culture based not on generating benefits for consumers, workers, communities and the environment but rather perverse incentives that encourage problematic practices, such as stock buy-backs[12]. This ultimately undermines viability of company in a long-term.

What does 'bad' corporate governance look like?

Perhaps the most famous example of a company where internal decision-making processes went terribly wrong is Enron – whose top executives lied about financial results for years to inflate the value of their personal stock options. The actions were undetected by the board of directors, auditor, US regulators, rating agencies or media for years until the firm spectacularly imploded into bankruptcy in 2001.

There are numerous other examples of publicly listed companies with dysfunctional governance structures that led to egregious misconduct:

- **LuxLeaks scandal** – European companies including Shire and Ikea entered into tax agreements with Luxembourg to reduce their tax burden.
- **Deepwater Horizon oil spill** – BP's culture of cost-cutting reduced safety oversight and resulted in the largest accidental marine oil spill in the history of the petroleum industry.
- **Irresponsible supply chain management, particularly in the garment and electronics industries** – The drive to reduce labour costs has led to the outsourcing of production. This, coupled with the failure to oversee and guarantee the health, safety and equitable pay for workers, has led to a pattern of human rights violations in several low wage countries. Perhaps the most notable recent example is the collapse of Rana Plaza in Bangladesh, which occurred despite the problems having previously been identified.



What does 'good' corporate governance look like?

It is harder to identify good governance than to point to bad corporate governance. We might say that a well-run company is sustainable, meaning that it is managed in a transparent and democratic way and it is accountable to robust standards that govern its performance in all applicable areas, including environment, human rights, labour, and tax[13]. Good corporate governance allows company to look well in the future, anticipate challenges and opportunities, build capacities to create value on an ongoing basis, embrace creating real value for customers and building wealth for shareholders as mutually reinforcing objectives, and recognize societal and environmental sustainability as essential conditions for delivering on these objectives in long run. Good corporate governance must embrace all these objectives and implement them in business strategy through valuation, monitoring and incentive mechanisms. Companies that are run in this way are more likely to act ethically even in the absence of a clear business case.

There are significant advantages to strong corporate governance, including better relations with stakeholders, less litigation and costly disputes, and reduced interference from regulatory authorities. Good corporate governance results in superior performance on the market for products and services as well as on capital markets - at least in the long-term. It also puts company in a position to shape new standards, both regulatory and with respect to customers' expectations[14].

Responsible corporate governance offers the possibility of forging a vision for business that sees corporations providing benefits to the communities in which they are situated and creative solutions to the complex challenges we face that cannot be addressed by governments or civil society alone, such as climate change.

II: PREVALENT SYSTEMS OF CORPORATE GOVERNANCE

Speaking broadly, experts tend to talk about three systems of corporate governance that have emerged from the Anglo-American, German and Japanese contexts. Within each system, there is considerable variation in terms of application. Also the systems have influenced each other. For example, the rising importance of American investors in Japan has led to increasing pressure on Japanese companies to reform their governance in line with the US model. More generally, it is possible to discuss corporate governance models as falling within either the category of being oriented towards the interests of labour (stakeholder-oriented) or dominated by the voice of shareholders (shareholder-oriented).

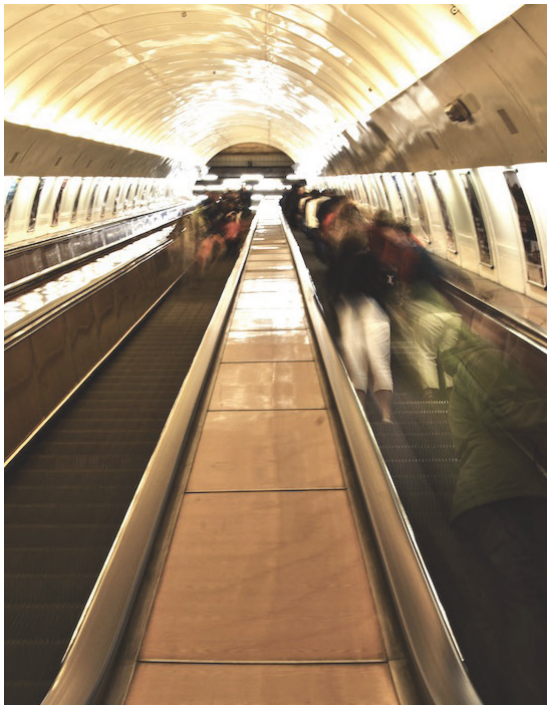
Below is a brief outline of these two corporate governance models along with an analysis of their strengths and weaknesses.

Shareholder Wealth Maximisation-Oriented Model

At its core, the shareholder value maximisation-oriented model perceives the sole or primary purpose of the corporation to be to maximise its value for shareholders. This belief has been developed only since the 1970s by economists such as Milton Friedman and Michael Jensen at the University of Chicago and has led to a focus on quarterly earnings and short-term share price as the main basis for investment decisions.

The immediate challenge this presents is that it is impossible to speak of 'shareholders' as a homogenous group with a coherent set of interests. While certainly shareholders expect to earn profits, both their expectations for financial returns and their time horizons vary significantly.

> For example, institutional investors like pension funds and sovereign wealth funds (e.g. Norway) may have extremely long time horizons because they seek to provide a return to their members and citizens over the course of their entire lifetime, or indeed over the course of many lifetimes. As a result, they may be patient investors prepared to invest in research and development to promote long-term innovation (such as new technology, which may take 10-20 years to be profitable) or invest in sustainability measures that are costly in the short-term (e.g. the transition to clean energy or upgrading equipment at a factory).



> At the other extreme, hedge funds and activist investors may seek to 'unlock' shareholder value by pressuring boards to buy back stocks, layoff employees, buy other companies in order to acquire their innovations (rather than investing in risky explorative research) or engage in financial engineering to increase stock price.

In some places, the pressure to raise share price is simply driven by business culture, management reacting to demands from shareholders, and sometimes a misunderstanding of the legal obligations of directors.

There are several serious critiques that are associated with the current model:

1. Serious environmental and human rights implications

The use of the corporation as a legal form has had tremendous advantages in the past due to its ability to stimulate risk-taking and innovation. At the same time, it has passed along many costs to the broader society - what economists call negative externalities - due to its failure to properly account for its impacts. The problem is particularly acute for climate change, where rapid and deep change is needed to avert impending crisis. For example, scientists have demonstrated that even if we reduce our carbon emissions by 80 percent before 2050, it will take 1000 years for the world to cool down.

2. Wealth creation coupled with growing inequality

In the 20th century, incomes for middle-class individuals consistently rose despite economic recessions, wars and other upheaval. That is no longer the case. Recent research has shown that a very large part of the increase in the top 10% US income share comes from the top 1%. The primary cause is the rise of top executive compensation in large U.S. corporations, which is now largely based on stock options[15] salary packages that are tied to share price. Yet the wages of lower and middle-class workers have essentially flatlined. Rising inequality within large companies has contributed, along with other factors, to increasing inequality across society, particularly in North America and Western Europe.

3. Economic growth without job creation

As we begin the 21st century, we have witnessed an unprecedented situation where increased corporate profitability has not translated into job opportunities. There are numerous reasons for this, not least the rising role of automation and outsourcing. The fact remains that companies are not reinvesting their returns into research and development (R&D) and/or employment but rather maintaining significant cash reserves, buying other companies, paying out dividends to shareholders and buying back shares[16].

Enlightened shareholder value

Certain jurisdictions have adopted a concept called 'enlightened shareholder value', meaning that boards of directors must consider the needs of other groups beyond shareholders.

The UK is the foremost example, where directors are required to make decisions that are in the best interests of the members as a whole (meaning, all shareholders), taking into account the interests of stakeholders, including employees, creditors, the environment and broader society[17]. In Canada, directors must make business decisions that are in the best interest of the company as an ongoing entity, in other words ensure that the company is able to continue operating into the future[18].

A central issue with these approaches is the lack of an enforcement mechanism, meaning that concerned citizens or civil society groups are unable to bring a claim alleging the failure of directors to pay appropriate attention to the interests of stakeholders[19].

Following on from the financial crisis, the UK sought to address what it saw as passive institutional investors (such as pensions and investment funds) and encourage them to act

as engaged, responsible 'owners'. To this end, the UK Stewardship Code was launched in 2010, targeting UK institutional investors. **There are three key critiques of this approach:**

1. The Code is quite weak as it requires reporting on a comply-or-explain basis[20]
2. Companies tend to focus on 'tick-box' compliance with the formal requirements of the Code rather than truly improving their underlying governance[21]
3. Thefragmentation of shareholding structures has meant that an increasing number of shareholders are located outside the UK and are therefore not covered by the Code[22]

Another problem specific to the UK is that boards are unable to block attempts to buy out the company, which seems to create pressure to keep share prices high in the belief that it will discourage hostile takeover bids. In this area, UK law is more shareholder-centric than the US, where directors have more power to block hostile takeover attempts even where the potential purchase is offering attractive share prices to stockholders[23].

Stakeholder-Oriented Model

In the mid 1980s, business models that placed a number of groups at the centre of decision-making, first began to achieve prominence. These models saw stakeholders as "any group or individual who is affected by or can affect the achievement of an organisation's objectives", meaning a broad range of interest groups including employees, creditors, customers, and extending to society and the environment - as well as shareholders[24].

The most well-known example of a stakeholder model is Germany, which has adopted a pluralistic governance structure called co-determination. Companies with more than 2,000 Germany-based employees allow workers to elect one-half of the members of the supervisory board, which in turn appoints the managing board, monitors its performance and approves major business decisions. Austria has a form of co-determination similar to that in Germany. The Netherlands has a system called 'structuurvennootschap' that applies to all larger companies except for those with an international group structure such as Royal Dutch Shell and Unilever. There, directors must have the confidence of employees but there is no direct representation. Members of the supervisory board must take care of the interest of the company and its related enterprise.

Other European countries have forms of employee representation, including Denmark, Luxembourg, Hungary, Slovenia and the Czech Republic, require companies to allow workers to elect or nominate a portion of the board's membership. France reserves board seats for labour representatives. The only EU states without formal worker representation are Belgium, Italy, Portugal, and the UK[25].

Europe considered adopting the stakeholder model at the regional level but eventually decided against it due to significant opposition[26].

General Assessment of these Models

Each of the existing corporate governance models has certain advantages and disadvantages.

> The shareholder-centric model is generally perceived to be effective in terms of streamlining decision making in order to generate profits. But critics note that a narrow focus on profit comes at the detriment of long-term prosperity, as discussed above.

> The stakeholder model is generally associated with improved working conditions. It is less clear, however, whether it is associated with improved environmental sustainability. In Germany, for example, many of the largest corporations disclose information about environmental and social matters, often using the Global Reporting Initiative's reporting standards and 29 German corporations have agreed to comply with a voluntary Sustainability Code created by the German Council for Sustainable Development. But there is no conclusive evidence that this has translated into improved environmental performance.

III: THE FUTURE OF CORPORATE GOVERNANCE

A change of corporate governance models to one that balances the interests of investors, workers, consumers, communities, and the environment would allow businesses to thrive in a climate of sustainability. For this to happen, it is essential that we shift the policy discussion from a single-minded focus on shareholders to a more holistic understanding of their role in the firm. This requires reframing the debate from 'how do we make investors more responsible?' to 'how do we integrate the needs of all stakeholders into core business decision-making?'.

This section briefly sets out alternative models of corporate governance and reviews the strengths and weaknesses associated with the adoption of any of these models.

1. Team production

Rather than focusing on conflict between a company's management and shareholders, some legal scholars argue for a 'team production analysis' of corporate structures. This analysis starts from the assumption that everyone associated with the company (employees, management, shareholders, creditors, local communities, etc.) has an interest in its success and should benefit from it. Directors should therefore seek to "maximise the joint welfare of all the firm's stakeholders"[27].

The conceptual appeal of this model is its emphasis on collaboration rather than the presumption that only one narrow set of interests should dominate. It does not appear to be a viable alternative model at this time but it has received some interest in Anglo-American jurisdictions and could provide the basis for a deeper discussion of a new corporate governance theory.

2. Trust firms

Another proposal is for a new form of company, the Trust Firm, that would grant voting rights on shares proportional to the remaining length of a holding period that the shareholder commits to at the time of share purchase[28]. During the holding period, shares could not be transferred. Transferable shares would not have any voting rights.

Trust Firms would have a Board of Trustees that is obligated to uphold the corporation's values. These values should be disclosed publicly to allow potential stakeholders to evaluate and decide whether to invest or otherwise engage with the company.

The idea behind this proposal is to reduce the incentives for excessive risk-taking by prioritising long-term shareholders, which should indirectly increase corporate responsibility. However, this proposal does not foresee any direct means to integrate environmental, social or labour issues into business decisions.

3. Hybrid business models

A number of alternative business models now exist to rival corporations. In addition to cooperatives, mutuals, voluntary associations and foundations, we have hybrid corporations such as the UK Community Interest Company (CIC), which gives tax benefits to social enterprises that limit their distributions to investors ('dividends'). Investors not allowed to retrieve their principal investment in the company as the company's assets are 'locked' and designated for general community benefit. Various other forms of social enterprises exist across Europe and there has been some discussion about creating an EU-wide form of social enterprise but so far that has not been taken forward[29]. The US has three types of hybrid corporate structures: the L3C (Low-Profit Limited Liability Company, the Benefit Corporation, and the Flexible Purpose Corporation[30].

There also exists the B Corporation (B Corp) movement, which is often confused with the US benefit corporation. B Corps are essentially companies that have gone through a private accreditation process analogous to the Fair Trade labelling standard. The company must have an explicit social or environmental mission, and a responsibility to take into account the interests of workers, the community and the environment as well as its shareholders. A company must also amend its articles of incorporation to adopt B Lab's commitment to sustainability and treating workers well. There are also certain reporting requirements.

B Corps might be benefit corporations but it is not required. For example, sportswear company Patagonia is legally registered as a California benefit corporation and is also a certified B Corp. Conversely, Unilever is also considering registration as a B Corp but it would retain its legal form as a publicly traded company[31].

Hybrid organisations are often very innovative but may have trouble scaling their activities and face the possibility of 'mission drift', meaning a gradually increasing focus on profits at the expense of social good.

IV OPPORTUNITIES FOR CIVIL SOCIETY ENGAGEMENT

There is an opportunity to reframe the debate about the corporation and its role in society, which would have three major implications.

First, the move to a new paradigm of corporate governance could result in less need for external regulation of business conduct as business leaders would consider the effects of their operations on a number of groups and factor that into all strategic decisions.

Secondly, it would be easier to advocate for externality regulation if key stakeholders agreed that the purpose of the corporation was not limited to advancing the interests of its shareholders. This is an attainable objective because the long-term interests of society and the company both favour sustainability, innovation, and a strong social licence to operate. In other words, there is a 'business case' for corporate governance reforms that look beyond the narrow interests of shareholders. Conversely, it is much harder to argue the business case in the current debate on externality regulation because the shareholder-centric model of corporate governance tends to perceive any new regulation of business activity as detrimental to the interests of shareholders. Sustainable companies may be more competitive over the long-term[32], but it is nearly always more profitable to pursue unsustainable business activities in the short-term.

Third and finally, reframing the debate on corporate responsibility could provide an opportunity for civil society to counterbalance and distance itself from the corporate social responsibility (CSR) discussion. That is, to move away from the fixation on voluntary corporate initiatives and market forces that currently characterises the CSR debate. It would also allow for the articulation of a positive vision for the role of corporations in society that rejects conflict between the economic benefits for society and environmental and social concerns.

This debate can be fostered and harnessed through **two main strands of work:**

A. Reframing the debate

- CSOs could reframe the debate on corporate responsibility based on a new vision of corporate purpose and the role of corporations in society.

- This strategy could be put in practice by holding conversations and conferences with business leaders and policy makers, clearly distinguishing the new vision from the CSR concept. This would refocus the debate and build relationships with new allies.

- The communication strategy could be further implemented by responding in the media (e.g. through opinion editorials and letters to the editor) to economic, environmental and social crises, explaining how they are connected to the dysfunctional behaviour of business and capital markets.

- Sustainability and corporate responsibility should be integrated into new standards in corporate governance, such as the UK Stewardship Code and the OECD Principles for Corporate Governance, to ensure policy coherence. CSOs may argue that CSR as well as business and human rights policies should be directly integrated into corporate governance frameworks.

B. Proposing policy reforms

- When engaging in corporate governance policy-making processes, such as reforming the UK Stewardship code, CSOs should promote not just the integration of corporate responsibility objectives, but also concrete measures to counterbalance the short-term influence of capital markets, embedding incentives for long-term strategy by companies and investors alike, tying shareholders' influence in corporate governance to long-term commitment, and limiting harmful practices such as financial engineering by stock buy-backs. This discussion would further contribute to reframing the debate on the role of corporations in society.
- CSOs could advocate for the integration of corporate governance elements into policy plans and standard-setting instruments in the sustainability and business and human rights areas, for example in the National Action Plans on Business and Human Rights. Similarly the importance of reforming corporate governance can be voiced at major conferences and stakeholder meetings.
- Ultimately, CSOs could argue that the definition of corporate purpose in company law as well as associated directors' duties should be changed to reflect broader societal purpose and environmental responsibility. This broadly formulated objective needs to be stated in precise terms and tools and have concrete monitoring and enforcement mechanisms that are available to civil society and affected groups.

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