SLAUGHTER AND MAY

Stakeholder Capitalism - Update for Directors and GCs

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A lot has recently been written about a company's purpose and its obligations to stakeholders, of which its shareholders are but one component. There is now a widespread expectation that directors will engage clearly and transparently with all stakeholders and not just pay lip service to their company's goals regarding environmental and other matters. Directors have always had to aspire to achieve social responsibility and shareholder value but must they now balance equally the creation of long-term shareholder value with the delivery of value to all stakeholders?

The BRT Commitment to Stakeholders

In August 2019 the Business Roundtable (**BRT**) published an updated *Statement on the Purpose of a Corporation*. In the updated statement, the influential US business group outlines its vision of a "modern standard for corporate responsibility".

The BRT statement contains a "fundamental commitment to all stakeholders", which it describes as a move away from shareholder primacy, the longstanding concept that shareholders are paramount and that the interests of stakeholders are only relevant as a derivative of the duty owed to shareholders.

The final section of the BRT statement sets out the commitments:

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:

- *Meeting or exceeding customer expectations*
- *Compensating [employees] fairly… [and fostering] diversity, inclusion, dignity and respect*
- *Dealing fairly and ethically with our suppliers*
- *[Respecting] the people in our communities and [protecting] the environment*
- *Generating long-term value for shareholders*

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities, and our country.

The BRT is not alone in expressing these views. Ahead of its annual meeting, the World Economic Forum has released the *Davos Manifesto 2020: The Purpose of the Company in the Fourth Industrial Revolution*, which is very similar to the BRT Statement. The British Academy has produced two detailed reports on the future of the corporation, *Reforming Business for the 21st Century* (2018) and *Principles for Purposeful Business* (2019). The latter sets out a "series of principles to guide lawmakers and business leaders in any jurisdiction towards the policies and practices that can release the potential of business to profitably solve the problems of people and planet, and to prevent business from profiting from harm."

Why now?

The BRT statement may be seen as a response to public discontent with the perceived failures of capitalism: rising inequality and low wage growth while corporate profits and executive pay remain high; tax base erosion and profit shifting; and profit-driven climate change and pollution. Some see these commitments to stakeholders, which have no legal force, as an attempt to forestall some of the more extreme changes which have been proposed by lawmakers and politicians in a variety of countries.

The commitment to stakeholders also reflects changing shareholder attitudes, as investors engage with listed companies much more on environmental, social and governance (**ESG**) issues. In Hong Kong, the Securities and Futures Commission has produced *Principles of Responsible Ownership* for investors. In October this year, the UK Financial Reporting Council published the *UK Stewardship Code 2020*. This is a voluntary code to which many large institutional investors are signatories. Under the *Stewardship Code*, firms are expected to integrate stewardship systematically into their investment approach, with explicit reference to ESG issues (including climate change) when assessing and monitoring investments.

At the same time, the BRT has lobbied against shareholder activism – probably in expectation that stakeholder and long-term considerations may provide companies with a shield against the greater focus on short-term returns often associated with activist shareholders.

What might change, and how should it be reported?

There are a number of ways in which this commitment to stakeholders might affect corporate strategy and policies in the future. Executive incentives could be subject to longer time horizons, linked with non-financial performance measures, or tied to operating profit rather than net profit to discourage aggressive tax structures. There could be a long-term recalibration of the proportion of profits paid in dividends (or share buy-backs) and the proportion reinvested in environmental, charitable and social objectives. A more inclusive form of capitalism might entail a more collaborative business style, with win-win deals for suppliers, better terms for employees, and more investment and involvement in local communities. Meeting all of these desires and objectives will pose challenges for directors.

Klaus Schwab, chairman of the World Economic Forum, noted in an article accompanying the Davos Manifesto that “to uphold the principles of stakeholder capitalism, companies will need new metrics.” Indeed, despite the increasing importance of ESG issues to institutional investors, and some companies’ increasing willingness to provide information about ESG performance, there is not currently a standardised international framework for ESG reporting.

There are a considerable number of frameworks in existence – the London Stock Exchange, for example, has published guidance on ESG reporting, and the Listing Rules of the Hong Kong Stock Exchange contain a number of environmental and social “comply or explain” requirements in addition to certain “recommended disclosures”. What is needed, though, is a more standardised framework to enable companies to accompany their commitment to stakeholders with an empirical method of assessing their progress.

To ensure meaningful change, regulators and lawmakers will need to consider how companies’ responsibilities to stakeholders should be enforced. Disclosures made under reporting frameworks and public pressure, particularly from institutional investors, still may not be enough to ensure the required changes in behaviour from public listed companies, and a different approach will be required for private companies, so as to recognise stakeholder concerns without creating an undue burden on small and medium-sized enterprises or stifling their growth and creativity.

Stakeholder capitalism and directors' duties

In Hong Kong, directors have a duty to act in good faith for the benefit of the company as a whole, which the Companies Registry has explained as a duty to act in the interests of all shareholders, present and future. In the UK, directors are bound by a duty codified in the Companies Act 2006 to promote the success of the company for the benefit of its members of a whole, including a requirement to "have regard to" long-term and ESG factors similar to those outlined in the BRT statement. In the US, directors owe a duty of care to the corporation and its shareholders, tempered by the "business judgment rule", which broadly protects directors from shareholder claims where they have acted in good faith.

In each case, as it stands, directors' duties certainly do not prevent directors from taking stakeholder concerns into account, and, in the UK, the Companies Act has required them to do so for over a decade. However, the "fundamental commitment to all stakeholders" in the BRT statement suggests an equal commitment which is not currently enshrined in law. The British Academy recognises this, and has called for a change in the law. However, even without a change in law, it is clear that stakeholder capitalism will become more ingrained in the way companies behave, and in the way their shareholders expect them to do business.

The courts' interpretation of directors' duties will continue to evolve. Given the type of commitments in the BRT statement - dealing fairly with suppliers, supporting communities, delivering value to customers, and investing in employees - make general good business sense, it may prove difficult to convince a court that directors observing them were in breach of their duty to act in the best interests of shareholders as a whole.

However, under current law in Hong Kong and many other jurisdictions, directors must still have regard to the prime obligation of directors – to act for the benefit of the company by managing their companies in such a way as to create and enhance shareholder value. If directors in Hong Kong (and many other jurisdictions) are to be under a duty to have equal regard to all stakeholders, it will be necessary for company law to be revised in due course to reflect these changing attitudes.

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