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Sustainable Companies through Enlightened Boards: Combining Private and Public Interest in the Decision-Making of Large Public Firms

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1. INTRODUCTION

This article is centred on the proposal of a new institutional structure for board of directors (BoDs) of large public firms.[1] The proposal is envisaged as an *ex ante* means to address problems of decision-making within corporations whose activities impact on a wider range of societal constituencies and therefore pose issues of sustainability for society at large, beyond the success or failure of the individual company.

A number of corporate scandals that occurred over the past fifteen years have exposed flaws in the decision-making process of large public corporations. Many of these failures have caused constituencies outside firms to suffer the consequences of strategic choices that did not take under due consideration the interest of a broad range of stakeholders, namely employees, creditors, local communities and the environment.

Recent events have magnified this problem. The Global Financial Crisis[2] (GFC) has caused a depression that increased unemployment in most Western economies,[3] together with social unrest and suffering. The various banks' bailouts that were funded with taxpayers' money have reduced the public resources available, *inter alia*, for education and healthcare. Beyond the collapse of the financial services industry, the BP oil spill in the Gulf of Mexico in 2010 reawakened concerns about the environmental dimension of corporate failures. Besides the unquantifiable ecological disaster, the oil spill has compromised the economic life (tourism, fisheries most notably) of the coastal areas hit by the spill, leaving a legacy of social problems among the local communities.[4]

Arguably, failures of financial institutions and environmental disasters were characterized, *inter alia*, by lax systems of decision-making. One notable reason for this is that risk-management and control functions were not properly factored in firms' strategies[5] and that decisions were myopically geared towards the maximization of shareholders' wealth, which entailed pursuing increases in the value of stock on the part of management, to the detriment of long-term objectives.[6] This has resulted in the failure to take account of different societal interests.

The proposal advanced in this article aims at recalibrating key decision-making processes in large public firms in order to align them with more socially inclusive and sustainable goals.

2. WHAT HAS GONE WRONG?

The challenge of controlling directorial behaviour is intrinsic in large public firms characterized by dispersed shareholding.[7] This is prevalent in the US and the UK tradition and has given rise to a number of legal issues revolving around three main areas. First, the

* I thank the conference participants and the reviewers of this article for the very constructive comments; errors remain my own.

1 Large public firms in this article are referred to as entities listed on stock exchanges, which, because of their activities and/or size, create externalities on a varied range of societal groups. Examples of this category are represented by financial institutions, multinational corporations, or companies involved in the extraction of natural resources. This categorization will be clarified by the proposal put forward in section 3.

2 See A. Arora *The Corporate Governance Failings in Financial Institutions and Directors' Legal Liability*, 32(1) Company Lawyer (2011).

3 See E. Posner, *A Failure of Capitalism* (Harvard University Press 2009).

4 See D. Jamail 'BP's Silent Disaster', 16 Oct. 2013, Aljazeera available at www.aljazeera.com/indepth/features/2013/10/bp-silent-disaster-20131015132359247265.html.

5 Posner, *supra* n. 3, at 80; one reason for this is that risk managers' activity is not conducive to profit-making.

6 See L. Stout *The Shareholder Value Myth* (Brett-Koehler Publishing 2012); L. Mitchell *Corporate Irresponsibility – American Newest Export* (Yale University Press 2001).

7 The issue was first addressed by A. Berle & G. Means, *Modern Corporation and Private Property* (New Brunswick London 1991).

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direction of corporate activity and in whose interest it should be pursued (encapsulated in the corporate objective question).[8] Second, the relationship between shareholders and directors as regards their conflicting interests (which is referred to as one of the agency problems);[9] and lastly, the set of duties that are designed to tie directors to the company and its objectives.[10]

While much literature is available on each of these three fundamental legal issues, the problems have resurfaced under more specific guise in the context of recent events. In particular, they flow into two corporate governance problems which are identified in this article as being at the heart of corporate failures and therefore requiring reform. The first is the unresolved dilemma of the corporate objective which has become more urgent because of the ubiquitous application of shareholder value as parameter of corporate success (mainly in the UK and the US, but increasingly also outside these jurisdictions).[11] The second problem is represented by flawed systems of control over directorial behaviour. This pertains to both internal governance mechanisms, epitomized by the function of non-executive directors, and external mechanisms which rely on gatekeepers and more generally on market mechanisms, such as stock options and the market for corporate control. Additionally, linked to the above problems, the lack of necessary competence and independence in BoDs emerged as a central issue within the corporate failures of the last fifteen years. This was augmented by the intellectual bias of board members who remained driven by shareholder primacy rhetoric and by short-term goals.

The above contentions are corroborated by two brief accounts: Northern Rock and BP. The collapse of Northern Rock, in the context of the GFC, can be seen as a failure of the underlying banking model, as a monitoring failure of the UK Financial Services Authority (FSA),[12] but most importantly for the purpose of this analysis, as a fundamental non-fulfilment of the BoD's duties. The House of Commons Treasury Committee report highlighted the dubious governance constraints on the BoD and its inefficiencies in dealing with issues of risk-taking.[13] It was observed in particular that the board failed to oversee the overall corporate and financial strategy in the post-demutualization years and to ensure the bank's liquidity and solvency.[14] It also became evident that, beyond governance flaws, the board – and in particular non-executive directors – failed to appreciate the long-term implications of structured finance transactions entered into by the bank, particularly with respect to the effects they had on the bank's capital structure (and its increasing level of leverage), on short-term liabilities and the bank's interconnectedness with other institutions.[15] Ultimately, Northern Rock exemplified a common problem across the banking industry, namely the extreme employment of a business model conceived to maximize rates of return on equity (shareholder value essentially) through aggressive asset growth, minimization of capital and funding risk.[16] In essence, a model that increased short-term profits for shareholders by externalizing the business risk onto other stakeholders and society. This emphasized the urgency to align the corporate objective with a wider range of stakeholders and with longer-term goals.

The environmental disaster that followed the BP oil spill uncovered deep-seated problems in the supervision of high-risk activities and raised questions on the role and goals of corporations in a democratic society. The nature of BP's business and the obvious repercussions of its activities on society prompted reflections on how such corporations balance different interests[17] and whether Corporate Social Responsibility (CSR) is implemented beyond mere rhetoric.[18] It has been observed that BP repeatedly ignored environmental legislation in favour of pursuit of short-term profits from oil extraction.[19] BP's business, in other words, was primarily focused on profitability and the company acted in a socially responsible manner only when CSR would contribute to its 'green image' or when it would not hinder profitability.[20] This behaviour was the result of flawed decision-making in the BoD whereby the observation of environmental laws and CSR was seen as subordinate to the pursuit of shareholder value. As identified as one of the main corporate governance failures in this article, the

8 See A. Keay, *The Corporate Objective* (Edward Elgar 2011).
9 See E. Fama, *Agency Problem and the Theory of the Firm*, 88 J. Political Econ. (1980).
10 See A. Keay, *Good Faith and Directors Duty to Promote the Success of the Company*, 32(5) Company Lawyer (2011).
11 See for a reflection on European and Nordic Company Law: B. Sjafjell, *Regulating Companies As if the World Matters: Reflections from the ongoing Sustainable Companies Project*, 47 Wake Forest L. Rev. 113, 129–130 (2011).
12 The Financial Services Authority was the financial regulator and supervisor in the UK at the time of the GFC.
13 House of Commons, Treasury Committee '*The Run on the Rock: Fifth Report of Session 2007-08*', Vol.1, London the Stationary Office Limited 2008, 19.
14 *Ibid.* Northern Rock presented a highly leveraged capital structure, heavily reliant on inter-bank loans (wholesale as opposed to retail), which aggravated the collapse of the bank once the market froze and institutions became averse to lending to each other.
15 H.S. Shin, *Reflections on Northern Rock: The Bank Run That Heralded the Global Financial Crisis*, 23 J. Econ. Perspectives 8 (2009).
16 M. Onado, *Northern Rock: Just the Tip of the Iceberg*, in *The Failure of Northern Rock: A Multi-Dimensional Case Study* 107 (F. Bruni & D.T. Llewellyn eds., The European Money and Finance Forum 2009).
17 See N. Lin-Hi & I. Blumberg, *The relationship between corporate governance, global governance, and sustainable profits: lessons learned from BP*, 11 Corporate Governance (2011).
18 See on this: T. Lambooy, M. Varner & A. Argyrou, 'The Corporate Responsibility to Remedy (3rd Pillar Ruggie Framework) – Analysis of the Corporate Responses in Three Major Oil Spill Cases: Shell – Nigeria, BP – US (the Gulf), Chevron – Ecuador', (2 Nov. 2011). University of Oslo Faculty of Law Research Paper No. 2011-26. Available at SSRN: http://ssrn.com/abstract=1953190 or http://dx.doi.org/10.2139/ssrn.1953190.
19 M.A. Cherry & J.F. Sneirson, *Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing after the BP Oil Disaster*, 85:983 Tulane L. Rev. 114 (2011).
20 *Ibid.*, 115.

interests of other stakeholders at BP were not adequately represented on the board nor attended to.

Corporate law does not specifically require that directors maximize shareholders wealth, both in the UK and the US.[21] While the law allows for other interests to be considered (sustainability among others), corporate governance has remained aligned to shareholder primacy, mainly due to the influence that business rationales have on BoDs (hence the intellectual bias that is mentioned earlier in the article) and that financial-economic theories retain on policy-making.[22] Shareholder value has also been fuelled (as it became evident during the GFC) by perverse market incentives, namely stock options geared to short-term metrics, that lead managers to understate future risks (like environmental or financial risks) in order to cash in bonuses linked to short-term performances.

3. A NEW INSTITUTIONAL FRAMEWORK OF CORPORATE BOARDS

The recurring corporate governance failures, which have been illustrated by the above accounts of Northern Rock and BP, call for reforms in order to address the fundamental problems previously highlighted, namely: (1) the dynamics of decision-making and control within BoDs; and (2) the intellectual bias within BoDs. However, reforms should not seek a 'one-size-fits-all' solution, but rather a model targeting the large public firms that, because of their activities and size, and regardless of their industry, pose significant threats to society. My proposal introduces a classification of large companies, resulting in two tiers of public corporations, each subject to different degrees of regulation. The proposed classification is based on five criteria that have been discussed in greater detail in a previous work.[23] These are: (1) size and number of employees at group level; (2) group turnover; (3) geographical spread; (4) range of activities; (5) externalities on social groups. These criteria aim to identify tier-one corporations by assessing the impact that they have on different social groups. While tier-two firms would remain regulated by a framework permeated by private corporate interests, tier-one corporations would be subject to the type of regulation necessary to internalize their externalities in light of their social dimension.[24]

The aim of my proposal is to redesign the structure of BoDs of tier-one entities. This would occur through the inclusion on their board of the State as an equilibrating arbiter of both economic and social interests. While the regulating powers of the market and of related financial-economic theories have traditionally advanced the pre-eminence of firms' economic interests,[25] a broader concept of corporate law encompassing wider socio-economic interests has been understated.[26] The resulting narrow view of company law has hindered its role in regulating a number of legal relationships that give rise, *inter alia*, to social and environmental costs.[27] This has caused a democratic deficit in large public corporations, consisting in the lack of public legitimization of directorial powers and of corporate activities within society.[28] While the decision-making process in such entities has had effects on a broad range of social constituencies, it has remained anchored to the interests of a very narrow section of society. The proposal advanced in this article therefore aims at filling this democratic deficit by providing a legitimization of corporate decision-making for entities whose activities impact on society.

The State, because of its democratic underpinning, is envisaged in this article as the 'natural' custodian of different societal interests. The inclusion of a democratic-based social interest in BoDs would be premised on the setting up of a permanent, state-based institutional/regulatory body, independent from both government and the market.[29] Independence would be achieved through an institutional design whereby the body is independent from political control, but at the same time accountable through procedural constraints.[30] The aim in other words would be to create a permanent public institution that is not affected by problems of 'time limit' which are typically associated with changes in governments and political fluctuations. At the same time the

21 This is subject to exceptions under specific situations (e.g., takeover bids) which are regulated differently under UK and US law. See V. Bavoso 'The Global Financial Crisis, the Pervasive Resilience of Shareholder Value, and the Unfulfilled Promises of Anglo-American Corporate Law', forthcoming *ICCLR* 2014, at ssrn.com/abstract=2360265.

22 See A. Johnston, *Reforming English Company Law to Promote Sustainable Companies*, forthcoming European Company L. (2014); see also Stout, *supra* n. 6.

23 V. Bavoso, *Explaining Financial Scandals: Corporate Governance, Structured Finance and the Enlightened Sovereign Control Paradigm* 244–245 (Cambridge Scholar Publishing 2013),.

24 *Ibid.*, 245, where the function of each criterion is explained in detail. Examples of tier-one firms would be financial institutions, because of the systemic importance they have, which would depend not only on their size, but on the level of interconnectedness and contagiousness of their liabilities (Lehman Brothers for instance); similarly, relatively small firms may trigger social concerns because of the externalities they create on the environment or on local labour markets (Parmalat for instance). Ideas in this direction are also discussed by T. Lambooy, *Corporate Law and CSR: Will There be a Constitution for Multinational Companies in 2030?* 273 in *The Law of the Future and the Future of the Law* (TOAEP Publication Series 2011).

25 Chiefly through 'contractarian' theories of the firm centred around the agency relationship between shareholders and directors. See C. Bruner, *Power and Purpose in the Anglo-American Corporation*, 50 Virginia J. Intl/ L. (2010).

26 See G. Teubner, *Corporate Fiduciary Duties and Their Beneficiaries: A Functional Approach to the Legal Institutionalization of Corporate Responsibility*, in Hopt & Teubner *Corporate Governance and Directors' Liabilities* (De Greuter Berlin 1987).

27 Johnston, *supra* n. 2, at 3.

28 J.E. Parkinson, *Corporate Power and Responsibility* ch. 1 (Clarendon Press Oxford 2002).

29 This is conceived as a very different entity from the Independent Regulatory Agencies that emerged, especially at EU level, after the 1980s. See on this G. Majone, *The Regulatory State and its Legitimacy Problems*, 22:1 West European Politics 2 (1999).

30 Bavoso, *supra* n. 23, at 256.

institutional body's public link would be preserved by accountability procedures established with relevant ministries, which would ensure consistency with broad social interests.

A public career path premised on a specific educational and selection process would be a prerequisite for the state professionals. This would equip them with the necessary skills and expertise to balance decision-making processes and weigh the different interests at stake in tier-one BoDs.[31] The representation of the pluralist, democratic-based interest at board level would thus occur by drawing professionals from the institutional body, to act in BoDs in a capacity similar to that of non-executive directors. While serving on the board, professionals would still work for the state and would be remunerated with public money by the institutional body from which they are drawn. This institutional arrangement would further enhance the balancing of different interests on BoDs.

It is contended that the proposed institutional framework would contribute to establishing more sustainable companies in two ways. First, it would impact on the dynamics of BoD's decision-making. The passing of major board resolutions would depend on special powers of the professionals in the board. The majority of them would need to approve the resolutions, ensuring that due regard is given to the public/social interest alongside the private economic one. Equally, a majority of the professionals would have a power of veto over high-risk activities. Alternatively, they could refer specific resolutions raising higher concern to the above mentioned regulatory body (topical examples could be that of transactions that increase the level of leverage of a bank in a way that can harm systemic stability; or operations that involve risks for employees and the environment in case of energy or mining firms). Most importantly, these powers would result in an *ex ante* gatekeeping function. It needs to be emphasized that the judgment of state professionals would remain aligned to the social dimension of tier-one entities, also due to their compensation structure. As mentioned in the previous paragraph, fixed salaries would more likely keep professionals averse to the high level of risk-taking that has been induced by perverse market incentives like stock options.

Second, the proposed design would bring intellectual and professional resources which are currently lacking from BoDs.[32] State professionals would complement the expertise already available on the board because of their different background and would therefore depart from shareholder-oriented rhetoric, pursuing the corporation's objective in a more balanced and contextual way. More specifically, their different, ad-hoc educational path would flow into a new knowledge-based profession, whose skills would in turn be reflected in a deeper awareness and understanding of specific issues, such as environmental or financial ones. Because of this underlying presuppose, this proposal remains a medium to long-term institutional design and the type of profession that is here envisaged is not currently available in other sectors.[33]

Drawing from some of the failures that contributed to recent scandals, it can be argued that state professionals would be able to heed warning signs raised by risk-managers, whereas directors of financial institutions have been incapable of doing so because they followed the irrational exuberance of traders, motivated by lust for short-term profits.[34] The intrinsically truncated rationality of market actors would thus be complemented by a more socially responsible approach to business and a deeper awareness of its long-term implications.

4. CONCLUDING REMARKS: TOWARDS A DIFFERENT BALANCE IN BOARD OF DIRECTORS

The article advanced the urgent need to reform the governance structure of large public firms in light of the repercussions of their activities on different social groups. This encompasses an 'enlightened' participation of the State in corporate affairs via professionals drawn from a new institutional/regulatory body. The BoD in particular, as the engine behind corporate decision-making, should be equipped with an organizational framework and a set of intellectual skills suitable to guarantee a balanced judgment of corporate strategies that encompass profit-making together with long-term social and environmental concerns.

The advocated governance structure would substantially reduce the democratic deficit that large public firms currently have and would recalibrate governance processes in order to align them with more inclusive and sustainable goals.

31 A public educational path should complement the expertise that is currently available among market-players in key areas such as finance or climate change. It is argued that these specializations should be grounded on the awareness of social dynamics and ethical issues that have been understated in BoDs of large public firms.

32 The state body from which BoD's professionals are drawn would be institutionally designed in a way to remain independent from both market and government; see Bavoso, *supra* n. 23, at 256.

33 This means that state professionals could not simply be drawn from existing professions, such as academia, civil service or the bar, even though the newly established professional body may have similarities with some existing regulators.

34 Posner, *supra* n. 3, at 80.