Redefining directors' duties in the EU to promote long-termism and sustainability

Frank Bold

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About Frank Bold

Frank Bold is a purpose-driven law firm established in 1995 with four offices in the Czech Republic as well as offices in Brussels, Belgium and Krakow, Poland. The firm uses both business and non-profit approaches to solve social and environmental problems. Frank Bold provides legal expertise in corporate accountability and corporate governance to the European institutions as well as to civil society, municipalities, and businesses.

About the Purpose of the Corporation Project

After the Global Financial Crisis, the contemporary model of corporate governance became increasingly criticised for forcing corporations to focus on short-term profit maximisation for shareholders only at the expense of long-term strategising, innovation and sustainability. Continued reliance on this model limits the scope and impact of efforts by policy-makers to mitigate these effects.

A consensus has begun to emerge that corporations should focus on creating long-term sustainable value but that we lack clear vision on how to achieve this outcome. In order to produce more clarity on appropriate structures and practices for publicly listed corporations, Frank Bold initiated the Purpose of the Corporation Project to provide a strategic, open-source platform for leading experts and organisations interested in promoting the long-term health and sustainability of publicly listed corporations in the areas of policy-making and business management. The academic basis for the Project is provided by Dr. Jeroen Veldman and Prof. Hugh Willmott, who run the Modern Corporation Project[2] at Cass Business School, London. Between 2014 and 2016, the Project organised the Corporate Governance for a Changing World Roundtable Series to identify the outcomes that corporate governance should deliver and working back from there, design corporate governance which is fit for the challenges of the 21st century.

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Executive Summary

The purpose of this paper is to explore ways to enhance director duties and corporate governance by explicitly incorporating sustainability factors into those duties and focusing directors' attentions on the long-term.

This paper comes as a direct response to the recommendations set out in of the EU High Level Expert Group on Sustainable Finance's paper 'Financing a sustainable European economy' (the HLEG Paper), and the European Commission's Action Plan: Financing Sustainable Growth (Action Plan).[1]

In the context of conflicting public policy rhetoric that promotes both shareholder primacy and corporate social responsibility, we consider how directors' duties could be clarified at an EU level to contribute to the objectives of the European Commission's Action Plan to transform Europe's economy into a sustainable system, to manage financial risks stemming from environmental and social issues, and foster transparency and long-termism in financial and economic activity. We also discuss wider aspects of corporate reform that are relevant to these aims.

This paper is divided into three substantive sections, each addressing different aspects of the relationship between directors' duties and sustainability.

In the first substantive section (Section B), the paper considers the duty to act in and promote the interests of the company and recommends that the EU and its member states clarify in law and in the accompanying guidance that:

1. **The primary beneficiary of directors' duties is the company (rather than shareholders or other stakeholders).** Directors' duties are, in all jurisdictions, owed to the company, rather than to its shareholders or any other third parties. This point is often lost when language is used loosely. Whilst shareholders may, by virtue of their rights in relation to the company, benefit from directors discharging their duties to the company, they are not themselves the beneficiaries of the duties, and can only exceptionally enforce them on behalf of the company. Therefore, we recommend that the legislation should clarify that the company, as a legal entity, rather than shareholders or other stakeholders, is the beneficiary of directors' duties, and has exclusive right to enforce them. Guidance should make clear that the company's activities impact a wide range of stakeholders (including shareholders) and societal interests (such as the environment). Directors' duties will indirectly benefit these stakeholders and interests in varying degrees at different times, but none of them should take precedence over the interests of the company, which is the touchstone of directors' duties.

2. **The primary interest of the company is to survive in the long-term in order to achieve the purpose for which it was incorporated, taking into consideration the economic, social and environmental issues to which its activities give rise. Shareholder value should not be prioritized over such considerations and directors do not have a duty in any jurisdiction to maximise shareholder value. Instead, directors should give parity to all material stakeholders and issues that are important for the long term health of the company.** The long-term interests of the company are expressly referred to in a number of jurisdictions, but the interpretation of those interests is often confused by assumptions about shareholder primacy. On the other hand, attempts to broaden the interests of the company to take account of interests beyond those of the shareholders have generally failed to provide sufficient clarity. Efforts to describe the drivers of long-term corporate success are more likely to be fruitful. Clarifying that a company's interest is to sustain itself for its own benefit (rather than, for example, the benefit of shareholders), and that this requires embracing sustainability issues critical to the business of the company, will also further assist in implementing Recommendation 1 above.

In the paper's second substantive section (Section C), it considers how directors' duties could be developed to promote the long-term success of the company whilst minimising social and environmental impacts. It recommends the introduction of new directors' duties with respect to two aspects of sustainability:

3. **A duty to identify and mitigate long-term economic, social and environmental risks to the company's interests.** In order to act in the interests of the company, directors are expected to consider and identify the long-term risks to a company's interests and to take steps to mitigate them. In practice, this analysis is often limited to short-term financial risks. Therefore

it is desirable for the law to more explicitly require directors to identify and mitigate all of the economic, social, and environmental factors that materially affect the long-term prospects of a company and the attainment of its specific social objectives. This analysis and mitigation should be published in a suitable integrated reporting format. The legislation (and/or the legislative guidance) should specify salient material risks for key industries to ensure that an appropriate baseline has been established and these material risks should be aligned with the sustainability taxonomy being developed by the European Commission. Directors should be required, under the legislation, to identify additional material risks to the company, taking into account the specific nature of the company. The focus of the duty would be internal (i.e. risks to the company) rather than external (impacts on stakeholders). A more externally focused duty is considered in Recommendation 4 below.

4. **A duty to act within the planetary boundaries and social foundations, supported by a legal requirement for directors to carry out ongoing human rights and environmental due diligence in relation to a company's operations (including its supply chains) and to develop a strategy to mitigate any such impacts.** Recommendation 3 does not require directors to consider the impacts of the company on external resources if these impacts do not directly affect the longevity of the company or its unique social objectives. Such considerations will be necessary because directors may adopt a strategy of the company directly benefiting from its contribution to systemic risk in the short term, whilst seeking to avoid the impact on its own business in the longer-term. This approach does not support the European Commission's aim to develop a sustainable economic system. Climate change represents a typical example of this tragedy of the commons. Whilst it could be argued that these systemic issues will, at some point, impact on the longevity of the company (and so be addressed under Recommendation 3), the risk may be too remote to calculate as material at this particular point in time. To address this problem, directors should be required to operate the company in a way that does not collide with planetary boundaries or undermine social foundations. This legislation should define planetary boundaries and social foundations to the maximum extent possible, as well as the appropriate due diligence requirements, but directors should be legally obligated to more specifically develop this in the context of the company's specific business model. Further work will need to be done to ascertain key performance indicators in respect of each of the planetary boundaries and social foundations, so that companies can report against a consistent baseline for the purposes of comparison and objectivity. Pressure from investors and civil society (assisted by reporting initiatives such as climate-related financial disclosures) alone is not sufficient: this issue should be raised to the level of directors' duties.

We also recommend that a duty of the company (rather than the directors) be introduced, which requires the company to identify, prevent and mitigate human rights violations and significant environmental harm.

Recommendations 1 to 4 would improve the position of shareholders concerned with sustainability who could bring a derivative action on behalf of the company (because they would have wider grounds on which to do so). However, the shareholders bringing the action would still have to prove that as a result of directors' negligence or malintention the company suffered financial harm or that the directors endangered the company's unique social mission, if it had one.

Given that there are many adverse environmental or social impacts that do not in themselves cause a company measurable financial damage (for example, systemic violations of core workers' rights in a company's supply chain are only likely to do so if they become known to the public and cause reputational damage), this may not always be helpful. To improve the effectiveness of the suggestions above, we recommend that as part of a larger company law reform project, a duty should be imposed on companies to identify, prevent, and mitigate human rights violations and significant environmental harm, and that such duty be owed by the company to the public, and particularly those who suffer such harm. This recommendation is in line with recent legal developments in Europe, particularly in France which has introduced a legal requirement for companies to carry out such due diligence.

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Finally, in the paper's last substantive section (Section D), it considers what additional company law reforms may be needed in relation to commercial, for-profit companies that wish to expressly set out a specific social purpose to ensure that the implementation of such social purpose is robust. It recommends that:

5. **It is affirmed that companies can adopt a social purpose that either expressly takes precedence over their commercial purpose, or is to be balanced with that commercial purpose by the directors at their discretion.** The European Commission's Reflection Group on the Future of EU Company Law has previously suggested that regulation could be introduced to allow companies to amend their articles of association to include a social purpose. Given that companies in the majority of European jurisdictions are already free to do this, such new legislation may cause confusion, with companies potentially assuming that an explicit social purpose is exceptional, and that most commercial companies would not consider this. Therefore, we recommend that the European Commission instead affirms that there is nothing in company law that prevents companies from adopting a social purpose that takes precedence over, or is balanced with, a company's commercial purpose. Going further, the Commission should encourage all companies to adopt a social purpose and give preferential status in law to companies that do so (see Recommendation 6).

6. **A regulation of social purpose "status" for companies be considered.** It is desirable to ensure that any expression of a company's specific social purpose has legal force in order to guarantee to investors, consumers, employees or other stakeholders who become involved with such companies that the governance of that company is substantially oriented towards their social purpose, rather than only paying lip service to it. There is also a need to ensure that this legal framework does not absolve other companies from having to adopt a long-term focus which takes into account the social and environmental impact of their operations. We therefore recommend that the European Commission considers developing a specific 'status' for mission-led companies that declare a social purpose, irrespective of their legal form (and whether they be small social enterprises, or large publicly traded companies), provided that they meet certain criteria which will ensure their accountability for actively seeking to achieve such purpose. This criteria could include, for example, the expression of a social purpose in the articles of association, the establishment of an impact committee to monitor compliance with the company's purpose, external verification, and transparent reporting.

Finally, it is worth emphasising that the effectiveness of directors' duties clearly depends on their alignment with other essential elements of corporate governance which influence directors' decision making. Therefore, any clarification of directors' duties needs to be part of a comprehensive revision of the framework for corporate governance and sustainable finance. Analysis and recommendations for these wider revisions have been set out separately in the report 'Corporate Governance for a Changing World'.[2]

Section A

Introduction

Objective

The purpose of this paper is to respond to one particular aspect of the EU High Level Expert Group on Sustainable Finance's paper 'Financing a sustainable European economy' (the HLEG Paper)[3], which recommended that the European Commission "explore ways to enhance director duties and corporate governance by explicitly incorporating sustainability". This recommendation was further developed in the European Commission's Action Plan: Financing Sustainable Growth (Action Plan)[4] where it was noted that "rules relating to how directors can act in the company's long-term interest may need to be clarified". [5]

In this paper, we consider how directors' duties could be clarified at an EU level to contribute to the objectives of the Action Plan to help to transform Europe's economy into a sustainable system, to manage financial risks stemming from environmental and social issues, and to foster transparency and long-termism in financial and economic activities.

To do so, we analyse examples from EU member states and other jurisdictions, and the questions that might need to be considered in order to apply these to an EU-wide context. In particular, we examine the overarching directors' duty of promoting the company's interests (closely linked to the company's purpose), as well as additional duties that have been, or could be, developed to respond to long-term sustainability concerns.

Conflict in public policy between shareholder primacy and corporate social responsibility

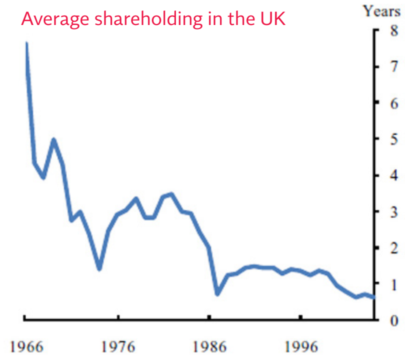
Before starting this analysis, it is worth observing two conflicting trends that contextualise the need to reform directors' duties.

On the one hand, there is increasing public awareness of the importance of 'corporate social responsibility'. Companies are encouraged through investor engagement, campaigns and media to pay attention to systemic and long-term governance issues, such as human rights and the environment. This approach has been enshrined in a range of soft and hard law legislation and codes, at an international level (including the United Nations Guiding Principles on Business and Human Rights[6] and the OECD Guidelines for Multinational Enterprises[7]) and at national levels (including the Modern Slavery Act 2015 in the UK[8] and the Devoir de Vigilance legislation in France[9]), which have all helped to develop a more critical and substantial definition of 'corporate social responsibility', beyond that of voluntary corporate initiatives that are irrelevant to a company's core business[10]. Notably, however, we see that a number of the most substantive initiatives are soft-law, rather than hard-law, suggesting that the law has not yet caught up with social expectations.

On the other hand, there is an increasing shift towards adopting a shareholder primacy narrative in corporate governance (including in the G20/OECD Principles of Corporate Governance[11] and the EU Shareholder Rights Directive[12]), in which shareholders' interests eclipse those of other stakeholders who would be affected, for example, by a company's position in relation to human rights and the environment. Interestingly, this trend can also be observed in jurisdictions where a more pluralist approach is provided for in the legislation, suggesting that either the law is not well enough understood or not effectively implemented.[13] Shareholder primacy is not therefore necessarily rooted in law, but is instead arguably a cultural phenomenon.[14]

This issue is complicated by the proliferation of short termism in capital markets. With the average length of shareholding in the UK having dropped from six years in the 1950s to six months in 2015,[15] orientating a company's interests around shareholders (unless there is a single shareholder with a committed long-term focus) inevitably leads to a short-term focus, exposing a company to long-term systemic risks and declining innovation, and rendering it unable to substantively deliver any other purpose than maximising shareholder value.[16]

Average shareholding in the UK



As a consequence, we see increasing reliance on shareholders (particularly those with longer-term investment horizons such as such as pension funds and sovereign wealth funds) to encourage the integration of sustainability and long-termism in companies' strategies through investor engagement. There are several hurdles to cross if investors are to effectively fulfil this role: they have to have capacity to effectively engage with all their investee companies; they must be able or willing to accept lower financial returns on investment in the short-term; and their influence must outweigh investors with short-term goals.[17] An additional problem of this strategy is that it encourages companies to focus primarily on those areas of concern that are highlighted by the particular shareholders that are engaging with them -whose interests may or may not be aligned with the interests of the company-[18], rather than by a broad spectrum of stakeholders.

Clarifying directors' duties and the purpose of the corporation as a way of resolving this conflict

Whilst there have been attempts to reconcile these two trends (for example in the EU Non-Financial Reporting Directive[19] or the South African King IV Report on Corporate Governance[20]), they have the potential to be pitted against each other in a recent proposal from the European Union for the establishment of a 'Capital Markets Union'.[21] The proposal envisages small and medium sized enterprises trading their shares on capital markets, thus exposing them to short-term motivations, but it simultaneously seeks to "promote truly sustainable development from an economic, social and environmental perspective," with an openly long-term approach.[22]

In order for the Capital Markets Union, the Action Plan and recent proposals in France (the 'French Government Action Plan for the Growth and Transformation of Enterprises', which we refer to in this paper as the French Government Action Plan)[23] to reach the objective of promoting long-termism and sustainability, this conflict will need to be addressed. One tool for doing so will be the reform of directors' duties to provide clarity and consistency across jurisdictions in the EU.

Surya Deva[24] has noted that reforming directors' duties plays a role in removing the "...pressures that company law creates on corporate managers to pursue the goal of profit maximisation with total disregard for the interests of stakeholders other than shareholders."[25] He has suggested that there are, in company law, four models for obtaining long-term value for companies:

→ through directors' duties (as in the UK and Australia);

→ through amending a company's purpose (as in China and South Africa);

→ through stakeholder involvement on the board (as in India, South Africa and a number of European countries);

→ and through reporting and disclosure (as pursued in the UK through the 'Strategic Report' and at an EU level, with the recent Non-Financial Reporting Directive)[26].

Deva argues that a combination of these models within one jurisdiction may be most effective. In our view, clarifying a company's purpose, and its relationship with the interests of its stakeholders (one of which will be its shareholders), is central to any reform of directors duties, as across jurisdictions there is an 'overarching' duty to promote the interests of the company.[27]

Clarifying this duty at an EU level will be essential in order to prevent companies from practising jurisdictional arbitrage,[28] and to remove the pressure, and possible competitive and financial consequences, from any one country that might otherwise decide to do so.[29] In addition to providing better protection to directors, an explicit integration of sustainability factors in directors' duties would improve the environment for investor engagement on a clear basis as well as increasing the accountability of directors to properly consider environmental and social issues.

This paper thus focuses its analysis on reforming directors' duties and clarifying companies' purposes. It does not consider in detail the other two models referred to by Deva (i.e. stakeholder involvement on the board or reporting and disclosure), although we acknowledge that these are essential to consider if reform is imminent.

The relevance of directors' duties

The directors of a company are those responsible for implementing the company's strategy, overseeing its operations, and accounting for its performance. There is an expectation that such directors have a range of expertise appropriate to their role on the board, including a strong understanding of the sector in which their business operates, the management of a company and, increasingly, how a company interacts with the society it operates within, both now and in the future.

Directors' duties define the parameters of how the directors go about these tasks and exercise their expertise. The way that such duties are defined determines how the directors are accountable (i.e. what requirements there are for the directors to report on the performance of their duties) and who the directors are accountable to (i.e. who the duties are owed to and can be enforced by).

Appropriately defining such duties is therefore instrumental in clarifying for a director what she is accountable for, and how she is to carry out her role, including what factors she is to take into account in doing so, and who she is accountable to in the process. Such parameters are often inwardly focused on the governance of the company of which the individual is a director. The Guidelines for Directors issued by the Hong Kong Institute of Directors, for example, explain that "[companies] can hold property but need someone to look after it for them. They have requirements imposed on them by statute and therefore need properly designated officers upon whom a duty to ensure their compliance can be imposed and they need persons to represent their mind and will."[30] However, such parameters also determine the interaction of a company outwards, with society, including factors such as the environment and human rights, as the concept of 'enlightened shareholder value' in the UK suggests (albeit to a limited extent as we will explain below). Appropriately defining directors' duties is therefore critical to ensuring that the internal governance of a company is appropriate for the use and protection of external resources, and consequently for the protection of the company against long-term systemic risks.[31]

Areas outside the scope of this paper

The subject of directors duties is very broad, with the potential to link to a number of other areas of law. As explained above, we focus on the overarching duties of directors to promote the interests of the company, and additional, specific duties that could be introduced to promote long-term sustainability. To consider this in significant detail, this paper does not consider other duties that already exist but that are not expressly relevant to long-termism, such as conflicts of interests.

The paper considers the duties as they are applicable in a solvent situation, but acknowledges the role that insolvency plays in disrupting the position, in some jurisdictions, as to who benefits from the company's interests.

Similarly, as the focus of this paper is on directors' duties themselves, rather than the structure of the board more generally, this paper does not consider how directors' duties would vary, if at all, across one and two tier board structures or what role each of those plays in implementing and taking responsibility for the duties. It also does not consider in any detail the range of expertise that could or should be required of directors in order to fulfil their duties, such as carbon management, resource efficiency or human rights. Whilst these matters are all highly relevant to promoting long-term sustainability and should be considered alongside any reform of directors duties, this paper takes a more focused approach on the legal structure of the duties themselves and what form they could take.

Finally, it is important to note that the effectiveness of directors' duties depends on their alignment with other essential elements of corporate governance which influence directors' decision making. Therefore clarification of directors' duties needs to be considered as part of a comprehensive revision of the framework for corporate governance and sustainable finance, which includes: embedding and protecting the purpose of the corporation; reforming investors' fiduciary duties; implementing sustainability and integrated reporting and accounting standards; effective functioning of the board; aligning incentive structures for directors with a long-term perspective; meaningful engagement of stakeholders in corporate governance; and encouraging and empowering long-term and sustainable investment. Analysis of these issues, and detailed recommendations, is available separately in the Corporate Governance for a Changing World report.[32]

Overview

In the first substantive section (Section B), this paper considers the duty to act in the interests of the company. In particular, it considers who directors' duties are owed to and who benefits from them (which is relevant to all of the duties we consider in this paper), and what the interests of the company are.

In the second substantive section (Section C), it considers what other duties could be adopted to more effectively promote the success of the company in the long-term and to protect society's interests, paying particular attention to specific sustainability concerns.

In the final section before concluding (Section D), the paper considers other reforms in company law in relation to the social purpose of the company that could be introduced, or considered, as part of wider company law reform to promote long-term sustainability.

Section B

Clarifying the duty to act in and promote the interests of the company

Introduction

In jurisdictions where specific duties are imposed on directors, it has been acknowledged that a 'core' duty is to promote and protect the interests of the company, which is often expressed as a duty of care or duty of loyalty.[33] Whilst this approach is reasonably consistent, the interpretation of the term 'interests of the company' is not. This inconsistency is linked to confusion over: (i) who the primary beneficiary of the duty is; and ii) what the interests of the company are considered to be.

We consider each of these issues in turn below, including some proposals for how the ambiguity could be dealt with, and some questions that will need to be considered before reforming this aspect of directors' duties in order to promote long-termism and sustainability.

i) Who are directors' duties owed to?

Directors' duties are, in all jurisdictions, owed to the company, rather than its shareholders or any other third parties.[34] This point is, however, often lost when language is used loosely. Whilst shareholders may by virtue of their rights in relation to the company, benefit from directors discharging their duties to the company, they are not themselves the beneficiaries of the duties, and can only exceptionally enforce them on behalf of the company.

Some jurisdictions, however, suggest that directors' duties are, at least in part, owed to, or for the benefit of, shareholders or, less frequently, other stakeholders.

In the UK, duties are owed to the company but it is shareholders who are expressly stated to benefit from the company's interests, as a director is required "to 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."[35] As a result, it is not uncommon in the UK for it to be argued that directors' duties are owed to the shareholders, although it has been clarified by the courts that this is not generally the case.[36]

Interestingly, having acknowledged concerns about how a company is to take into account the effects it has on other stakeholders, the UK has adopted an 'enlightened shareholder value' approach (as set out in section 172 Companies Act 2006). This approach requires a director, when taking any decision, to have regard to: the interests of the company's employees; the need to foster the company's business relationships; and the impact of the company's operations on the community and the environment.[37]

This approach is seen by some as positive for having promoted long-termism and for its requirement that directors consider other stakeholders. However, it has been criticised by others for: not giving stakeholders sufficient voice;[38] not sufficiently promoting human rights;[39] and for giving directors "unfettered discretion"[40] to determine the extent to which they consider the other 'non-financial' factors set out in the sub-sections to section 172. Perhaps most notably, the interests of the stakeholders are subordinate to those of the company's shareholders meaning that stakeholder interests will only be acted upon where there is a shareholder case for doing so.[41] This is problematic because, as the HLEG has identified, whereas stakeholder interests may materialise in the longer-term, shareholder interests are generally more focused on the short-term.[42] The arrangement of section 172 thus provides confusing if not counterproductive guidance to directors of companies as to how to take account of sustainability, with the effect that, in practice, the UK's legislative shift towards enlightened shareholder value has arguably done little to change the existing focus on shareholder primacy.[43]

In India, this approach has been varied to require directors to act 'in the best interests of the company, its employees, shareholders, the community and for the protection of the environment'.[44] This is particularly relevant as the provision is otherwise based on section 172 of the Companies Act 2006 in the UK, but amended to promote the interests of third parties outside of an 'enlightened shareholder value' model. Although this example seems to offer benefits (if not least by equalising the interests of shareholders with those of other stakeholders), its implementation has led to a much more conservative interpretation, to the extent that it is reportedly deployed in the same way as the enlightened shareholder value approach that we see in the UK.[45]

Another example of this approach is the Netherlands, where directors are to act in the best interests of the company *and its enterprise*, which includes all relevant stakeholders.[46] The Dutch Supreme Court has also confirmed that shareholder interests "do not take priority over the interests of other stakeholders." The newly revised Dutch Corporate Governance Code also requires that the management board pays attention to 'the environment, social and employee-related matters, the chain within which the enterprise operates, respect for human rights, and fighting corruption and bribery.'[47] However, the Code does not provide the additional guidance and clarification that is needed in order to ensure that this approach can be effectively adopted.

These examples show both the difficulties of defining directors' duties as being owed to anyone other than the company, and also why appropriate consultation prior to reform, and effective guidance to complement legislation, is essential, particularly where sufficiently clear definitions are not otherwise provided and the temptation is to revert to the status quo of shareholder primacy.

In other jurisdictions, the duty to protect the company's interests is more clearly expressed as being owed to the company (rather than to stakeholders, as in India or the Netherlands, or by being qualified by reference to the impact on shareholders, as in the UK), but without clear guidance as to how this is to be implemented.

The core of the Czech directors' duty of care, for example, is to act in the "justifiable interest" of the company. According to the Czech Supreme Court, this means that the directors must 'take care of a company's property as if it was his own property'.[48] The law does not conflate the interest of the company with profit, nor does it require directors to pursue environmental or social objectives. Whilst some experts are of the view that the corporation must still respect the social and environmental circumstances related to its business and take into account corporate social and environmental responsibility. There is no indication that the practice of Czech directors is significantly different from other jurisdictions where this approach is not applied.

From the above it is clear that recent legislative interpretations of directors' duties (often in order to promote sustainability) have caused confusion as to whom they are owed and have, generally, failed to disrupt the prevailing strength of shareholder primacy and foster focus on sustainability.

The King IV Report in South Africa[49] has, however, more successfully made the distinction between who the duties are owed to and who benefits from them: "directors owe their duties to the company and the company alone as the company is a separate legal entity from the moment it is registered until it is deregistered. The company is represented by several interests and these include the interests of shareholders, employees, consumers, the community and the environment. Thus, requiring directors to act in good faith in the interest of 'the company' cannot nowadays mean anything other than a blend of all these interests, but first and foremost they must act in the best interest of the company as a separate legal entity. Any interest that may be primary at one particular point in time in the company's existence may well become secondary at a later stage."[50]

A similar approach is now also being considered in France, where the French Government Action Plan has suggested the Civil Code be amended "to affirm the need for companies to take into consideration social and environmental issues inherent to their activity". In doing so, the French Government Action Plan refers to the report 'L'entreprise, objet d'intérêt collectif', which was commissioned by four ministers of the government,[51] and specified that the Civil Code should state that the "the Company must be managed in its own interest, considering the social and environmental issues of its activity."[52]

On the face of it, this formulation may seem similar to the duty in the UK, given that it takes into account the perspectives of various stakeholders. However, the crucial difference is that this proposed French duty is not expressed to be 'for the benefit of' the company's shareholders, thus ensuring that the company's long-term interests can be prioritised, when they differ from those of the shareholders.

RECOMMENDATION 1:

Given the level of confusion about who directors' duties are owed to, we would recommend that it be clarified in legislation, taking the South African explanation as an example, that the company, as a legal entity, rather than shareholders or other stakeholders, is the beneficiary of directors' duties. Guidance should make clear that the company's activities impact a wide range of stakeholders (including shareholders) and societal interests (such as the environment). Directors' duties will indirectly benefit these stakeholders and interests in varying degrees at different times, but none of them should take precedence over the interests of the company, which is the touchstone of directors' duties.

ii) What are the 'interests' of the company?

Once it is clear that the duties are owed to the company and that its interests take precedence over the interests of its shareholders (or any other stakeholders) if they are in conflict, it should be made clear what the company's interests are. This will clarify how such duties are to be performed.

As a company is a legal person governed by its own constitution, its primary interest is to survive in the long-term, in order that it can achieve the purpose for which it has been incorporated (whatever that purpose may be). The long-term interests of the company are expressly referred to in a number of jurisdictions, but the interpretation is often confused by assumptions about shareholder primacy.

In the UK, for example, (where directors are to discharge their duties in the interests of the company, for the benefit of its members), directors are to "have regard to…the consequences of any decision in the long-term".[53] In Hong Kong, the reference to long-termism is more implicit by reference to the interests of "present and future shareholders,"[54] which the Hong Kong Institute of Directors has noted means "the directors may therefore legitimately balance a long-term view against short-term interests of present members."[55]

However, the link between long-termism and shareholder value is flawed and inadequate, as shareholders may not always be best served by long-term thinking, and shareholders are only one of the stakeholders that are relevant to a company's operations and its continued success.

Efforts to broaden the interests of the company outside of a shareholder model have generally failed to provide sufficient clarity. The newly revised Dutch Corporate Governance Code, for example, requires that the management board 'develop a view on long-term value creation by the company.'[56] However, what exactly is meant by 'value' or 'value creation' (and particularly, who it is to benefit) is unclear, and there is a risk this therefore gets interpreted in line with shareholder value. In Brazil, a director must achieve "the company's corporate purposes and…support its best interests, satisfying the requirements of the public at large and the social role of the company."[57] Whilst academics have defined the 'social role' by reference to labour conditions, consumer interests, competitors' interests and environmental preservation,[58] there is no sufficient legislative certainty as to what this entails.

More helpful, are efforts to describe the drivers of long-term corporate success. The King IV Report in South Africa, for example, refers to the 'triple context' of economy, society and environment and "advocates a stakeholder-inclusive approach, in which the governing body takes account of the legitimate and reasonable needs, interests and expectations of all material stakeholders in the execution of its duties in the best interests of the organisation over time. By following this approach, instead of prioritising the interests of the providers of financial capital, the governing

body gives parity to all sources of value creation including, among others, social and relationship capital as embodied by stakeholders."[59]

Clarifying that a company's interest is to sustain itself for its own benefit (rather than, for example, the benefit of shareholders) will also assist in clarifying that directors' duties are owed to -and enforced by- the company (rather than to the shareholders or other stakeholders).

This clarity, alongside an explicit requirement to consider the relevance of social and environmental issues for a company's future, will draw directors' focus to factors that affect the long-term health of the company, which will include consideration of a wide range of stakeholders.[60]

RECOMMENDATION 2:

We therefore recommend that it be clarified that the primary interest of the company is to survive in the long-term, in order to achieve the purpose for which it was incorporated, taking into consideration the economic, social and environmental issues to which its activities give rise. It should also be confirmed that shareholder value should not be prioritized over such considerations and directors do not have a duty in any jurisdiction to maximise shareholder value. Instead, directors should give parity to all material stakeholders and issues that are important for the long term health of the company.

Section C

Developing directors’ duties to promote the long-term success of the company whilst minimising social and environmental impacts

Introduction

Establishing that directors' duties are owed to the company, that the directors are to act in the interests of the company, and that these interests are best understood as sustaining the company over the long term (which requires taking into account all material stakeholders equally), serves the twin purpose of channelling directors' attention to long-term issues and helping to protect them from the pressure to maximise short-term financial performance.

Nonetheless, directors' responsibilities may be further developed to address particular sustainability concerns and promote more long-term thinking. This is especially the case given that some societal and stakeholder interests may require additional protection in directors' duties, because they are elusive to corporate self-interest, even if it is properly understood. This is typically the case for sustainability concerns where the related cost is externalized, such as human rights and environmental impacts that materialize in supply chains. One solution for this is to make explicit the requirement to analyse and address factors that materially affect a company's future. Another solution is to introduce certain public duties to a company that are to be given effect through directors' duties.

Below we present some of the options for developing directors' duties along these lines.

a) A duty to identify and mitigate long-term economic, social and environmental risks to the company's interests

In order to act in the best interests of the company, directors should be expected to consider and identify the long-term risks to a company's interests and to take steps to mitigate them. Specifically, directors should have an explicit duty to identify and mitigate all of the economic, social, and environmental factors that materially affect the long-term life of a company and the attainment of any specific social objectives (which may, for example, be enshrined in its articles of association or by-laws). The focus of the duty would be internal (e.g. risks to the company) rather than external (i.e. impacts on stakeholders). A more externally focused duty is considered as Recommendation 4 below.

In order to encourage considerations of long-term impacts, the basis for assessing 'materiality' will need to be clearly dissociated from a purely shareholder value perspective, which is often the focus of materiality assessments at present.[61] Furthermore, the material factors should not just focus on the company's financial success (which could be exponential in the short term but crash in the longer-term), but should also take into account all of the resources that a company requires in order to survive, and how the company applies such resources to ensure that they also continue to thrive in the long-term.

This may require certain risks to be defined in legislation as being 'material' for specific industries (so as to ensure that an appropriate baseline has been established), taking into account the European Commission's work on developing a sustainability taxonomy for the purpose of sustainable finance.[62] Article 173 of Grenelle II Law 2010, for example, confirms that climate change is a material risk for companies and requires them to report on climate change's impact on the business, and what the company is doing to mitigate such effects.[63] Some companies do this through scenario modelling, for example, by reference to the International Energy Agency's climate change scenarios, but care should be taken to ensure that such modelling takes into account a full range of factors on an objective basis, rather than being applied selectively. Some risks would have to be further defined by the board of directors, taking into account the specific nature of the company and following consultation with stakeholders, where relevant.

To evidence the performance of this duty, the law could require directors to produce a statement of material issues that are most likely to affect the longevity of the company (and the attainment of any specific social values it has declared), including systemic risks,[64] and to set out a sustainability strategy to address how to manage those material issues.[65] The statement and strategy could be explicitly connected to a company's annual reporting obligations and form a bridge between strategic reporting and the current requirement to include a non-financial statement in the annual report. In this respect, this reform may be used as a stepping stone towards integrated governance. Further, if a particular company sets out a specific social or environmental purpose, its directors could be required to explain in their statement how they are fulfilling this purpose on an annual basis, to ensure that the directors can be held to account by investors in respect of this purpose. Effective implementation of this proposal requires careful guidance to assist directors in:

- → ascertaining what is 'material' beyond its narrowest sense of financial impact on short-term interests of shareholders;
- → identifying what sustainability concerns they may be expected to consider in respect of those material issues;
- → understanding what analysis they should produce in terms of connecting those concerns with a company's business plan and performance, to mitigate their impact and promote long-term success.

Such guidance would also need to consider how an appropriate assessment of materiality would take into account different factors for different companies, considering their size and sector, for example.[66] In addition, legislation or guidance should set out the period over which risk modelling should be undertaken; whilst currently, the majority of assessments appear to consider a five year period,[67] a far longer period should be considered in order to accurately assess a company's long-term prospects and impacts.

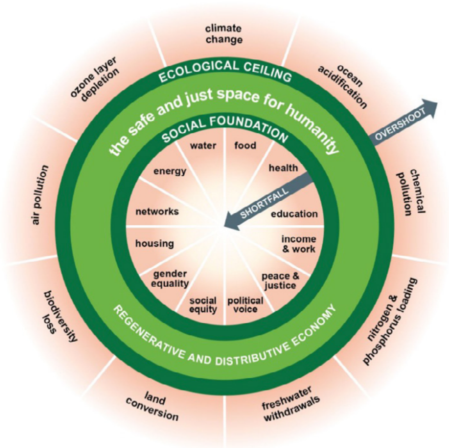
RECOMMENDATION 3:

We recommend that directors are explicitly required to identify and mitigate all of the economic, social, and environmental risks to the company's interests and the attainment of its specific social goals. We recommend that this analysis and mitigation should be reported on in a suitable integrated reporting format. We also recommend that the legislation specifies salient material risks for key industries.

b) A duty to act within the planetary boundaries and social foundations, including by requiring directors to carry out ongoing human rights and environmental due diligence

Recommendation 3 will clarify the obligation of directors to consider *risks* to the longevity of the company. It does not however require directors to consider the *impacts* of the company on external resources if these impacts do not directly affect the longevity of the company or its unique social objectives. Such considerations will be necessary because directors may adopt a strategy of the company which directly benefit from contributing to systemic risk in the short term, whilst seeking to avoid the impact on its own business in the longer-term. Climate change represents a typical example of this tragedy of the commons; a company may profit from a strategy that contributes to climate change (for example, an oil and gas producer) and yet avoid the adverse financial impacts in the end if it is nimble enough to change course at the right time (for example, by diversifying into other revenue streams, such as renewable energy).

Similarly, at present, directors may conclude after assessing the materiality of risks such as supply chain disruption and reputational damage, that it is in their company's best interests to tolerate participants in their supply chain committing serious environmental or social harm with potentially systemic impacts, such as depleting fish stock, massive deforestation, degradation of soil, or labour exploitation or financing conflicts. Whilst it could be argued that these systemic issues will, at some point, impact on the longevity of the company (and so be dealt with under Recommendation 3), the risk may be too remote to calculate as material to the longevity of the company, at a particular point in time.



To address this problem, directors could be required to operate within specific social and environmental parameters that prevent the company from contributing to systemic impacts.[68] One formulation of this idea is for companies to be managed in a way that enables the economy to "meet…the needs of all within the means of the planet." Under this concept, the 'needs of all' are referred to as 'social foundations'[69] which we could consider to include, at a minimum, human rights, whilst the means of the planet[70] (referred to as 'planetary boundaries') are various scientifically determined factors, including climate change.[71] This would therefore require directors to operate the company in a way that does not collide with planetary boundaries or undermine social foundations.

This new duty would provide directors with a powerful defence against the pressure to exploit short-term strategies with adverse impacts on sustainability, whilst empowering sustainable investors. A good example of this is that oil producers may stand to benefit from climate change, if due to the Arctic ice melting, new areas for oil exploration open up. A number of companies already seem to be taking advantage of this 'opportunity'.[72] A directors' duty that requires planetary boundaries to be considered would require directors not to focus only on whether this opportunity was for the benefit of the company financially (and, ironically in this case, over the longer term) but also to consider whether exploitation of such an opportunity would be within the planetary boundaries.

Some jurisdictions are already trying to impose some sense of this on their companies. In China, for example, Article 5 of the Companies Law of the People's Republic of China states: "In its operational activities, a company shall abide by laws and administrative regulations, *observe social morals* and commercial ethics, *persist in honesty and good faith*, accept supervision by the government and the public, and *assume social responsibility*" (emphasis added).[73] The extent to which this requirement is adhered to in practice is questionable however. More recently, "*L'entreprise, objet d'intérêt collectif*" report in France, which provides background to the French Government Action Plan, has suggested that "the firm shall be managed in its own interest, taking into account the social and environmental consequences of its objective."[74] However, as we saw when we considered different permutations of a company's interests in Section B, broad concepts such as this must be supported by clear metrics and key performance indicators, to ensure that they are specific and practical. The definition of, and science behind, 'planetary boundaries', and the clarity of international human rights (including labour rights) and humanitarian law, which define social foundations, provide a more rigorous, and consistent, framework for integrating social focus within directors' duties. Structuring this requirement as a directors' duty rather than an extension of the company's interests, acknowledges that, due to externalisation, a company's interests may not always adequately take into account that company's contribution to systemic impacts which are therefore best dealt with separately.

The proposed duty could require directors to identify where the business of the company sits in relation to the planetary boundaries and social foundations and to adopt appropriate strategies to maintain the business within that realm. Whilst legislation should define planetary boundaries and social foundations to the maximum extent possible (including, where relevant, by reference to international human rights and environmental law, and other standards and objectives, including the Sustainable Development Goals set by the United Nations), this legal mandate could be further extended by requiring the boards of companies to identify specific boundaries that are particularly relevant to the company's business model. Further work will need to be done to ascertain key performance indicators in respect of each of the planetary boundaries and social foundations, so that companies can report against a consistent baseline for the purposes of comparison and objectivity. More thought will also need to be given to the fair allocation of resources and burden across companies, or sectors, in respect of each planetary boundary,[75] as some will be more material to particular companies than others (for example, nitrogen and phosphorous loading will be particularly relevant to companies operating in the food sector, whilst aerosol loading is likely to be relevant to companies operating large supply chains).[76]

To facilitate directors' compliance with this duty, directors could also be required to carry out (and act on) human rights and environmental due diligence to ascertain whether their companies are causing or contributing to human rights violations and environmental harm by their own operations or their supply chains. This will enable them to identify where a social foundation is at risk of not being met, or a planetary boundary is at risk of being breached. Where due diligence identifies risks, the directors should be required to develop a strategy to mitigate them (and such strategy should be reported on in an integrated format, as per Recommendation 3).

There are already precedents for this approach. International standards such as the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises already require companies, in a soft-law context, to address risks that are connected to company by its business relationships, and relevant definitions could be drawn from there. The EU Non-Financial Reporting Directive also requires large listed companies and financial corporations to disclose their analysis of risks of severe impacts. The Swiss government has also released a report on the legal obligations of company directors to conduct due diligence with regard to business activities abroad, including a proposal to introduce a specific directors' duty to exercise human rights due diligence.[77] Pressure from investors and civil society (assisted by reporting initiatives in relation to climate-related financial disclosures) alone is not sufficient: this issue should be raised to the level of directors' duties and legislated for.

RECOMMENDATION 4:

We therefore recommend that directors are required to operate companies within planetary boundaries and social foundations, which legislation should define to the maximum extent possible and which should be further and more specifically identified by directors in the context of the company's specific business model. We also recommend, to facilitate compliance with this duty, that directors are expressly required to carry out ongoing human rights and environmental due diligence in relation to a company's operations (including its supply chains) and to then develop a strategy to mitigate any such impacts.

Introducing a duty of the company to conduct human rights and environmental due diligence

On its own, the various reforms proposed to directors duties would not create any new enforcement options, although they would improve the position of shareholders concerned with sustainability who could bring a derivative action on behalf of the company (because they would have wider grounds on which to do so).

However, the shareholders bringing the action would still have to prove that as a result of directors' negligence or malintention the company suffered financial harm or that the directors endangered the company's unique social mission, if it had one. Given that there are many adverse environmental or social impacts that do not in themselves cause a company measurable financial damage (for example, systemic violations of core workers' rights in a company's supply chain are only likely to do so if they become known to the public and cause reputational damage), this may not always be helpful.

However, the effectiveness of these reforms, specifically Recommendation 4, would be greatly improved if accompanied by the introduction of a duty of the company itself to identify, prevent, and mitigate such risks, and that this duty be owed to the public (including, primarily, those harmed by the materialisation of the risk).[78] The French duty of vigilance represents an example of this type of legislation. It requires certain large companies to establish means of preventing human rights violations and environmental damage in their supply chains (including their subsidiaries).

The company must report these means in an annual 'vigilance plan'. If a company does not comply, any concerned party can request a judge to compel the company to produce a plan. Furthermore, the law establishes that the author of any failure to comply with its due diligence duties shall be liable and obliged to compensate for the harm that due diligence would have enabled the company to avoid.[79] A similar proposal is currently under consideration in Switzerland, following a successful public initiative organised by the Responsible Business Initiative campaign.[80]

We would therefore also recommend that, as part of a larger corporate law reform project, a duty is imposed on companies to identify, prevent, and mitigate human rights violations and significant environmental harm, and that such duty be owed to the public, and primarily to those who suffer such harm.

Section D

Wider company law considerations in relation to the social purpose of the company

Introduction

If adopted together, the recommendations considered so far in this paper should go a long way to ensuring that all companies (not just those that incorporated as socially oriented companies) act in a manner that is sustainable, both for a company, and for society.

Some companies, however, may also choose to expressly identify a specific social purpose. Whilst this is welcomed, there is a need to ensure that these public declarations have legal force. This will ensure that investors, consumers, employees and other stakeholders who become involved with such companies on the basis of their declared social purpose, do so with some assurance that the governance of the companies is substantially oriented towards their social purpose, rather than only paying lip service to it. There is also a need to ensure that, even if the law provides a framework for companies that specify a social purpose, this does not absolve other companies from having to adopt a long-term focus which takes into account the social and environmental impact of their operations.

The suggestions below seek to address these concerns.

A. Clarifying that companies can have a social purpose

The European Commission has itself suggested that regulation could be introduced to allow companies to amend their articles of association to include a social purpose.[81] Given that companies in the majority of European jurisdictions are already arguably free to do this, this appears to be a misguided proposal. For example, the articles of association of Novo nordisk A/S, a Danish multinational pharmaceutical company, require the company "to conduct its activities in a financially, environmentally, and socially responsible way."[82]

On a larger scale, the B corporation certification requires companies to amend their articles of association to include a social purpose and integrate such purpose into their directors' duties which is similar to the approach suggested by proposal 11 of the French report 'L'entreprise, objet d'intérêt collectif' and supported by the French Government Action Plan. Triodos Bank N.V., a certified B corporation and the largest ethical bank in the world, for example, specifies its object in its articles of association as follows: "With the exercising of banking business, the company aims to contribute to social renewal, based on the principle that every human being should be able to develop in freedom, has equal rights and is responsible for the consequences of his economic actions for fellow human beings and for the earth. All in the widest sense of the word."[83] As of May 2018, there were over 2,500 certified B corporations around the world.

Introducing legislation to allow companies to amend their articles of association to include a social purpose, as proposed by the European Commission, is thus likely to cause confusion, with companies potentially assuming that an explicit social purpose is exceptional, and that most companies will not consider this.[84] Instead, the European Commission could simply affirm that companies are free to express a social purpose, if they wish to do so.

RECOMMENDATION 5:

We would therefore advise that the European Commission affirms that companies can adopt a social purpose that either expressly takes precedence over their commercial purpose, or is to be balanced with that commercial purpose by the directors in the exercise of their discretion.

B. Considering a social purpose 'status' for companies

It is advisable to ensure that any company's express reference to a social purpose has legal force in order to guarantee to investors, consumers, employees or other stakeholders who become involved with such companies that the governance of that company is suitably orientated towards their social purpose, rather than only paying lip service to it.

The recent French Government Action Plan suggests that instead of developing a special legal form for companies adopting a particular social or environmental purpose, a specific 'status' could be attained by a company of any legal form that sets out a specific social or environmental purpose (whether that be, for example, a company limited by guarantee or a public limited company), and that meets certain additional governance criteria to safeguard its performance in accordance with that purpose. The report 'L'entreprise, objet d'intérêt collectif' that lies behind this part of the French Government Action Plan suggested the following four criteria which may provide a starting point for the discussion:

→ clear expression of the socially beneficial purpose of the company in the company's articles of association;

→ the existence of an impact committee with adequate resources to consider the company's compliance with its socially beneficial purpose (and possibly composed of stakeholders);

→ third-party assessment of and public accountability by the company's governing bodies for respecting the social purpose expressed in the articles of association;

→ the publication of a non-financial statement, as required for large listed companies and financial corporations by the EU Non-Financial Reporting Directive.

To ensure that any such status is robust, the term "socially beneficial purpose" must be sufficiently defined in legislation, and companies must be able to justify how their purpose fits within that definition, to make clear to their stakeholders what the company's specific purpose is and whether it is adhering to it.

Similarly, the non-financial statement should be of a prescribed form, to ensure meaningful disclosure. There should also be adequate monitoring of a company's adherence to the criteria, to ensure that it is still entitled to retain the status. Finally, the framing of the purpose of the status will be important; it must be clear to companies that do not want to pursue the status, that this does not absolve them from performing to the fullest extent in accordance with the duties outlined in sections B and C of this paper. The purpose of developing the social purpose status is to ensure that companies that are declaring a social purpose are held to account for doing so, not to require only those companies to conduct their business in a socially and environmentally sustainable manner.

RECOMMENDATION 6:

We would therefore advise that the European Commission considers developing a specific 'status' for companies that declare a social purpose, to be awarded to companies that meet certain criteria which will ensure their accountability for actively seeking to achieve such purpose.

Conclusions

Moving towards a solution

There is currently significant public and political drive to increase companies' long-term success and sustainability. However, this is threatened by an entrenched perspective of directors' duties that promotes short-term shareholder value over the interests of the company, and over the impacts that the company may have on any other stakeholders.

This conflict needs to be addressed. This can be achieved in part by clarifying that directors' duties are owed to the company, rather than to any particular stakeholders (including shareholders), and further by clarifying that the primary interest of the company is to survive in the long-term, which requires giving parity to all material stakeholders and issues that are important for the long term health of the company, rather than to prioritise the promotion of shareholder value. These clarifications will not, however, be sufficient to ensure that companies operate sustainably, as they can avoid paying the costs of certain social and environmental externalities. In order to ensure that a company operates to reduce such impacts (regardless of whether they impact on a particular company's long-term success), specific additional duties relating to social and environmental factors should be introduced. Finally, consideration should be given to wider reforms of company law, to ensure that appropriate guidance and accountability frameworks are in place for companies to more clearly develop specific social purposes where they wish to do so.

To achieve the above, we have recommended that:

1. **It should be clarified in legislation, that the company, as a legal entity, rather than shareholders or other stakeholders, is the primary beneficiary of directors' duties. Guidance should make clear that the company's activities impact a wide range of stakeholders (including shareholders) and societal interests (such as the environment). Directors' duties should indirectly benefit these stakeholders and interests in varying degrees at different times, but none of them should take precedence over the interests of the company, which is the touchstone of directors' duties.**

2. **It should be clarified in legislation that the primary interest of the company is to survive in the long-term, in order to achieve the purpose for which it was incorporated, taking into consideration the economic, social and environmental issues to which its activities give rise. Shareholder value should not be prioritized over such considerations and directors do not have a duty in any jurisdiction to maximise shareholder value. Instead, directors should give parity to all material stakeholders and issues that are important for the long term health of the company.**

3. **Directors should be explicitly required to identify and mitigate all of the long-term economic, social, and environmental risks to the company's interests and its attainment of any specific social goals. This analysis and mitigation should be published in a suitable integrated reporting format, and the legislation should specify salient material risks for key industries.**

4. **Directors should be required to operate the company within planetary boundaries and social foundations, which legislation should define to the maximum extent possible and which should be further and more specifically developed by directors. To assist directors in performing this duty, they should be required to carry out ongoing human rights and environmental due diligence in relation to a company's operations (including its supply chains) and to develop a strategy for how to mitigate such impacts.**

5. **The European Commission should affirm that companies can adopt a social purpose that either expressly takes precedence over their commercial purpose, or is to be balanced with that commercial purpose by the directors in the exercise of their discretion.**

6. **The European Commission should consider developing a specific 'status' for companies that declare a social purpose, provided that they meet certain criteria which will ensure that they are actively seeking to achieve such purpose.**

There is clearly a lot more work to be done in order to further develop and support these recommendations. In particular, this paper does not consider in detail the definitions of the planetary boundaries, the key performance indicators that should be applied to reporting requirements, or the guidance that should be developed around legislative change. All of these will be necessary in order to ensure a robust shift away from shareholder value and towards long term sustainability. Sufficient time and resource should be devoted to these additional areas of research, to ensure successful and long-lasting legislative and cultural reform.

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