SLAUGHTER AND MAY

C-19

THE INCREASING DEMANDS OF A SOCIAL LICENCE TO OPERATE

May 2020

Introduction

In the early stages of the COVID-19 crisis, it was quickly evident that the market had moved from a focus on earnings to the more existential question of what business platform would emerge.

Now, another lens of assessment of prospects has re-emerged, the concept of the social licence to operate. It is no clearer a route to valuing the prospects of a business but it is clear enough that for a business to return from this disruption in good shape, it will also need to take care of its reputation and of how it is perceived to have behaved. Everyone, from employees and suppliers, to customers and communities, will remember long after the crisis subsides how they were treated by a business.

Recent history

Origins

The idea of a social licence to operate began in the 1990s in the mining sector, amongst concerns worldwide for environmental damage and community impacts from mining activities. It explained or referred to the quality of the relationship between a mining project and its host community, and the social performance that binds the two.[1] It was not widely known outside extractive industries even at the time of the global financial crisis when corporate social responsibility was the nomenclature.

In 2011 the concept was integrated into the United Nations Guiding Principles on Business and Human Rights,[2] since when it has become a feature of the International Investment Treaty and Tribunal agenda[3] and various Bilateral Investment Treaties.[4] A demonstration perhaps, that the expectations society has from businesses are increasingly being approached as a matter of law.

It is not the purpose of this piece to impose a definition of what is an intuitive concept, but we offer that it means the ongoing acceptance by stakeholders and the general public of a business's (or an industry's) practices, operating procedures and impacts, based on an assessment of those impacts, and the business's legitimacy, credibility and trustworthiness. It reflects a balance of benefits and costs, contributions and externalities. It is influenced by the expectations of stakeholders, their needs and available alternatives. It is contextual and not absolute.

Company purpose

The social licence to operate is distinct from a company's purpose, another live and adjacent concept that we have written about before.[5] A business purpose comes from the business itself, although to be authentic it needs to be activated and accepted by its stakeholders. A social licence to operate is in effect granted by stakeholders' acceptance of the business's activities and its performance against expectations (whatever the purpose of the business).[6]

A social licence to operate is dynamic. The expectations of society, its acceptance of a business's activities, shifts with the perceived and actual priorities of the moment. It seems clear however that a company with a strong and well defined purpose, particularly if it has elements of social benefit and a culture that aligns with it, will likely enjoy a stronger social licence to operate. It may even be better placed to weather crises and other external pressures with that licence and its reputation intact.

Global financial crisis and new Governance regulation

The years that followed the global financial crisis were characterised by a policy response of quantitative easing resulting in historically low interest rates and extended public expenditure constraints, latterly known as austerity. The impact on society of these policies was an observable widening of income and wealth inequality, combined with a widening of such things as the executive pay gap or differential, and prolonged public distrust of banks and business in general.

Against this background, the various government green papers and consultations on governance that preceded the 2018 version of the Corporate Governance Code (the **Code**) together contributed to some significant governance developments becoming applicable to (listed and to some significant privately held) companies. For the first time, the Code required a company to articulate its purpose, values and strategy, and ensure its culture and behaviour are aligned.[7]

Further, effective engagement with employees and stakeholders, and an obligation to report on these interactions, was introduced. The Companies (Miscellaneous Reporting) Regulations 2018 then required directors to report on how stakeholder interest had been taken into account in board decision-making.

For most companies, these requirements applied for the first time during the 2019 financial year, meaning the first reporting season fell in the first few months of 2020, with many dotting the i's on their first mandated statement of purpose on the cusp of the crisis. The events of recent weeks and the short term future provide an unexpected context in which to judge what for many, at first attempt, will be work in progress.

The current experience

From the early moments of companies facing the first impacts of COVID-19, the connection between treatment of employees, customers and communities on the one hand, and dividends, buybacks and executive remuneration on the other, has been not only obvious but for the most part accepted as a given. Countless business leaders have stressed their priority concerns for employees' safety and for security, and for the interests of customers and suppliers. Many have also been focussed on contributing to the public good - a motivation derived from clarity of purpose.

Of course there has been a scramble to adjust to whatever impacts there have been on financial health. But there has also been clarity that the long term interests of the business and shareholders are best served by protection of the franchise above all else. And it actually goes further: for some the experience has brought home tangibly what is their, or part of their, business purpose.

In the United Kingdom, there was conjecture, even expectation, that the various support schemes such as the CCFF, CBILS and CJRS would make the connection between access to funds and payments to shareholders and bonuses.[8] The Department for Business, Energy and Industrial Strategy was forthright in its view that *"while executive pay is ultimately a matter for individual companies to decide so long as they comply with the law, we would expect companies to act in a socially responsible way and exercise judgment and discretion when considering executive pay"*.[9]

To illustrate with an extreme, the notion that a company would accept state support and use its funds to pay shareholders or directors (however superficial this example may be) was obviously unpalatable.

In fact, none of the schemes have formally made this connection. But common sense (and in some places soft power) has delivered the same outcome, backed up by the prospect of uncomfortable discussions with lenders, shareholders, employees, regulators and, of course, public opinion. To put it another way, the credibility and legitimacy at the heart of the company's social licence to operate would be undermined by an inappropriate combination of state support and shareholder preference.

Investors' expectations, government assistance and public opinion

Investors have not been silent. In its letter to FTSE350 chairpersons on 7 April, the Investment Association wrote:[10]

"We support firms who place their primary focus on maintaining a business that is ultimately sustainable over the long-term rather than prioritising short-term financial returns." and

"Companies' approach to paying a dividend should include ensuring employees and suppliers can be paid... we favour companies that can demonstrate they are well run and take a long term view of how they treat their employees, communities, suppliers, pension savers and customers."

And in a statement on 27 April, focused specifically on executive remuneration:[11]

"... Remuneration Committees will need to ... ensure the executive experience is commensurate with that of shareholders, employees and other stakeholders." and

"Remuneration Committees and management teams should be even more mindful of the wider employee context through this period. Failure to do so may have significant reputational ramifications."

In its open letter to UK Plcs of 2 April, Schroders expressed similar views:[12]

"... in the short term, companies need to prioritise their key stakeholders, in particular employees but also customers and suppliers ... the primary focus should be on maintaining their business ... where companies seek additional capital we would expect their boards to suspend dividends, and to reconsider management's remuneration."

As did Glass Lewis:[13]

"We expect Boards to proactively seek changes that align with employee and shareholder experiences, recognising that executives might need to take a pay cut."

On 23 April, the International Corporate Governance Network (ICGN) published *Governance Priorities During the COVID-19 Pandemic*:[14]

"COVID-19 presents a new era of engagement, one which… elevates the importance of social factors as a key determinant to a company's long-term financial health and sustainability.

*We therefore respectfully submit to you the **ICGN Statement of Shared Governance Responsibilities** which broadly emphasise the need for companies to: […]*

- *Pursue a long-term view on social responsibility, fairness and sustainable value creation and publicly define a social purpose as we all adjust to a new reality;* [emphasis added]
- *Take a holistic and equitable approach to capital allocation decisions, considering the workforce, stakeholders and providers of capital;*
- *Communicate comprehensively with all stakeholders to instil confidence and trust in a company's approach to build resilience into strategy and operations."*

It is notable that the ICGN prefaces purpose with "social", distinguishable from our own Code terminology.

And a recent blog from the *Principles of Responsible Investment* team observes that *"the responsible investment community needs to step up its actions on social issues … particularly those around human and labour rights. For far too long we have ignored the modern forms of exploitation surrounding the gig economy."*[15]

In some countries, government assistance has in fact been conditioned on social or political objectives. Poland was the first country to make access to its support for large enterprises contingent on the beneficial owner's tax residence, and Denmark followed shortly after by excluding companies based "in tax havens" from accessing compensation under its aid packages. Others followed, and many are still being encouraged to. In France, Air France's rescue package has been made conditional on a 50% reduction in per passenger and per kilometre carbon omissions.[16] Austria, Canada, Japan and Hong Kong (in varying degrees) offer priority or additional assistance to companies that maintain employment or otherwise seek alternatives to redundancy.

Commentary observing the need to rewrite the social contract proliferates - in the immediate term to tackle economic hardship and more fairly share the burden, and beyond to address the inequalities laid bare. There is a call to build back in a way that differs from the economic orthodoxy of recent decades and to learn lessons from the failure to do so after the global financial crisis.

The authors are diverse. *The Times* calls for a new social contract between business, government and society, which includes proactive input from the business lobby on how to stimulate the economy and meet the increasing debt burden.[17] *Financial Times* encourages us to ride the wave of social capital that flourishes in the face of the pandemic, and to restore it in the longer term as a means to rebuild the foundations on which capitalism was built.[18] *Fortune Magazine*, in an interview with Rebecca Henderson, offers that *"reimagining capitalism is not easy or cheap"* but the pandemic has made it *"much more real to business leaders"* and driven home *"the idea that well-functioning capitalism can't exist without a strong, healthy political system and public institutions"*.[19]

Of course, there are those who offer an alternative view, particularly proponents of free enterprise capitalism who argue that companies cannot be moral arbiters and that it is wrong for business to impose views on society.[20] But if the expectation of investors and the stimulus packages offered by governments tell us anything, it is that capitalism is being encouraged to do more to bring about a better society and companies must follow suit in order to avoid revocation of their social licence to operate. This may not in fact be at odds with the free enterprise system in any case, because if the companies with the strongest purpose and social licence to operate better survive periods of instability and crises (whether through governments or investors choosing to support socially responsible companies or otherwise), stakeholders of all varieties will be more attracted to them in the future. It is notable for example, that high ESG-rated businesses and the ETFs that channel funds to them appear to have fared somewhat better in the recent weeks of market volatility.[21]

The point is that businesses are in a maelstrom of increasing expectations and uncertainties.

What now?

For companies that have enjoyed success, it has often been difficult to conceive of circumstances where the balance of interests required by section 172 of the Companies Act 2006 between shareholders with those of stakeholders has been challenging or unobvious.[22] There was a strong residual presumption that the interests of shareholders were primary and in any case there was enough left to do the necessary for other stakeholders. The pandemic has however provided a textbook example of a different equation.

Many, many companies have shown great leadership and generosity in repurposing their activities or redirecting their resources to provide essential healthcare equipment or materials or capacity, or to prioritise essential workers or the vulnerable, showing clear civic purpose.

In the business world, there has been widespread acknowledgement of the essential importance of the workforce, their safety and wellbeing, but also of their long term value to the business. Furthermore, there has been recognition of the importance of the collective behaviour of all business's representatives to all its stakeholders, which is a product of a strong culture.

These behaviours have both set, but also met, public expectations. There has been more generally a realisation that pay levels of our workforce do not equate to their value to society. What last year were described as low skilled are frequently this year's essential workers. The importance of the national workforce, the interdependencies of value creation and ordinary people, have never been so apparent. The importance of community and society, and the role of government and business in providing what is needed to survive, has also been brought home.

Yet if these recognitions are quickly de-emphasised, how will that be received in the employee and stakeholder engagements of the immediate future? Having shown the galvanising impact of purpose in business, can this be dialled down?

These issues are mirrored in public conversation. As the homelessness charity, Crisis observed:[23]

"We literally went from a target of ending rough sleeping by 2025 to doing it by the weekend. If we can do it in a pandemic, why on earth can't we do it in normal times?"

In many countries, measures to ease lockdown restrictions have included more space for cyclists and pedestrians, reversing the presumption of occupying the road margins. Air pollution and the health impacts of this have seen marked improvements. Aviation emissions and oil demand have fallen dramatically.[24] We have also seen a different experience for consumer-facing businesses that provide essential needs, aligning with stronger underlying purpose, to those that meet desires. Whilst enforced, it is notable how our focus has shifted to experience (family, place and time) rather than to consumption (shopping, restaurants and holidays).

Who knows what is reversible and what will be reversed. But if all these things feed into expectations, then those expectations will only be surrendered voluntarily, not taken away. And if the social licence to operate is built on expectations, that licence is now built on new ground.

The consequences of the lockdown have affected people in different ways. The experience of the lower paid, whether an essential worker risking health or those losing job security, has been widely noted as unequal. And the burden of the financial cost of the extraordinary borrowings incurred by government will fall primarily on the young and future generations.

As *Financial Times* observes:[25]

"Sacrifices are inevitable but every society must demonstrate how it will offer restitution to those who bear the heaviest burden of national efforts."

We can expect that those most affected will have ideas on how best the support to business and the economy should be deployed and how we go about rebuilding our society. They will voice their views.

Reputations are earned slowly and quickly lost or damaged. Good reputation and a strong social licence follow from a positive culture which is overseen by the board, runs through the organisation, and aligns with a clear purpose. The pandemic will do many things, but it will offer a lens through which to identify the businesses that meant what they said and those who were faking it; those that acted with legitimacy, credibility and trust, and those that did not.

There is little doubt that the terms of the social licence to operate, always dynamic, have stretched meaningfully and quickly over recent months and will continue to do so.

Another thing for boards to consider.

If you would like further information about this topic, please speak to your usual Slaughter and May contact.

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1 Ian Thomson and Robert G Boutilier, 'Social License to Operate' in Peter Darling (ed), *SME Mining Engineering Handbook, Third Edition* (Society for Mining, Metallurgy, and Exploration 2011) 1779.

2 United Nations, *Guiding Principles on Business and Human Rights*, 2011; and United Nations, *The Corporate Responsibility to Respect Human Rights: An Interpretative Guide* HR/PUB/12/02 1.

3 For example, *Bear Creek Mining Corporation v Republic of Peru* ((ICSID Case No ARB/14/21)); *Abengoa, SA y COFIDES, SA v United Mexican States* (ICSID Case No ARB(AF)/09/2); *Álvarez y Marín Corporación SA and others v Republic of Panama* (ICSID Case No ARB/15/14); *South American Silver Limited v Bolivia* (UNCITRAL, PCA Case No 2013-15).

4 For example, the 2018 Dutch Model BIT expressly included reference to instruments that promote responsible business practice: https://www.rijksoverheid.nl/ministeries/ministerie-van-buitenlandse-zaken/documenten/publicaties/2019/03/22/nieuwe-modeltekst-investeringsakkoorden

5 Slaughter and May (December 2019), *Stakeholder Capitalism – Update for Directors and GCs*: https://www.slaughterandmay.com/media/2537755/stakeholder-capitalism-update-for-directors-and-gcs.pdf

6 In '*Principles for Purposeful Business's, The British Academy* offers that "*the purpose of business is to solve the problems of people and planet profitably, and not profit from causing problems*": https://www.thebritishacademy.ac.uk/publications/future-of-the-corporation-principles-for-purposeful-business. And in '*British Academy Review', No.* 30 (Summer 2017), the importance was noted of developing the notion of purpose in companies which can "*simply mean the purpose of a business in terms of, for example, making reliable cars or cheap washing machines. But it can also have a more normative notion to it, in terms of the role of business in society and the obligations of business to future generations as well. Purpose has really become the flavour of the month; companies need to get a purpose*".

7 UK Corporate Governance Code 2018, Section 1, Principles A-E.

8 Covid Corporate Financing Facility (CCFF), Coronavirus Business Interruption Loan Scheme (CBILS), Coronavirus Job Retention Scheme (CJRS).

9 *The Times,* Alex Ralph (8 April 2020), *Executives 'must take pay cut too'*

10 https://www.theia.org/sites/default/files/2020-04/Letter%20to%20FTSE%20Chairs%20-%20April%202020_0.pdf

11 https://www.theia.org/sites/default/files/2020-04/Remuneration%20and%20COVID-19.pdf

12 https://www.ft.com/content/5aed1aa4-d720-43b1-b799-1dad8c506413

13 https://corpgov.law.harvard.edu/2020/04/01/glass-lewis-approach-to-governance-in-times-of-the-coronavirus-pandemic/

14 https://www.icgn.org/sites/default/files/6.%20ICGN%20Letter%20to%20Corporate%20Leaders_23%20April%202020.pdf

15 *Principles for Responsible Investment* blog, Fiona Reynolds (27 March 2020), *Covid-19: harnessing the power of collective investor action for change.* https://www.unpri.org/pri-blog/covid-19-harnessing-the-power-of-collective-investor-action-for-change/5626.article

16 https://www.reuters.com/article/us-health-coronavirus-france-economy/air-france-must-cut-emissions-domestic-flights-for-aid-minister-idUSKBN22B2EL

17 *The Times*, Jimmy McLoughlin (20 April 2020), *Business must adopt a new social contract as we reinvent capitalism.*

18 *Financial Times*, Andy Haldane (24 April 2020), *Reweaving the social fabric after crisis*; *Financial Times*, Editorial Board (3 April 2020), *Virus lays bare the frailty of the social contract.*

[19] https://fortune.com/2020/04/28/capitalism-rebecca-henderson-harvard-business-school/

[20] For example, *Financial Times,* Robert Armstrong (29 December 2019), *Warren Buffet on why companies can't be moral arbiters.* https://www.ft.com/content/ebbc9b46-1754-11ea-9ee4-11f260415385

[21] MSCI ESG Indexes during the Coronavirus crisis (22 April 2020): https://www.msci.com/www/blog-posts/msci-esg-indexes-during-the/01781235361

[22] Where a director is required to act in the way they consider, in good faith, will be most likely to promote the success of the company for the benefit of its members as a whole, having regard to the interests of various stakeholders (including the company's employees, and business relationships with suppliers, customers and others).

[23] https://www.thetimes.co.uk/article/homeless-swap-the-streets-for-hotel-suites-during-coronavirus-lockdown-kxwbv6nz2

[24] According to the International Energy Agency's Global Energy Review 2020, Global energy demand declined by 3.8% in the first quarter of 2020, with most of the impact felt in March as confinement measures were enforced in Europe, North America and elsewhere. Oil demand was down nearly 5% in the first quarter, mostly by curtailment in mobility and aviation, which account for nearly 60% of global oil demand. By the end of March, global road transport activity was almost 50% below the 2019 average and aviation 60% below. https://www.iea.org/reports/global-energy-review-2020

[25] https://www.ft.com/content/7eff769a-74dd-11ea-95fe-fcd274e920ca