CORPORATE RESPONSIBILITY
the corporate responsibility coalition

June 15th 2005

Mr Patrick Barry
Corporate Law and Governance Directorate
Department for Trade and Industry
5th Floor
1 Victoria Street
London SW1H 0ET

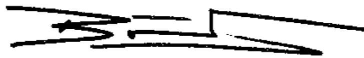
Re: Draft Regulations on the Operating and Financial Review and Director's Report

Dear Mr Barry,

The Corporate Responsibility Coalition is pleased to submit our response to the *Company Law Reform White Paper* consultation document.

We look forward to further discussion regarding our recommendations.

Yours Sincerely,



Brian Shaad
Policy Coordinator, CORE Coalition

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RESPONSE OF THE CORE COALITION TO THE 2005 COMPANY LAW WHITE PAPER

Delivering Company Law for ALL Stakeholders

Summary

This paper represents the response of the Corporate Responsibility (CORE) Coalition to the UK Government's 2005 Company Law Reform White Paper. CORE is a broad coalition of 130 organisations, representing over five million individuals across the UK, who share a commitment to promoting sustainable development and corporate accountability.

We appreciate the government's efforts to tackle the difficult task of reforming Company Law and believe that any new proposals must respond, not only to the needs of encouraging and promoting enterprise, but must also strive to balance the broader interests of society, community and the environment. This principle has already been supported in other government commitments on sustainable development, notably the Johannesburg declaration in 2002.

We believe that the Government's reliance on "Enlightened Shareholder Value (ESV)" to respond to societal needs and sustainable development objectives will not be adequate either to meet the demands of investors or other stakeholders, or to establish a long-term investment culture. Nor do we regard ESV as an appropriate means of defining and enforcing directors' duties in the pursuit of such goals.

Over the past few years, interest in seeing companies run for and on behalf of all stakeholders has dramatically increased, such that the Government's dismissal of the idea of a pluralist approach to Company Law, in CORE's opinion, continues to reflect short-term thinking. As this is the most fundamental review of Company Law in 150 years, we urge the Government to re-open their examination of a pluralist approach to corporate governance and take the opportunity to draft a truly modern form of Company Law that genuinely meets the needs of the 21st century.

In summary, we make the following recommendations to the UK Government:

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1. UK Company Law must reflect the broad range of interests of stakeholders, not just shareholders, while being fully aligned with both our national and our international commitments on sustainable development and other public policy commitments, such as the UN Universal Declaration of Human Rights, the OECD Convention on Bribery and Corruption and the Millennium Development Goals. The best way to respond to these commitments and thus to the interests of all stakeholders is through enhanced Director's Duties instead of reliance on ESV. ***UK Company Law should include a statutory requirement for Director's to consider, act, mitigate and report on any negative impacts on other stakeholders.***

2. The Government must address how best to create legislation for the undesirable activities of UK enterprises in their overseas operations. There is ample evidence that group company structures permit UK parent companies to unfairly take advantage of weaker regulatory regimes, particularly in developing countries. In an age of globalisation, it is critical to prevent subsidiaries under the control of UK-based companies from exploiting workers and the environment in a manner which would not be permitted in the UK, while parent companies hide behind the 'corporate veil'.

3. The Operating and Financial Review (OFR) must be strengthened and linked to the Director's Duties statement. By separating the OFR regulation from the overall application of Company Law, the government failed to ensure that reporting requirements meets the needs of either shareholders or stakeholders.

I. COMPANY LAW AND SUSTAINABLE DEVELOPMENT

1.1. The 2005 Company Law Review (CLR) White Paper is the culmination of a process of formal and informal public consultation begun in 1998. The CLR's predominant objective "entailed the pursuit of policies to facilitate productive and creative activity in the economy in the most competitive and efficient way possible for the benefit of *everyone*."[1] In our opinion, this means ensuring that Company Law not only supports business success, but also means success in terms of managing environmental, community and other social matters.

1.2. Originally, the CLR Steering Group was highly cognisant of the need for business to be managed in a way that considers its responsibilities more widely. In the first report of the CLR Steering Group, it is stated that "businesses normally best generate wealth where participants operate harmoniously as teams and that managers should recognise the wider interests of the community in their activities"[2], and that companies may cause various kinds of external harm, including damage to health and safety, abusive employment or contracting practices, and environmental damage[3]. At the time, they wrote, "it may be argued that, as a matter of principle, the law should be changed to allow directors discretion to sacrifice commercial advantage for ethical or public objectives." This advice was not heeded.

1.3. We must recognise that companies today are a complex set of systems with mechanisms in place for management of a range of issues, from human resource management and health and safety systems to environmental management. Nonetheless, proposals put forward by the Government continue to assume that Company Law should only apply to systems of financial management and control, relying instead on an unwieldy patchwork of secondary legislation that governs failure of companies in spheres beyond finance, many of these half-hearted and inadequate in themselves.[4]

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[1] DTI, "Modern Company Law for a Competitive Economy, The Strategic Framework", 1999 Ch 2, Para 2.4 p8 URN 99/654
[2] "The Strategic Framework" Ch 5.1 Para 5.1.9 pg. 36
[3] "The Strategic Framework", Ch 5.1 Para 5.1.40 p. 49
[4] For example, The Environment Agency's Spotlight on Business 2003 found that "harm to the environment should bring harm to the pocket of the minority of companies that are irresponsible. But fines for environmental offences are still far too low, and do not begin to reflect the damage done to the environment or even match the costs avoided. Offenders should not only face much stronger penalties, they should always have to pay to repair the damage caused and compensate the communities affected."

1.4. Company Law must take account of sustainable development policy. The UK has made commitments in the Johannesburg Declaration, the Kyoto Protocol and the OECD Convention on Bribery and Corruption, amongst others, to ensuring that it implements laws that govern the behaviour of business vis-à-vis sustainable development. Under the WSSD Plan of Implementation (POI) the UK committed to *'actively promote corporate responsibility and accountability through among other means…appropriate national regulations.*[5] *'* It also made a pledge to the effect that its private sector *"in pursuit of its legitimate activities…, including both large and small companies, has a duty to contribute to the evolution of equitable and sustainable communities and societies."*[6] . The Government must see the Company Law reform process as an opportunity to integrate sustainable development into the DNA of UK companies. Failure to do so will result in a patchwork of approaches that will lead to higher costs for taxpayers in the long-run.

II. ENLIGHTENED SHAREHOLDER VALUE WILL NOT DELIVER

2.1. The 2005 White Paper concludes its task of modernising Company Law by enshrining in statute the principle of Enlightened Shareholder Value (ESV) in the belief that success will be optimised where directors recognise that the success of companies can only be achieved by "taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers.".[7] The objective of this aim is a laudable one, but the CORE coalition strongly believes that the principle, as drafted into regulation, is unlikely to achieve its intended aims.

2.2. The Report of the Working Group on Materiality (2004) recognised the significant impact that business has on environment, society and community. While many of these impacts may be positive, there are significant instances where the impacts actually cause harm to communities affected by business operations, yet these are

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[5] Chatham House Sustainable Development Programme, "Following up the World Summit on Sustainable Development Commitments on Corporate Social Responsibility: Options for Action by Governments", Executive Summary, p.1
[6] "Following up the World Summit on Sustainable Development Commitments on Corporate Social Responsibility", Executive Summary, p.1
[7] *"Company Law Reform"*, Chap 1: Summary, p.5

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often not accounted for in the bottom line. For example, whilst Shell's operations in Nigeria continue to come under serious criticism from human rights and environmental campaigners, the company has been nonetheless rewarded by investors by having achieved a sharp rise in the company's share price to date. While the National Farmer's Union and others have criticised several companies in the Supermarkets sector, Government efforts to stem abuse of worker and environmental rights have yet to eradicate harmful practices on the part of key players amongst the leaders, such as Tesco or Asda[8].

2.3. The proposals in the White Paper aim to provide the highest level of accountability to shareholders. Yet CORE would like to remind the Government that shareholders only give one form of capital to a company – financial capital. Companies use other forms of capital to deliver value – environmental capital, human capital and social capital, most often provided by other stakeholders. There is insufficient evidence that having a singular duty to shareholders is likely to produce the best outcome for either business or society overall. CORE believes that companies and directors must be accountable for all forms of capital and this can best be achieved by adopting a pluralist approach to UK Company Law.

2.4. We point to the weaknesses in adopting the language of ESV in legislation. Firstly, success is too narrowly defined in terms of financial outcomes. For example, section B3 (General duties of directors) states as the primary duty a "Duty to promote the success of the company for the benefit of its members." This appears to mean that where a conflict between public good such as environmental or employee matters and company 'success', members' financial interests must take precedence.

2.5. Second, language drafted into the proposed legislation is too woolly to enforce. Section B3(1), states that "as a director you must act in a way you consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole." The term, "consider" is highly subjective and will be judged differently by different actors and is further reduced by having to consider the members' interests only. It sets no guidelines by which directors can consider their duty.

[8] See, for example, ActionAid's report *Rotten Fruit: Tesco profit as women workers pay a high price*, published in April of 2005. http://www.actionaid.org.uk/wps/content/documents/tesco_southafrica.pdf

2.6. We believe that the proposed section B3(3) represents a retrograde step, from the current section 309 of the UK Companies Act 1985, which provides better protection to third parties. In particular, B3(3)(b) refers only to the "need" of the company, implying that there are circumstances in which a company has no need to consider employees, the environment or community. Company directors will easily be able to justify that in their own reasonable judgement, they didn't need to consider the impacts of their business operations beyond the financial bottom line, as that was the duty they had within the law. Finally, we have been advised legal experts that B10 will also be used by the courts to take a very narrow interpretation of section B3.

2.7. The Government must also consider the significant issue of market failure when it comes to the social and environmental responsibility of business. The assumption that ESV will deliver is based on a misguided notion that market pressures will automatically punish those companies that fail to take social or environmental issues into account. This assumption is not actually matched by evidence.

2.8. For example, it is extremely unlikely that, as currently constituted, consumer pressure will deliver the necessary incentives for positive change. Ethical consumers in the UK represent fewer than 5% of the population on an active basis, with most consumers concerned with things like price, taste, or quality. An increase in competition for price actually limits the ability of market leaders to enforce ethics and we have seen a trend towards companies lowering standards rather than raising them in light of competitive pressures. The parent company of one of the UK's fastest growing companies, ASDA, is seeing a barrage of legal challenges in the US for its failure to fairly treat employees, while it is alleged that workers' rights in developing countries are being severely abused.

2.9. Trends towards market concentration have also reduced consumer choice and limit the range of ethical shopping options. Evidence from the supermarkets sector, for example, shows that the four largest supermarket chains account for 74% of the food retailing market in 2004 – and Tesco alone 28%. But even an 8% market share was considered by regulators to confer sufficient market share to enable abuse of power along the supply chain in such a way that it would act against the public interest. In the Competition Commission's 2000 report on the sector, it identified "27

practices in relation to suppliers that… were against the public interest", noting that these led, among other adverse effects, to less choice for consumers. However, the binding Code of Practice introduced on their recommendation has proved ineffective, and an OFT review of the Code in 2004 found that 80-85% of respondents believed it had failed to change supermarkets' behaviour.

2.10. ESV also makes a wrongful assumption that the interests of stakeholders and shareholders are naturally aligned. Yet, even where there are significant risks from potential reputational concerns, evidence from CORE membership demonstrates that businesses seek to adopt risk-avoidance measures that do not actually mitigate against the substance of the problem. Companies often place the burden of these risks on third parties, or hide behind a corporate veil that shields the risk from investors in the UK. For example, risk avoidance measures adopted in the supply chain have led to a predominance of auditing that labour standards are adequate, rather than tackling the root causes of labour rights abuses. As a result, the predominance of double book-keeping in places like China for social standards has become the norm. In another example, the recent cases involving Thor Chemical Holdings and Cape Asbestos, both UK subsidiaries working with dangerous substances (mercury reprocessing and asbestos mining respectively) in South Africa, are illustrative of companies seeking to limit their liability through subsidiary vehicles while Directors of the UK parent retain de facto control and knowingly put overseas employees at risk through those operations. Stronger and clearer duties on these UK Directors may have done much to ensure that the subsequent human tragedies did not take place.

2.11. Even where members have expressed particular interest in non-financial issues, the ability to hold a company to account for not taking these into consideration is limited. The possibility of minority shareholders, for example, challenging any decision of the board is extremely limited under both current and proposed provisions.

3. ACCOUNTABILITY FOR SUBSIDIARIES HAS BEEN IGNORED

3.1. The most recent White Paper has also failed to address the particular governance questions raised by corporate groups. This is despite the significant

policy issues raised by recent legal actions such as those in the Thor Chemicals and Cape plc case, whereby companies were found to use a corporate veil to shield themselves from liability for harm to individuals and the environment. This demands more serious policy consideration in the development of Company Law.

3.2. Multinational corporations present distinct challenges to corporate governance since they effectively coordinate their activities, as integrated economic networks, beyond the boundaries of individual nation states. We believe that a formal commitment should be made from the Government to investigate, as a matter of urgency, the impacts of UK-based multinationals overseas and to develop policy within the domain of Company Law which can overcome the improper use of the corporate veil, on behalf of all stakeholders. We point to a current effort by Chatham House[9] to develop a multi-stakeholder solution to this complex and critical issue.[10]

4. ENHANCING DIRECTORS' DUTIES

4.1. CORE recommends that the best way for the Government to deliver sustainable development objectives, both in the UK and abroad, and to overcome market failure is through explicitly ensuring that directors are held accountable for the social and environmental impacts of the company. UK Company Law should include a statutory requirement for directors to consider, act, mitigate and report on any negative impacts on other stakeholders.

4.2. The idea of a stakeholder-driven company, referred to as a pluralist responsibility was, however, rejected by the Company Law Review team almost solely on the grounds of administrative expediency and practical enforceability. CORE believes that there was not enough consideration given to how such an approach could work in practice and that rejection on the basis of implied impracticality is extremely weak. Social enterprises, for example, regularly demonstrate that having pluralist

[9] "Transboundary Accountability for Transnational Corporations: Using Civil Claims" http://www.chathamhouse.org.uk/index.php?id=256

[10] In the draft bill for the offence of Corporate Manslaughter, published in March 2005, the government decided that this offence would not have extra-territorial jurisdiction. We consider this decision to be indicative of a very confusing message from government. Different liability for serious crimes committed abroad may communicate a message that they are not regarded as seriously as those committed in England and Wales. We would like to record our dismay at this decision as part of the consultation exercise for this draft bill.

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responsibilities can be possible to enforce while resulting in profitability for stakeholders and investors alike. One would not expect such a response by the Government for any matter as serious, from climate change to terrorism, on the grounds of complexity alone.

4.3. On the apparent problem of how to enforce duties to a range of stakeholder interests, one need only look so far as the legal profession itself. For example, solicitors owe professional duties to both their clients and more widely to the administration of justice. Their professional regulator has oversight over those duties, and power to punish its members in case of transgressions. This is not to suggest that such a model should be applied to company directors – but the model of professional ethics does indicate one possible avenue for further enquiry. It is, simply stated, too soon to close the door on pluralism.

4.4. We agree with the White Paper that a statutory statement of Director's Duties will clarify director's responsibilities, but that these must make a clear statement of responsibility for social and environmental matters and seek to foster mutually beneficial relationships between stakeholders. The current drafting does not provide such clarity and even fails the test of ESV.

4.5. The forthcoming Company Law legislation must place an added duty on directors to ensure that they act on information regarding negative social and environmental impacts. The OFR, in its current state is unlikely to deliver necessary action on the part of companies, except where serious financial penalties arise.

4.6. Thus, the purpose of the OFR must be linked to an overall Duty of Directors. This is not currently the case. CORE believes that a duty should be placed on directors requiring them to report on any significant negative social and environmental impacts of their business activities, operations, policies and products and that this must also be coupled with a legal duty requiring directors to take reasonable steps to reduce and mitigate those impacts.

4.7. Such a regime would provide a clear purpose for reporting: i.e. to identify the jobs that need to be done in order to ensure directors have taken reasonable steps to meet their social and environmental duties. As such, the OFR would represent a

valuable management tool for directors, rather than just another document they need to produce for shareholders.

4.8. Practical measures by which to enhance directors' ability to enforce such a set of duties should also include mandatory training on social and environmental issues.

5. CONCLUSION: CREATING OPPORTUNITY

5.1. The White Paper notes that one of the aims of a modernised Company Law regime is to provide flexibility to enable changes to the law to be made in future. We agree with the Government that it is not possible to codify all expectations that we might have of business, as this may change over time. However, we disagree that this is a reason for failing to explicitly state particular social or environmental responsibilities of business at the present time. With flexibility built into changing the law, as suggested in the draft legislation, we believe this provides sufficient ability for us to review and modify these as necessary, according to raised societal expectations in the years to come.

5.2. We fundamentally believe that the expectations of companies, and public interest in the issues discussed in this paper (i.e. pluralism) have evolved significantly over the period since the CLR started and that this interest presents an opportunity for the Government to re-examine its effort. We insist that the government keep open a serious space for discussing these issues while offering practical alternatives to the current shareholder-driven model of the company. Learning from social enterprises could, for example, offer a model set of Articles of Association for all companies that embeds pluralist principles as an explicit option.

5.3. In conclusion, CORE agrees that companies must be run in the best interests of all stakeholders, but have found through experience that the market alone is insufficient to enable company directors to take these wider interests into account, as the ESV model assumes. The only way to achieve a more balanced approach is through ensuring Directors are required to take account of wider stakeholder concerns. We believe that this can best be implemented through providing a statutory requirement for directors to be responsible for stakeholders, through transparency

and the internalising of externalities via a wider duty to stakeholders, and lastly by providing a more effective means of enforcement that includes stakeholders in the process.

26-28 Underwood Street London N1 7JQ • Telephone 020 7566 1665 • Fax 020 7490 0881
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