Sustainable Shareholder Value: A period of enlightenment for New Zealand?

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No one would dispute that life in most business organizations was much simpler in years gone by. In reality, it was a less complex period with minimal and clearly understood expectations among the various parties (investors who put up the money to start or finance the business, owners and their employees who needed to get and keep the business running, suppliers to make the raw materials available for production, and customers who purchased the product or services). *Organizations face a much more complex state of affairs in today's society*. The recognition by the public… that today's business organization has evolved to the point where it is no longer the sole property or interest of the founder… or even a group of owner-investors has been the principal driving force behind this societal transformation.[1] (Emphasis added.)

I. Introduction

When asked about the purposes of a company, traditionally many directors would have provided two responses: it exists to *make pecuniary gain*; and it exists to *serve the interests of its shareholders*.[2] However, in recent years, a company's *proper* objective has been a moot-point between academics and members of the business and legal communities. This is because the corporate governance approach adopted to achieve a company's objective is *entirely subjective and ethical*. The concept of corporate governance is best seen in terms of a core and series of penumbras; at its core are directors' duties, meetings and shareholders remedies, and on its outskirts are a series of penumbras of hard/soft law, codes of practice and business ethics.[3] Corporate governance is best divided into two approaches that both 'hinge on the purpose of the corporation and its associated structure of governance arrangements'.[4] The narrow shareholding perspective is one of these approaches, and views the company as a legal instrument. In contrast, the other wider approach sees the company 'as a locus in relation to wider external and stakeholders' interests, merely than just

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1 Ronald Sims, Ethics and Corporate Social Responsibility: Why Giants Fall (2003) 71.

2 A company may exist to serve the interests of its shareholders, but it is well known that a company has a separate legal existence from its shareholders: *Salomon v Salomon* [1897] AC 22. This principle has been incorporated into modern New Zealand law by s 15 of the *Companies Act 1993*.

3 John Farrar, 'In Pursuit of an Appropriate Theoretical Perspective and Methodology for Comparative Corporate Governance' (2001) 13 *Australian Journal of Corporate Law* 1.

4 Steve Letza, Xiuping Sun, and James Kirkbride, 'Shareholding versus Stakeholding: A Critical Review of Corporate Governance' in *Corporate Governance: An International Review* (2004) 12 (3) 242, 243. The central place of non-shareholder stakeholders has been explicitly recognised by the OECD in the Preamble: see *OECD Principles of Corporate Governance*, 'Preamble'<http://www.oecd.org/dataoecd/47/50/4347646.pdf>11.

shareholders' wealth'.[5] Traditionally companies have been governed so as to achieve fair value for its shareholders at any cost. Yet in recent years there has been a marked shift in the particular governance approach taken. It is now one that is socially responsible to non-shareholder stakeholders, aptly named Corporate Social Responsibility (CSR).

The definitions of corporate governance and CSR are often confused; corporate governance refers to broader issues of company management practices, whereas CSR refers to only 'one aspect of an organization's governance and risk management processes'.[6] Part of the confusion stems from the fact that CSR is conceptually fluid; it does not have a precise or fixed meaning. Generically, CSR can be described in terms of a company considering, managing and balancing the economic, social and environmental impacts of its activities.[7] It can also be viewed as a continuing commitment by companies 'to behave ethically and contribute to economic development while improving the quality of life' for non-shareholder stakeholders.[8] As can be seen, CSR is a part of the wider corporate governance approach of stakeholder theory.

This paper investigates whether New Zealand needs to legislate to require a company to adopt CSR practices by considering its non-shareholder stakeholders' interests. Section 172 of the United Kingdom's Companies Act 2006 (CA 2006 (UK)), which directs company directors to consider its non-shareholder stakeholders, will be analysed as a potential model from which New Zealand can proceed. Its defects will also be accentuated with possible solutions offered as to how New Zealand would address these. Section II of this paper explores the first two of the corporate governance camps; shareholder value theory (SVT). Stakeholder theory and its various constituents are examined in section III. It will also examine the ability of stakeholder theory to achieve sustainable shareholder value. Section IV covers the genesis of the CA 2006 (UK) and the possible interpretations and defects of its s 172. The last section of this paper will examine whether New Zealand should adopt a provision similar to that of the United Kingdom and whether *locus standi* to pursue directors should be given to all the company's stakeholders.

This paper will argue that sustainable shareholder value is best achieved when a company recognises the contribution made by all of its stakeholders and not just its shareholders. It is necessary that the subjective and ethical dimensions are removed from CSR in order to ensure that sustainable shareholder value is achieved. It is only then that the number of large corporate collapses will be reduced. Directors need to be legislatively required to adopt the CSR centered approach of stakeholder theory. It is argued that this will not be a radical change for New Zealand directors, as many already informally follow a stakeholder approach. The change will simply formalise the approach taken by directors. New Zealand needs to adopt a provision similar to s 172 of the CA 2006 (UK) so that shareholder value *and* stakeholder interests are *both* sustained.

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5 Ibid.

6 Parliamentary Joint Committee on Corporations and Financial Services, Commonwealth of Australia *Corporate Responsibility: Managing Risk and Creating Value* [2006] <http://www.aph.gov.au/Senate/committee/corporations_ctte/corporate_responsibility/report/.> 2.19-2.20.

7 Ibid, xiii.

8 World Business Council for Sustainable Development, *Corporate Social Responsibility* <http://en.wikipedia.org/wiki/Corporate_social_responsibility>.

II. Shareholder Value Theory

By definition, SVT is an approach that views the primary responsibility of management to be 'to maximize shareholders return via dividends and increases in the market price of the company's shares abound'.[9] SVT requires a company to be run in a way that maximizes the interests of shareholders ahead of its other stakeholders. The theory was academically popularized in the 1930s by Berle, who argued that directors should not be responsible to any one other than the shareholders of the company.[10] Berle's view was sourced in the idea that a shareholder's investment is his own personal property. The practical use of this view in the business world was limited until the late 1970s, but has since occupied a preeminent position, particularly in the United States.[11] This section therefore considers how the nature of business changed from the 1930s to the late 1970s so that shareholder value became the preeminent approach followed. The advantages and criticisms of the SVT will also be examined with two case studies used to illustrate the failings of the approach.

A. *The Changing Nature of Business – Background*

SVT's preeminence as the preferred corporate governance approach resulted from the aggressive tactics of investment bankers, aptly named raiders, seeking to take over vulnerable companies with low share market value. The aim of these raiders was to purchase, restructure and resell vulnerable companies for a healthy profit. This aim had two tenets:[12] poorly managed companies were identified so that a simple change in strategic management would increase share value; and undervalued assets would be identified so that their hidden value could be realised. Directors were therefore pressured to remain ahead of the game because any fall in their company's share value would directly threaten their own existence.[13] Hence, SVT was employed to alleviate this threat.

Corporate incentives were also used to entice directors to make and implement decisions that led to share value maximisation. This was an attempt to align managerial interests with shareholders so that both benefited from an increase in share value.[14] Directors were quick to realise that they could make large personal gains if they focused on increasing share value. As a result, directors utilized the methods of the raiders to raise share value and prevent takeover. These methods included[15]: the removal of under-performing areas; outsourcing activity; and dismissing long-term employees. For the most part, directors were making decisions in light of whether the outcome could increase share value.

9 A Rappaport, Creating Shareholder Value: The New Standard for Business Performance (1986) 1.

10 A Berle, 'Corporate Powers as Powers in Trust' (1931) 44 *Harvard Law Review* 1049. Berle's view was criticised by Merrick Dodd, who viewed companies as economic institutions that have a social service role to play in the broader community as well as making profits for their shareholders: see Merrick Dodd, 'For Whom are Corporate Managers Trustees' (1932) 45 *Harvard Law Review* 1145, 1162.

11 However, the preeminence of SVT in the US was attenuated by the corporate constituency statutes that permit directors to consider the various interests of non-shareholder constituencies in the actions they take: Corporations and Markets Advisory Committee *The Social Responsibility of Corporations* [2006] <http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2006/$file/CSR_Report.pdf>18-23.

12 Rappaport, above n 9.

13 A Kennedy, The End of Shareholder Value: The Real Effects of the Shareholder Value Phenomenon and the Crisis it is Bringing to Business (2000) *xi*.

14 This is based on the market economy theory: individuals inherently want to promote their own interests.

15 Kennedy, above n 13 at *x*.

B. Arguments in favour of Shareholder Value Theory

Proponents of SVT view the company as a series of contracts; shareholders, by investing capital, are in a contractual relationship with the company. Directors, who manage this relationship, should therefore act for the benefit of shareholders as they are the owners of the company.[16] Shareholders expect a reasonable return on the capital they contribute as they bear the greatest risk in the company's future. This means that the company should be operated to maximise returns for shareholders. A second argument is sourced in the company's operation for pecuniary gain. It states that profit maximisation is best achieved by satisfying consumer demand,[17] which also enables directors to fulfill their fiduciary duty by ensuring shareholders gain optimal entitlements. Profit maximisation is also used to argue that most shareholders are in favour of directors implementing only SVT because it fosters economic efficiency. If directors only have to consider one group of interests, it will take much less time to make a decision. Agency theory can also be utilised to justify taking a SVT approach. Directors, being employed to run the company on behalf of the shareholders, should do so in a way that best suits shareholders' interests. Lastly, SVT is supported by the following evidence;[18] private property rights and the logic that shareholders are the owners of the company, the purpose of management being to maximise value for the capital providers, shareholder-oriented economies outperforming other economies and that a company has a higher chance of being successful if its key people have targeted outcomes to achieve.

C. Criticisms of Shareholder Value Theory

SVT has long been criticised by commentators. The focus of this criticism is largely centered on SVT's two main principles: (1) profit; and (2) risk.[19] Firstly, profit maximisation should not be centered exclusively at shareholders as it does not convey any distribution criterion between different stakeholders.[20] It is wrong to assume that just because a company's objective is to make profit that the company should be managed for the shareholders. Secondly, whilst it is acknowledged that shareholders do take some risk in providing capital to a company, they are not the only ones that make company specific investments that create vulnerability.[21] In fact, shareholders may be in a better position, as their liability is limited to any capital contributions made, and the tradeable nature of shares permits diversification.[22] Further, SVT's short-term focus 'mortgages the future of the business and in many cases has seriously damaged business.'[23] This contributes to a company's failure to maximise social wealth. Lastly, SVT's treatment of shareholders as the owners of a company is flawed. It needs to be emphasised that whilst the shareholders own shares in a company, they do not own the company due to its separate legal personality.

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16 R Grantham, 'The Doctrinal Basis of the Rights of Company Shareholders' in A Borrowdale, D Rowe, and L Taylor, L (eds), *Company Law Writings: A New Zealand Collection* (2002) 113-15.

17 Michael De Bow, and Dwight Lee 'Shareholders, Non-Shareholders and Corporate Law: Communitarianism and Resource Allocation' (1993) 18 *Delaware Journal of Corporate Law* 393, 397-98.

18 J Healy, Corporate Governance and Wealth Creation in New Zealand (2003) 54 and 58.

19 (1) That a company exists to make profit and (2) As capital providers, shareholders bear the greatest risk.

20 M Aglietta, and A Reberioux, Corporate Governance Adrift: A Critique of Shareholder Value (2005) 34.

21 For example, an employee may embark on specific training that can only be used for that company.

22 Aglietta, above n 20, 35.

23 Healy, above n 18, 53.

D. Corporate Illustrations

It is often stated by advocates of SVT that there is 'overwhelming evidence to support the view that shareholder value should be the explicit goal of all corporations'.[24] This subsection illustrates, by reference to two noted corporate case studies, the failings of attaching undue focus solely to shareholder interests.

1. *Enron*

The collapse of Enron illustrates that a company can be widely respected as a CSR practitioner and be deficient in allowing breach of fiduciary duties by its directors.[25] Enron, with its corporate culture, employee investment schemes and shareholder profits, was perceived by many to be the ideal corporation that was adopting all of 'the management norms in vogue at the time'.[26] Originally a small natural gas company, Enron grew to become involved in the United States' electricity distribution and the construction of power-plants and pipelines internationally.[27] Enron's peak share price was $90 with the company assets amounting to over $63 billion.[28] However, Enron was making losses that were covered by the manipulation of its records by auditing company Arthur Anderson. Some of Enron's top executives knew that the company was making a loss and profited substantially by selling their shares before its share price plummeted.[29] Enron was placed under bankruptcy protection, but the loss had already been suffered with its share price falling to 26 cents and 27,000 employees losing their jobs and pension plans.[30]

Enron executives' manipulation of corporate financial governance rules 'in continued pursuit of the rapid growth [policy] for which the company had become noted' was the major cause of its collapse.[31] Clearly the rapid growth policy was based on SVT and shows that any form of sustainable trading was of little importance. The focus on share value, by relying upon accounting-based performance measures, led Enron's executives to make distorted decisions. Enron's collapse illustrates the major weakness in taking exclusively a shareholder focus; it is only beneficial as a short-term approach. As a response to the failures of Enron's corporate governance, the United States enacted the Sarbanes Oxley Act 2002. In tandem with the corporate governance rules of the New York Stock Exchange, the Act aims to protect investors by 'increasing the accuracy and reliability of corporate disclosure and reporting'.[32] Critics view the Act as being ineffective and having the potential to mislead the market that regulation can solve its problems.[33]

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24 J Bughin, and T Copeland, 'The Virtuous Cycle of Shareholder Value Creation' (1997) 2 *McKinsey Quarterly Review* 3.

25 D Vogel, The Market for Virtue: The Potentials and Limits of Corporate Social Responsibility (2005) 38.

26 Aglietta, above n 20, 224.

27 D Branson, 'Enron – When all Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?' (2003) 48 *Villanova Law Review* 989, 997-99.

28 Aglietta, above n 20, 224.

29 In the year of Enron's bankruptcy, its CEO made $9.6 million and the CFO made $3 million from stock options: see Aglietta, above n 20, 241.

30 Aglietta, above n 20, 224.

31 D Campbell and S Griffin, 'Enron and the End of Corporate Governance?' in Sorcha MacLeod (ed), *Global Governance and the Quest for Justice Vol 2* (2006) 48.

32 Ibid, 51.

33 L Rebstein, 'Market vs Regulatory Response to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002' (2002) *Journal of Corporation Law* 1, 61. Rebstein further argues that markets are capable of responding more precisely than regulation to corporate fraud.

2. *James Hardie Limited*

The James Hardie Group put SVT in greater contention with its decision to restructure its affairs to a Netherlands-based company that had the coincidental effect of safeguarding it from a number of Australian asbestosis claims.[34] Prima facie, the Group exhibited CSR by establishing the Medical Research and Compensation Foundation with funds to meet all legitimate compensation claims.[35] However, the Foundation in 2003 noted the funds of the trust were inadequate to meet claims beyond 2007. The Group had made misleading statements and under-funded the Foundation by $2 billion. Despite the Group being out of Australian jurisdiction, negotiations occurred to fix the compensation that should be paid to the Foundation. Farrar suggests that the Group, by being enriched from dealing in the asbestos, 'had the capacity and moral obligation to provide funding to compensation current and future asbestos victims'.[36] The final compensation amount was approved by 99.6 per cent of the shareholder vote cast.

The Group's conduct illustrates a governance approach grounded in SVT. The statements of David Jackson QC confirm this, where he states that the Group moved jurisdictions for 'international growth and to improve the after tax returns to shareholders'.[37] Whilst the Group did exhibit CSR in favour of asbestos victims, its jurisdictional move shows that the directors placed the shareholders' interests first. The directors wanted to reap the benefits of the corporate group structure to increase shareholder value.[38] A point of interest is that, whilst the Group's directors adopted an approach based in SVT, its shareholders overwhelming favoured compensation instead of solely pecuniary gain.[39]

III. Stakeholder Theory

Deakin is of the view that there is a shift in the idea of SVT so that shareholders exercise their powers not as representatives of the market but as agents of society.[40] This view clearly embraces the approach of stakeholder theory that focuses upon the relationships that a company has with all of its stakeholders and not just its shareholders.[41] These reciprocal relationships mean that when a decision is made directors should consider its impact upon stakeholders. Stakeholder theory is not entirely distinct from SVT, as both promote the making of pecuniary gain.[42] SVT has a agency focus, whereas stakeholder theory sees the company as a community in which the directors 'act

34 Law and Bills Digest Section Information and Research Services, 'In the Shadow of the Corporate Veil: James Hardie and Asbestos Compensation' (2004) 12 *Research Note* 1.

35 E Dunn, 'James Hardie: No Soul to be Damned and No Body to be Kicked' (2005) 27 *Sydney Law Review* 339.

36 John Farrar, Corporate Governance: Theories, Principles and Practices (3rd ed, 2008).

37 D Jackson, Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation (2004) 33.

38 Dunn, above n 35, 346-48.

39 Whether this was just as a result of the media attention will remain a moot-point.

40 S Deakin, 'The Coming Transformation of Shareholder Value' (2005) 13 *Corporate Governance: An International Review* 11, 16.

41 J Androif et al, 'Unfolding Stakeholder Thinking: Theory, Responsibility and Engagement' (2002) 19.

42 It is upon the SVT's and stakeholder theory's focus that the distinction between the two is seen.

as trustees [whose] role is to balance the interests of the various stakeholders… to the benefit of all'.[43] This section therefore explores the basis of the stakeholder theory.

A. Stakeholder Classification – An Examination of the Concept

The notion of stakeholders accentuates the fact that a company's actions can affect more groups than just its shareholders.[44] The term stakeholder is fluid and it is difficult to formulate a static definition as there is limited consensus on the groups or individuals that should be included. However, a working definition for this paper is essential. Most rudimentarily, the term embraces a wide range of interests covering any individuals or groups that are impacted by the activities of a company.[45] A more specific definition is:

> The stakeholders in a corporation are the individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities, and that are therefore its potential beneficiaries and/or risk bearers.[46]

Further, the Australian Corporations and Markets Advisory Committee (CAMAC) cites an inclusive definition of a stakeholder as being:

> Those groups or individuals that: (a) can reasonably be expected to be affected by the organisation's activities, products and/or services; or (b) whose actions can reasonably be expected to affect the ability of the organisation to successfully implement its strategies and achieve its objectives.[47]

The above definitions allude to the fact that a stakeholder should at least have some interest in the company's performance. Not every stakeholder's interest is of equal value, as this will be determined by how closely connected they are with the company. The CAMAC suggests that the following groups are stakeholders;[48] shareholders, financiers, creditors and suppliers, employees and consumers, communities and pressure groups and NGO's. The main groupings are considered by the following subsections.

1. *Shareholders*

A shareholder, pursuant to s 96(a) of the Companies Act 1993 (CA 1993 (NZ)), is a person whose name is on the share register for the time being as holding one or more shares in the company. A share is the 'legal interest of shareholders in the company [being a] definite portion of share capital'.[49] A share is a form of personal property, as it is an asset of the person whose name is on the register.[50] Connected to the view of a share as an asset, is the idea that shareholders are

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43 Healey, above n 18, 61. The stakeholder approach is implemented as follows; identification of particular stakeholders in the company, the establishment of certain procedures to take those stakeholders into account and the achievement of an outcome that satisfies all stakeholders.

44 CAMAC, above n 11, 54.

45 C Mallin, Corporate Governance (2004) 43.

46 J Post, L Preston, and S Sachs, Redefining the Corporation: Stakeholder Management and Organisational Wealth (2002) 19.

47 CAMAC, above n 11, 55.

48 Ibid 55-56.

49 Susan Watson, 'Shareholders' in Susan Watson, et al The Law of Business Organisations (4th ed, 2003) 253.

50 G Walker et al, Commercial Applications of Company Law in New Zealand (2002) 20.

the ultimate owners of the company.[51] Shares, as assets, give shareholders certain entitlements;[52] dividends and a proportionate entitlement to surplus assets on solvent liquidation and the right to participate in company meetings. Shareholders can be differentiated from other stakeholders on the basis that they personally provide the company with capital and they have rights protected by statute.[53] Not every shareholder is solely concerned with the maximisation of profit. Many shareholders are attracted to socially conscious investing that involves assessing a company's social, environment and ethical conscience before investing.[54] This shows that shareholders themselves recognise that they are not the only stakeholder in the company.

2. *Employees*

The legal regulation of the employment relationship protects employees' interests in a variety of ways; equal opportunities, health and safety and protection from restructuring. New Zealand employees' interests in a company are protected by the Companies Act 1993, Employment Relations Act 2000 and the Health and Safety in Employment Act 1992. Comparatively, United Kingdom employees were protected by s 309 of the Companies Act 1985 that required company directors to balance the interests of the employees with shareholders.[55] These legislative protections are not the only source of directors' obligations to employees,[56] as employees are reliant upon being considered because their livelihood is affected by the making of any adverse decision. An employee also voluntarily contributes to a company's wealth-creating capacity by providing labour and will benefit from its success through job security and pay increases. Not every employee has an equal stake in the company: it is dependent on the position that they hold within the company. However, directors do need to remember that every employee does play some part in its day-to-day operation.[57] A director's failure to recognise this could cause unnecessary cost to the company, as the typical modern employee is more mobile, less loyal and is not prepared to put up with being ill-treated.[58] This is in contrast with Japan, where employment in a Japanese company is largely considered to be a lifetime commitment. Japanese employees are therefore akin to an asset for the company and occupy an important position within the company. While employees are not the owners of their company, 'Japanese companies are run for the benefit of employees'.[59]

51 Ibid. However, Grantham suggests that there has been a steady weakening of this position to the extent that the 'ownership model was no longer appropriate': See Grantham, above n 16, 135.

52 Watson, above n 49; Walker, above n 50.

53 In New Zealand, shareholders are protected by the *Companies Act* 1993*,* the *Securities Act* 1978 and the *Securities Market Act* 1988.

54 C Harrington, 'Socially Responsible Investing: Balancing Financial Needs with a Concern for Others' (2003) 195 *Journal of Accountancy* 1, 52.

55 It has been said that s 309 provided no enforceable benefit to employees as there was no specific remedy available for its breach. This provision is now superseded by s 172 of the Companies Act 2006: Charles Wynn Evans, 'The Companies Act 2006 and the Interests of Employees' (2007) 36 *Industrial Law Journal* 1, 190.

56 Ibid 188.

57 J Du Plessis, J McConvill, and M Bagaric, Principles of Contemporary Corporate Governance (2005) 21.

58 Mallin, above n 45, 80.

59 H Kanda, 'Comparative Corporate Governance Country Report: Japan' in Klaus Hopt et al, (eds) *Comparative Corporate Governance* (1998) 938. This does not mean that shareholders interests are totally subordinated or disregarded.

3. *Creditors/Suppliers*[60]

Creditors and suppliers, whose primary focus is on making profit, form a vital part of the relationship networks of a company, as they willingly and voluntarily provide credit or supply goods. In exchange, these stakeholders benefit from the success of the company through demand for their products or services. The fact that these stakeholders are voluntary does not mean that directors should not consider their interests. A decision to wind up the company or terminate a creditor's contract may have a detrimental impact, as the supply of goods or services may amount to a significant part of their commercial activity. However, a New Zealand director's consideration of these stakeholders does need to be reconciled with the requirements of ss 135 and 136 of the CA 1993 (NZ).[61]

4. *The Community*[62]

A company has a large impact on the community in which it operates. As a company will usually employ large numbers of the community, its financial failure means that people will have to move away from the area to gain jobs.[63] When in financial trouble, a company can be wound up due to financial necessity or it can be restructured. The former necessitates a decision without extensive consultation with the community, but the latter permits a director to consider the community's interests. The community's right to be considered comes from the assistance given to the company in its commercial success.[64]

5. *The Environment*[65]

The environment, as an involuntary stakeholder, is a major contributor to the economic performance of a company by supplying 'corporations with raw materials and [by]… assimilating the wastes that are inevitably produced in economic activity'.[66] As such directors need to consciously consider the environment because it does not have a voice or cannot generally be given a direct financial stake in the company.[67] Hence, environmental pressure groups and government regulations that regulate environmental damage are of the utmost importance. The environment as a stakeholder has been emphasised in the Australian Company Codes of Conduct and Ethics that have become a part of its corporate governance arrangements.[68]

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60 When describing the place of creditors as stakeholders in a company Mallin identifies two categories; those that supply credit and a company's suppliers: See Mallin, above n 45, 23.

61 Although s 169(3) of the Companies Act 1993 (NZ) states that these duties are owed to the company, they were clearly intended as a protection for creditors' interests.

62 The reference to the community grouping does not refer to the whole of society, rather just the local community surrounding the company.

63 Mallin, above n 45, 25.

64 Examples of directors' decisions to close down companies include Bendon in Te Aroha and Toyota in Thames. The Toyota case is an example of a company being socially responsible of its own volition.

65 The term environment does not only include the natural surroundings but the various domestic and international environmental lobby groups: Mallin, above n 45, 46.

66 M Jacobs, 'The Environment as Stakeholder' (1997) 8 *Business Strategy Review* 25.

67 Ibid, 27.

68 Du Plessis, above n 57, 26.

B. Stakeholder Theory and Sustainable Shareholder Value

Stakeholder theory improves a company's efficiency, profitability, competition, and sustainability. When directors consider every stakeholder, the company will not only be sustainable in general, but it will also achieve sustainable shareholder value (SSV). Whilst corporate sustainability and SSV are distinct,[69] they are linked by stakeholder theory. Corporate governance is now firmly geared towards stakeholder theory and SSV. This is evidenced by the OECD Principles of Corporate Governance, which state that a company's corporate governance framework should encourage active coordination between corporations and stakeholders in creating wealth, jobs, and sustainability of financially sound enterprises.[70] These recognise that stakeholder interests enable sustainability to become an essential part of business conduct. Whilst SVT can be justified from an economic perspective, as profits are what inherently drive a company, a company's legitimacy really depends on its ability to meet the expectations of a diverse range of stakeholders.[71] A company should now be regarded as 'an organisation engaged in mobilizing resources… to create wealth and other benefits for its multiple… stakeholders'.[72] Prima facie, the United Kingdom has gone some way to recognising the prominence of stakeholder theory by enacting s 172 of the CA 2006 (UK) which states the director's duty to promote the success of the company.

IV. The Companies Act 2006 (UK)

The CA 2006 (UK), which contains about 1,300 sections, is a comprehensive treatment of United Kingdom company law. The CA 2006 (UK) includes in its statement of directors' duties, what purports to be the objective of a modern company. This objective is found in s 172(1), which gives directors a degree of direction as to the interests they should consider in their business decisions. Section 172 promotes the pursuit of sustainable shareholder value by 'encouraging wider consideration by directors of the context and consequences of their decision making power'.[73] This section therefore canvasses the genesis, the policy and the principles of the CA 2006 (UK) in order to understand how the United Kingdom reformed its company law legislation. The possible enforcement, interpretations, and defects of s 172 will also be considered for the purposes of assessing the provisions effectiveness.

A. Background to the Companies Act 2006 (UK)

The enactment of the CA 2006 (UK) was drawn-out with the Company Law Review being established in March 1998.[74] The review was conducted by a committee, known as the Company Law Review Steering Group (CLRSG), being made up of eminent company lawyers and business people. The CLRSG submitted its final report in July 2001 that sought to identify the principles that

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69 Corporate sustainability focuses on contributing to the economic, environmental, and social development of the communities in which a company operates; whereas SSV focuses more on the long-term benefit of maintaining shareholders investments.

70 K Hopt, 'Preface' in OECD, above n 4. Further, the OECD provides the principles that are to be implemented for this to be achieved: OECD, above n 4, 46-48.

71 Post, above n 46, 9.

72 J Garten, The Mind of the CEO (2002).

73 Wynn-Evans, above n 55, 193.

74 A Steinfeld et al, Blackstone's Guide to the Companies Act 2006 (2007) 1.

company legislation should embody.[75] The CLRSG stated that[76] directors' duties should be clear and accessible; company legislation had to be enabling rather than prescriptive, operate efficiently and recognise the modern asset mix of companies and enhance international competitiveness. Further, the CLRSG stated that company law needs to be based on the 'enlightened shareholder approach',[77] as it achieves better wealth generation and competitiveness.[78] This view, which is the basis for s 172, represents a hybrid between SVT and stakeholder theory.[79] Hence, the CLRSG made three recommendations:[80] (1) more focus on the private company; (2) *that corporate governance be improved*; and (3) the need for institutional structures.

In response to the recommendations, the government drafted two White Papers in 2002 and 2005 that included 'much of the Bill that was eventually brought forward'.[81] The 2005 paper contained two proposals based on the CLRSG's report:[82] the inclusion of other constituencies in the directors' duties and the introduction of corporate constituency reporting. The Company Law Reform Bill was introduced in November 2005 and after protracted debate received the Royal Assent on 8 November 2006. It will come into force in stages: the first was on 1 January 2007. The following objectives underpin the CA 2006 (UK); the enhancement of a long-term investment culture, the need for ensuring better regulation and a Think Small First approach, making it easier to set up and run a company, to provide flexibility for the future and to promote the themes of accessibility, transparency, and deregulation.[83]

2. *Section 172 of the Companies Act 2006 (UK)*

The enactment of s 172 followed the CSR debate that had been raging in the United Kingdom.[84] Section 172(1) requires directors to have regard to several matters when considering the promotion of the company's success 'for the benefit of its members as a whole'.[85] It is noted that a director only has to have regard to the non-exhaustive list of relevant factors, which means that they must give the matters appropriate weight but need not act with the aim of furthering them. In other words, a director's decision need not be dictated by the matters in s 172(1)(a)-(f) if that 'is not, in his [or her] good faith opinion, appropriate for the purpose of promoting the success of the company as a whole'.[86] A factor of particular interest is in s 172(1)(a): the long-term consequences of any decision. The CA 2006 (UK) does not define what is mean by long term and does not give

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75 For present purposes only the guiding principles in relation to directors' duties are relevant.

76 Justice Mary Arden, 'Companies Act 2006 (UK): A New Approach to Directors' Duties' (2007) 81 *Australian Law Journal* 162, 64.

77 This approach is similar to the concept of sustainable shareholder value mentioned above.

78 Arden, above n 76, 165.

79 This view proceeds on the basis that a company's success occurs by maximising relationships with stakeholders and acknowledging the dominance of shareholder interests.

80 Arden, above n 76, 165. The third recommendation was not accepted by the government.

81 Above n 74, 1.

82 A Dignam, 'Lamenting Reform? The Changing Nature of Common Law Corporate Governance Regulation' (2007) 25 *Company & Securities Law Journal* 293, 292.

83 Above n 74, 3-4.

84 With cases of corporate fraud and New Labour's adoption of stakeholder arguments: Farrar, above n 36.

85 Subsection 172(2) of the CA06 deals with the situation where a company exists for purposes other than the benefit of its members, such as a charitable company. In such a situation, the reference in s 172(1) to promoting the success for the benefit of its members as a whole is replaced by achieving those other purposes: see above n 74, 85.

86 Arden, above n 76, 168.

any guidance as to how far into the future a director's consideration must go. It would be very difficult to impugn a director's decision on this ground. Lack of guidance is an inherent weakness of s 172(1), as it sets out factors for directors to regard, but fails to give any guidance as to the form that this regard should take and what they must do in order to comply.[87]

Another factor of interest is that creditors are not explicitly mentioned in s 172(1).[88] However, the creditor constituency may be covered by the catch-all term 'others' in s 172(1)(c). The reason as to why creditors are not mentioned is that they are protected from situations where they are most vulnerable by s 172(3).[89] Section 172(3) states that the new duty of loyalty is subject to any enactment or rule requiring directors to 'consider or act in the interests of creditors'.[90] No guidance is given as to what rule or enactment will limit the application of s 172(1).[91] Therefore, whilst a director owes a fiduciary duty of loyalty to promote the success of the company,[92] its effect is limited as it may be displaced by the company becoming insolvent.

Prima facie, by enacting s 172 the United Kingdom is moving from SVT to a strict application of stakeholder theory. Section 172 does bear some similarities with the United States constituency statutes that were introduced to prevent SVT's harsh effects.[93] However, these statutes authorize the directors to consider the interests of other stakeholders, whereas under s 172(1) they are obliged to have regard to the factors in (a) to (f). Section 172(1) does not amount to a true stakeholder provision, as it does not state how much weight a director should attach to the factors, which means that directors could simply pay lip service to the factors. The United Kingdom government clearly wished to retain a 'shareholders first' interpretation and not elevate the other stakeholders to a position of equality. This is made clear where the Australian CAMAC states that s 172 makes it clear that directors owe fiduciary duties only to shareholders rather than to a range of interests groups.[94]

It is unclear whether there will be an increase in the number of board decisions challenged for failure to have regard to the requisite factors of s 172. It seems unlikely that there will be any significant change, as s 172 implicitly suggests that directors only have to have regard to the relevant factors in (a)-(f).[95] Section 172 is a subjective provision, for it gives the directors the discretion to decide what factors are to be considered and how much weight to attach to them. This is consistent with the business judgment rule that the Courts will not override the views of commercial actors unless they are satisfied that the particular actor has conducted themselves so unreasonably in comparison to the standards of other *reasonable* actors.[96] An increase in challenges will be

87 Parliamentary Joint Committee, above n 6, 55.

88 Although one potential category of creditor (suppliers) is mentioned.

89 Another reason is that by giving creditors the right to be considered it would be giving them additional legislative rights on which to rely when proceeding against directors. This could mean that creditors simply rely on the section in order to attach liability to directors.

90 This provision is a clear reference to case law that has developed in the United Kingdom and Australia that provides that if the company is in some form of financial difficulty they must consider its creditors: A Keay, Company Directors' Responsibilities to Creditors (2007) 151.

91 Above n 74, 85.

92 Arden, above n 76, 167.

93 Section 172(1) can also be usefully compared with section 2.01 of the American Law Institute's Principles of Corporate Governance: Analysis and Recommendations, Farrar, above n 36.

94 CAMAC, above n 11, 103-07.

95 Above n 74, 85.

96 The test is objective and remains one of good faith in the context of business judgments.

unlikely because non-shareholder stakeholders are not given a right of enforcement. Shareholders are the only stakeholders that are given *locus standi* to take an action under the CA 2006 (UK). Section 260(1) gives shareholders the right to bring derivative proceedings in 'respect of a cause of action vested in the company'.[97] Section 178(2) states that the duties in ss 171-177 are enforceable like any fiduciary duty owed by a director. If directors breach s 172(1), members could seek to take action on behalf of the company.[98] Section 263 sets out the requirements for applying for leave to commence proceedings.[99] The requirement that is of most relevance is whether the Court is satisfied that a person acting in accordance with s 172 would not seek to continue the claim.[100] Section 172 is therefore an important provision within the entire scheme of the CA 2006 (UK).

The above interpretation illustrates that directors, under s 172, will be more inclined to consider the interests of shareholders above those of non-shareholder stakeholders. This is because shareholders are the only ones that can pursue them in Court for breach of the duty.[101] The approach fostered by s 172 sounds surprisingly similar to the main objective of SVT: shareholder wealth maximization. As non-shareholder stakeholders are not given the *locus standi* to bring proceedings against directors, s 172 is therefore merely an empty and toothless provision that only pays lip service to stakeholder theory. In order to truly embrace stakeholder theory, New Zealand would need to significantly revise and amend s 172 of the CA 2006 (UK).

V. A Similar Stakeholder provision for New Zealand

Two commentators have suggested that the United Kingdom 'appears to be setting out on a third way that merges elements of the shareholder and stakeholder approaches'.[102] At first glance s 172 does seem to embrace both approaches, but it should not be referred to as an exemplar of convergence in corporate governance theories. In fact, by not giving its non-shareholder stakeholders the *locus standi* to proceed against directors, s 172 is more akin to SVT. However, the United Kingdom is to be praised for enacting a provision that gives the appearance of embracing aspects of stakeholder theory.[103] A provision like s 172 gives the following benefits; it gives directors legislative permission to look at interests other than short-term shareholder interests, it permits directors to focus on long-term interests, which may be the favoured approach of some investors[104]

97 Section 260(3) states that a cause of action vests in the company where there is a breach of duty by the directors of the company.

98 In reality there are only a few situations where a shareholder would bring an action under this provision: where the shareholder invested for the long term and they feel as though the directors are only concentrating on the short term; where shareholders are also members of other stakeholder groups; or where a shareholder has concerns wider than his/her own interests and feels obliged to take proceedings. But even if proceedings were commenced a director could argue that they acted in good faith and believed that what he did promoted the success of the company for the benefit of its members a whole.

99 Leave will be granted where a prima facie case is made out.

100 Similarly under s 262, the Court in weighing its decision will consider the importance a person acting in accordance with s 172 would attach to continuing the claim.

101 However, there is the possible option of other stakeholders buying shares in the company so as to be gain *locus standi* and be entitled. The Court would still need to grant leave for this action.

102 C Williams, and J Conley, 'An Emerging Third Way? The Erosion of Anglo-American Shareholder Value Construct' <http://www.papers.ssrn.com/so13/papers.cfm?abstract_id=632347> 4.

103 The appearance comes from the requirement that directors have regard to wide-ranging interests.

104 This is particularly true of the shareholders who now adopt a socially conscious approach to investment: see III.A.1 above.

and it does not require directors to balance the interests of stakeholders.[105] New Zealand needs to consider adopting a similar provision to s 172 to ensure that it 'sets out on its own unique third way'[106] by giving the impetus to companies to achieve sustainable share value.

Whilst it is argued that New Zealand should adopt a similar provision to s 172, it is interesting to note that Australia, a country with comparable corporate law to New Zealand and the United Kingdom, firmly rejected the idea. Firstly, the Parliamentary Joint Committee on Corporations and Financial Services did adopt the SSV model as its preferred approach to directors' duties, but rejected the idea of similar legislative amendment. The Committee stated that s 172(2) created uncertainty as the provision gave no guidance to directors, the duty to have regard to the various interests created uncertainty and a tick box mentality to corporate governance would be created rather than a meaningful approach. Secondly, the CAMAC followed suit by stating:

> [A] non-exhaustive catalogue of interests to be taken into account serves little purpose for directors and affords them no guidance on how various interests are to be weighed, prioritised and reconciled… The Committee considers that… to require or permit directors to have regard to certain matters or the interests of certain classes of stakeholders, could in fact be counterproductive… In doing so, *could make directors less accountable to shareholders without significantly enhancing the rights of other parties*.[107] (Emphasis added.)

Both of the Australian Committees saw the fact that s 172 provides little guidance on what directors must do to comply as a major defect. The Committees were also of the opinion that the existing Corporations Act 2001 already permitted directors to have regard to the interests of stakeholders.[108] New Zealand's position is fundamentally distinct from Australia's. New Zealand's CA 1993 (NZ) is 'already looking dated with a number of gaps'[109] whereas Australia's corporate reform occurred at the turn of the century.

The CA 1993 (NZ) seems like the most appropriate framework for New Zealand's stakeholder provision.[110] It could take the form of an amendment to s 131 or could, following the United Kingdom, be included as a separate directors' duty. But does the policy of the CA 1993 (NZ) reconcile with what a stakeholder provision is trying to achieve or is separate legislative enactment required? One of the purposes of the CA 1993 (NZ) is to 'reaffirm the value of the company as a means of achieving economic and social benefits'.[111] This would appear to suggest that the CA 1993 (NZ) is geared directly in favour of benefiting different stakeholders. However, Farrar suggests that the CA 1993 (NZ) 'recognises the company as an important social institution yet is based on somewhat conservative ideas about its role in society'.[112] It is acknowledged that

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105 It is argued that if it was mandatory for directors to balance the interests of those involved in a company, they could use this to mask making decisions to their advantage.

106 Williams, above n 102. This would put New Zealand back into the forefront of corporate governance, as in recent years it has been lagging behind.

107 CAMAC, above n 11, 111-112.

108 Above n 6.

109 Farrar, above n 36.

110 The idea of having a stakeholder requirement in New Zealand legislation is not novel. Section 4 of the *State Owned Enterprises Act* 1986 states that the objective of a State Owned Enterprise is to operate as a successful business by being: as profitable and efficient as comparable businesses that are not owned by the Crown; a good employer; and an organisation that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates.

111 *Companies Act* 1993.

112 Farrar, above n 36.

this is true, as the CA 1993 (NZ) did increase shareholder rights and remedies and did not create rights for non-shareholder stakeholders against directors.[113] However, this does not mean that the CA 1993 (NZ) needs to retain its adherence to conservative ideas. The whole point of legislative amendment is to keep abreast of changes that occur in modern society.[114] It is only then that New Zealand can keep pace with the rest of the fast-moving corporate governance world.

It is then necessary to consider what form New Zealand's stakeholder provision would take within the CA 1993 (NZ). Three options appear to exist:[115] (1) inclusion of the provision within s 131; (2) the expansion of the category of entitled persons; or (3) a separate duty to promote the success of the company. Section 131 is a loose duty that states a director must act in good faith and what the director believes to be in the best interests of the company. The question then becomes just whose interests are caught by the phrase the company's best interests: stakeholders or just shareholders?[116] At first glance, stakeholders may be encompassed within the duty. However, the CA 1993 (NZ) gives no guidance as to what interests should be considered by a director whilst acting in the company's best interests,[117] as it is an essentially a subjective business decision with which the Courts are reluctant to interfere. This means that it is incredibly difficult for any stakeholder to take an action against a director for failing to act in the company's best interests. If New Zealand were to proceed with the first option it would run into the toothless problem encountered by s 172(1), as s 169 of the CA 1993 (NZ) states that a director's obligations are owed to the company and its shareholders.[118] The third option, whilst giving New Zealand a new stakeholder provision, would have the same *locus standi* problem. As seen from the defects highlighted in section IV.2 the provision would need to include;[119] legislative guidance as to how directors are to consider the interests of non-shareholder stakeholders, the appropriate weight to be given to each stakeholder, including how to reconcile a conflict of interests, a requirement for consultation where time is not of the essence and, most importantly, a resolution on the issue of *locus standi*.

The *locus standi* problem with the first and third options is similar to that faced by the United Kingdom. New Zealand needs to establish a mechanism that enables non-shareholder stakeholders to take action against a director for failure to consider their interests. This mechanism can be created by expanding the definition of entitled persons in s 2 of the CA 1993 (NZ). Section 2 states that an entitled person is a shareholder; and a person upon whom the constitution confers any rights and powers of a shareholder. This definition is linked to ss 164, 170 and 174, all of which allow the entitled person to initiate an action against the company directors. The definition needs

113 S Watson, 'Nature of a Corporate Entity' in S Watson et al, *The Law of Business Organisations* (4th ed, 2003) 97.

114 Indeed, if any amending stakeholder provision does not fit within the scheme of the Companies Act 1993 (NZ), then it may be that New Zealand needs to revise its entire company law legislation.

115 However, there is the option that separate stakeholder legislation could be enacted, if the changes recommended by this paper are too unworkable. But even then the legislation will have to be drafted so as to make it enforceable, so New Zealand is simply better off working with existing company legislation.

116 See A Butler, 'Fiduciary Law' in Butler et al Equity and Trusts in New Zealand (2003) 398-400.

117 The New Zealand position is still too unsettled but Heydon is of the view that 'directors owe duties to the company, even though in fulfilling them it may be proper to take into account the interests of shareholders… employees and persons who have contracted or may contract with the company': D Heydon, 'Director's Duties and the Company's Interest' in P Finn, (ed), *Equity and Commercial Relationships* (1987) 134-35.

118 Therefore non-shareholder stakeholders are not given *locus standi* under the *Companies Act* 1993 (NZ).

119 It needs to be emphasised that this paper recognises the danger of over-legislating so as to create a rigid business environment and therefore advocates only a limited amendment. The provision should give only sufficient principles to guide the Courts; flexibility is to be the key here.

to be extended so as to include people or groups who are affected by the actions of the company. In doing this the reciprocal relationship that exists between a company and its different stakeholders is acknowledged. It is necessary to place qualifications on this extension so as to not impose unreasonable requirements on directors. It would be necessary for the stakeholder, in order to qualify, to show that he has a significant stake in the company.[120] New Zealand should therefore adopt both the second and third options of having a new stakeholder provision based on s 172 and resolve the *locus standi* issue by expanding the definition of entitled persons.

The disadvantages of having such a provision can be easily refuted. Firstly, one may argue that giving *locus standi* to other stakeholders will create a flurry of litigation against company directors. This disadvantage will not eventuate, as, not only will the Court require a high threshold, but most stakeholders will not be able to satisfy the financial requirements of bringing an action against the directors. Additionally, it is also possible for a company under the CA 1993 (NZ) 'to insure against and agree to indemnify a director for all but criminal liability'.[121] Secondly, the business community would argue that the substitution of a director's business judgment with the view of a judge, who has little or no commercial experience and sits retrospectively, is wrong. This fear is needless, as the Courts will only intervene where it is patently obvious that no reasonable director would have acted in a similar fashion. The aforementioned high threshold would also assist in this regard. Thirdly, there is the issue of how to reconcile the often-conflicting interests of the different stakeholders. As already mentioned, the new provision could be drafted to attach different weight according to the importance of the groups,[122] or to give the Courts the discretion to decide which group is likely to feel the most impact on the facts of the case. Lastly, it may be argued that the new provision ignores that a company owes a primary duty to the shareholder and that it exists to make pecuniary gain. This is not the case, as the provision would emphasise that a company exists within a matrix where its actions have a much wider impact than simply on its shareholders. It would let the company pursue its own interests in a manner that recognises that it acts within an interdependent society. Such a stakeholder provision is the only way that sustainable shareholder value can be achieved for New Zealand companies.

VI. Conclusion

New Zealand company law currently gives no direction to its directors as to what stakeholder groups they should consider when making a decision for the company. It is a decision that is simply left to the director and the outcome will largely depend upon whether he/she takes a SVT or stakeholder theory approach to corporate governance. As a modern company's actions impact upon a variety of groups this is not a satisfactory position for New Zealand. It leaves the non-shareholder groups feeling unsure about how a company's decision may affect them. It is therefore necessary for New Zealand to legislatively require its directors to take a stakeholder theory approach to corporate governance. It is only then that non-shareholder stakeholders can be confident that their interests and the contributions they make will be considered. This will in turn achieve sustainable shareholder value for the company, as the fostering of healthy relationships

120 For example, creditors/suppliers would have to show that the supply of goods or services to a particular company amounts to a significant part, say 40-60%, of their business.

121 Watson, above n 113, 97.

122 But then the issue becomes which groups interests are to be accorded primacy. It is therefore better that this is determined by the Courts on a case-by-case basis.

between the company and stakeholders will not only see loyal employees, satisfied creditors, a prosperous community and an unpolluted environment, but will give shareholders significant returns on their investments.

In New Zealand's search for the form that the stakeholder provision could take, it should look to the United Kingdom's recently enacted s 172. However, New Zealand should utilise this provision only as a basic starting point, as whilst it may appear to move the United Kingdom from SVT and closer to a stakeholder approach, it retains predominantly a shareholder focus by not giving non-shareholder stakeholders the *locus standi* to proceed against directors. The New Zealand stakeholder provision should seek to remedy the defects of s 172 by providing directors with legislative guidance as to how to consider other stakeholder interests, requiring consultation and providing a basis from which non-shareholder stakeholders can proceed against directors. It is proposed that a new stakeholder duty be formulated and the definition of entitled person be expanded so that non-shareholder stakeholders can bring an action for breach of the provision. It will formally recognise that a modern company's objective is no longer grounded exclusively in SVT but exists to benefit all those who be classified as stakeholders. A statement by the Australian Stock Exchange's Corporate Governance Council seems to sum up the underlying basis for New Zealand's need for a stakeholder provision:[123]

> To be successful, *companies need to have regard to their legal obligations and the interests of a range of stakeholders* including shareholders, employees… creditors, the environment and the broader community in which they operate. It is important for companies to demonstrate their commitment to appropriate corporate practices and decision making. (Emphasis added.)

This statement may indeed be prophetic as far as New Zealand's 'setting out on a third way'[124] to develop an authentic stakeholder provision is concerned.

123 Farrar, above n 36.

124 Williams, above n 102.