WARWICK
THE UNIVERSITY OF WARWICK

Manuscript version: Author's Accepted Manuscript
The version presented in WRAP is the author's accepted manuscript and may differ from the published version or Version of Record.

Persistent WRAP URL:
http://wrap.warwick.ac.uk/183499

How to cite:
Please refer to published version for the most recent bibliographic citation information. If a published version is known of, the repository item page linked to above, will contain details on accessing it.

Copyright and reuse:
The Warwick Research Archive Portal (WRAP) makes this work by researchers of the University of Warwick available open access under the following conditions.

Copyright © and all moral rights to the version of the paper presented here belong to the individual author(s) and/or other copyright owners. To the extent reasonable and practicable the material made available in WRAP has been checked for eligibility before being made available.

Copies of full items can be used for personal research or study, educational, or not-for-profit purposes without prior permission or charge. Provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page and the content is not changed in any way.

Publisher's statement:
Please refer to the repository item page, publisher's statement section, for further information.

For more information, please contact the WRAP Team at: wrap@warwick.ac.uk.

Integrating Sustainability into Corporate Governance

Andrew Johnston

Christopher Bruner and Marc Moore (eds), A Research Agenda for Corporate Law (Edward Elgar 2023) (Forthcoming)

INTRODUCTION

For a long time, corporate governance focused on ensuring that shareholder interests took priority, with sustainability considerations relegated to the voluntary realm of corporate social responsibility supported by mandatory non-financial reporting. As climate change becomes more visible on a daily basis, there is growing recognition that companies must contribute to sustainability, bringing economic activity into line with the planetary boundaries on which life depends and the social boundaries that provide acceptable human outcomes.[1] A growing body of research, some of which is surveyed in this chapter, explores some of the ways in which companies are being, and might be, steered in that direction.[2]

The primary sticking point has been who should decide on matters of sustainability, and what contribution (if any) the law should make to channelling that decision-making. Corporate governance has gradually drifted towards recognising that sustainability is one of its concerns, but, both in the policy world and the academic literature, we are a long way from consensus as to exactly where sustainability stands in relation to shareholder primacy, which retains its totemic position in many analyses.

In essence, there are three ways in which social costs can be governed, bringing economic activity into line with the sustainability imperative: the firm, the market and the law.[3] Taking these in reverse order, conventional approaches insist that the problem of unsustainability should (and can) be dealt with by law (in the form of instrumental regulation or tax), leaving corporate governance free to focus on shareholder value and holding managers accountable to shareholders. An important role is also reserved for market forces. Indeed, the corporate governance system seeks to harness market forces in various ways, whether through requiring companies to 'comply or explain' in relation to a corporate governance code, allowing capital markets to express their views on a company's governance arrangements, or through various forms of non-financial disclosure, allowing those who interact with companies in various markets to adjust their dealings accordingly. The underlying assumption appears to be that, provided information asymmetries are addressed, markets will cure their own failures and push companies, in their quest for success, towards a level of sustainability that matches societal

[1] M Leach, K Raworth, and J Rockström, 'Between Social and Planetary Boundaries: Navigating Pathways in the Safe and Just Space for Humanity' (2013) World Social Science Report 2013: Changing Global Environments, Chapter 6 <https://doi.org/10.1787/9789264203419-10-en>.
[2] For a thorough overview of the current state of play, see B Sjåfjell and CM Bruner (eds), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (CUP 2019).
[3] With apologies to Ronald Coase whose works are collected as *The Firm, the Market, and the Law* (University of Chicago Press 1988).

expectations.[4] This is the business case for sustainability, the endlessly discussed 'win-win' scenario in which companies become successful by gaining a good reputation, and regulators do little more than mandate appropriate information disclosure.[5]

The last and most controversial solution, but arguably the one with the most potential, is to use the firm itself to govern sustainability. Managerial discretion lies at the heart of company law, reflecting the firm as an alternative to market forces in allocating resources.[6] This discretion is certainly capable in principle of encompassing sustainability considerations, and greater reliance on it would arguably lead to decisions being made by better informed actors, at lower cost and closer to the economic activity that must be made sustainable. Yet any suggestion that management should decide how far sustainability is to be integrated into company decision-making runs counter to the social norm of shareholder primacy, which insists that managerial discretion should be used only for the benefit of the shareholders. As such, conventional accounts claim that sustainability should only be taken into account by management if this is likely to produce better outcomes for shareholders (back to 'win-win'), with market forces policing those decisions, and the market for corporate control ready to kick in if there is too much profit sacrifice.

Rejecting the assumption that the only purpose of firms (and companies) is to produce shareholder value, a developing field of research has begun to explore how reforms to company law and corporate governance might steer companies towards paying greater attention to sustainability issues. Beginning from the perspective that regulation often fails or is absent, and that shareholders are unlikely to demand outcomes that differ significantly or meaningfully from short-term shareholder value, this research views managerial discretion as an important – and perhaps even the best – way of integrating sustainability into company decision-making. The question is what legal interventions are required to ensure that this happens whilst preserving managerial accountability. Recent contributions have explored whether it is best achieved by a legally binding corporate purpose, by reforms to directors' duties and company law enforcement or by procedural regulation that structures decision-making and seeks to elevate sustainability as a corporate priority. All of these approaches (discussed in the final section of this chapter) seek to balance integration of sustainability with continued managerial accountability.

This chapter is structured as follows. I begin by exploring the conventional approach, which is highly resistant to integrating sustainability into company decision-making, insisting that conventional regulation is the only way to solve the problem. I then probe claims that shareholders and market forces will pressure corporate management to integrate sustainability into their decisions. After that, I examine the argument that sustainability considerations can already be taken into account under mainstream company law; essentially the business judgement rule is broad enough to allow this to happen. The problem, however, is that the corporate governance system (and the social norm of shareholder primacy) creates significant pressure for companies to focus on shareholder returns. Finally, I look at a number of proposals

---

[4] This is certainly the assumption underlying ISO 26000. For an overview, see A Johnston, 'ISO 26000: Guiding Companies to Sustainability through Social Responsibility?' (2012) 9(2) European Company Law 110-17.
[5] This is particularly true of the UK approach. See A Johnston, 'Market-led Sustainability Through Information Disclosure: the UK's Approach' in B Sjåfjell and CM Bruner (eds) (n 2).
[6] R Coase, 'The Nature of the Firm' (1937) 4(16) Economica 386-405.

designed to steer corporate management towards integrating sustainability into their decision-making. The most credible proposals here rely on procedural regulation, taking care to ensure that the outcome is not managerial unaccountability. A brief conclusion follows.

RESISTANCE TO INTEGRATING SUSTAINABILITY AND RELIANCE ON CONVENTIONAL REGULATION

In the most regressive cases, arguments that sustainability should be integrated into corporate governance are simply caricatured as part of the 'stakeholding' agenda. The distance between 'enlightened shareholder value', where directors and managers take account of stakeholder interests as a means to the end of shareholder returns, and taking account of stakeholders where there is a business case for doing so is at most vanishingly small.[7] Nevertheless, this false dichotomy allows scholars who support shareholder primacy to fall back on the 'classic argument' that anything that reduces managerial accountability to shareholders would not only 'increase slack and hurt performance' but also might raise false hopes that corporate executives would protect stakeholders.[8] Strongly opposed to a 'managerialist agenda' and to 'obscur[ing] the critical need for external interventions to protect stakeholders via legislation, regulation and policy design', those writing in this vein claim that stakeholding is simply the release of self-serving management from the hard fought-for constraint of shareholder accountability, and 'should not be expected to deliver the hoped-for stakeholder protections'.[9] Bebchuk and Tallarita's work is a recent classic of this genre. Writing for close to one hundred pages, and avowing concern for 'a world on fire', they repeatedly claim that the only way to solve the sustainability issue is through legislation and regulation. Yet they apparently lack the space to describe the sustainability-driving legislation and regulation they have in mind beyond a claim that 'various laws, regulations, and policies aimed at protecting stakeholders are already in place; for example, reforms aimed at combating climate change or protecting consumers have been adopted in the past decade'.[10] This rhetorical sleight-of-hand also allows them to avoid examining or engaging with the substance of proposals, discussed in the final section of this chapter, to use procedural regulation to drive the integration of sustainability into corporate decision-making.

For those writing in this tradition, Milton Friedman's 1962 demands either have been, or could be, met: government is supposed to set, arbitrate, and enforce the rules of the game, and deal with 'neighbourhood effects' such as carbon emissions, leaving businesspeople to meet their 'social responsibility … to make as much money for their stockholders as possible.'[11] Entirely

---

[7] Compare for example the much-trumpeted change of position of the US Business Roundtable. In its 1997 statement it claimed that 'the principal objective of a business enterprise is to generate economic returns to its owners', although the long-term interests of stockholders would require consideration of 'the interests of the corporation's other stakeholders'. In 2019, its new 'Statement on the Purpose of a Corporation' expressed 'a fundamental commitment to all of our stakeholders', but was notably silent on the question of what happens where there is a conflict between shareholder and stakeholder interests. See Business Roundtable, 'Statement on the Purpose of a Corporation' (August 2019) <https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans>.

[8] L Bebchuk and R Tallarita, 'The Illusory Promise of Stakeholder Governance' (2020) 106 Cornell Law Review 91.

[9] ibid 170-71.

[10] ibid 174.

[11] M Friedman, *Capitalism and Freedom* (1962 University of Chicago Press, 1982 reissue) 25, 27-28, 133-34.

lacking is any discussion of the complexities of global supply chains, the epistemological challenge of identifying and mapping impacts, the difficulty of governing transnational externalities given jurisdictional limits and the political barriers to reaching agreement on global or regional regulation that allocates legal responsibility. Reducing proposals to use procedural regulation to steer management towards identifying and internalising externalities within a framework of accountability (discussed in the final section of this chapter) to mere 'stakeholding', these scholars act as though the last few decades of research about reflexive (or responsive) law and governance never happened.[12] All regulation is instrumental, assumed without further enquiry to be effective, whilst the possibility of using procedural or reflexive regulation to 'preclude or disincentivise corporate choices' appears entirely lost on them. Their brief is limited to preserving the purity of managerial agency for shareholders.

Anti-managerialist US corporate law scholars are not the only ones with a blind faith in the possibility of effective regulation. Even the most progressive, self-styled 'responsible investors' appear reluctant to engage with concrete proposals around using due diligence or sustainability strategies. The view taken by, for example, Aviva, is that capital markets do not factor in environmental and social costs, so that 'unsustainable companies have a lower cost of capital than they should and so are more likely to be financed than sustainable companies'. What is needed, it is claimed, is action to correct these market failures, 'including through government intervention of some kind', such as 'setting regulatory performance standards, creating fiscal measures such as carbon taxes, or setting up market mechanisms such as carbon trading schemes that price the externalities and ensure that the negative ones are corrected.'[13] If only politicians could get their act together, institutional investors could get on with saving the planet.[14]

A slightly more nuanced justification for doing nothing comes from those, such as Alex Edmans, who insist that companies will prosper by doing good, especially if they develop and use a purpose.[15] The purpose at the heart of this line of thinking should guide business judgements on 'whether to take actions that help some stakeholders and hurt others', 'where to allocate an enterprises' limited time and resources' and 'which opportunities to turn down.'[16] Yet Edmans apparently does not envisage a legally binding purpose statement; instead the company should disclose its purpose and a roadmap elaborating on its meaning,[17] and then set

---

[12] From amongst a vast literature, see e.g. G Teubner, 'Enterprise Corporatism: New Industrial Policy and the "Essence" of the Legal Person' (1988) 36(1) American Journal of Comparative Law 130-155; C Parker, *The Open Corporation* (CUP 2002), chapter 9 (discussing 'meta-regulation'); and C Coglianese and D Lazer, 'Management-Based Regulation: Prescribing Private Management to Achieve Public Goals' (2003) 37(4) Law and Society Review 691. For an overview of reflexive law and its relevance to internalising corporate externalities, see A Johnston, 'Governing Externalities: The Potential of Reflexive Corporate Social Responsibility' (2012) University of Cambridge Centre for Business Research Working Paper No. 436/2012, 15-23.

[13] Aviva, *Delivering the Sustainable Financial System the World Needs* (2017) 10.

[14] K Cztż and P Fisher, 'Introduction' in Paul Fisher (ed), *Making the Financial System Sustainable* (CUP 2021) 9 ('Ultimately *if politicians could simply agree* to set a universally applicable carbon price, most of the uncertainty surrounding the economic impact of climate adaptation or mitigation efforts would simply disappear and we could get on with solving the problem.' (emphasis added)).

[15] A Edmans, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit* (CUP 2020).

[16] ibid 269.

[17] ibid 275.

'various long-term targets' and report on progress in achieving them.[18] Edmans expects this disclosure to trigger 'conversations about what the company's purpose is and whether it's fulfilling it.'[19] He does consider giving shareholders an advisory 'say on purpose' to allow them to express their views on how the statement is being put in practice, but other stakeholders will have to rely on the 'mutuality' that the purpose makes evident.

Very much *en vogue*, we might term this type of purpose 'aspirational purpose'. Something along these lines can currently be found in the UK Corporate Governance Code, which requires company boards to 'establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned', and explain in the annual report any actions taken to ensure that management has aligned 'policy, practices and behaviour throughout the business … with the company's purpose, values and strategy.'[20] Not being embedded in the company's articles or otherwise made legally binding, this aspirational purpose would not be enforceable directly; any enforcement would come indirectly from market forces in response to (voluntary and probably non-comparable) company reporting on achievement of its purpose. This makes it difficult to see how aspirational purpose differs meaningfully from the Corporate Social Responsibility (CSR) publications it claims to supersede. Could it ever influence managerial decision-making where this runs counter to short-term demands for shareholder value? Or is this just another example of the long-standing practice of using soft law to head off regulatory intervention? Or is asking these questions simply an example of my outdated 'pie-splitting' mentality?[21]

Most externalities will be addressed through this process, Edmans seems to expect, because the business case means 'actions to create value for society often ultimately increase profits through unexpected ways.'[22] Beyond this, in those rare cases where 'true externalities still exist',[23] investors may accept lower profits despite 'legal primacy' because they are 'affected by the environment ... [and] may care about externalities even if they're not the stakeholders affected by them – they may be concerned for those that are.' The growth of responsible investment supports this argument about investor preferences, he claims.[24] Finally, where purpose and investor preferences fail, so that companies 'don't take into account externalities', this 'can be addressed by regulation' which is the 'simplest – and often most effective – solution.'[25] Regulators simply need 'to *prohibit* practices whose negative externalities outweigh any benefit, and *mandate* those whose positive externalities outweigh any cost'[26] or they 'can also tax actions that create negative externalities.'[27] This enormous

[18] ibid 276.
[19] ibid 284.
[20] Financial Reporting Council, *UK Corporate Governance Code 2018*, Principle B and Provision 2.
[21] Edmans (n 15) 42.
[22] ibid 76.
[23] ibid.
[24] ibid 68-69.
[25] ibid 373.
[26] ibid 373. Edmans later (ibid 374) admits a scintilla of doubt when he notes that 'Government regulation works best where an issue can be clearly measured, such as carbon emissions. Thus, it may have a greater role to play for environmental factors than social issues'.
[27] ibid 374. A lobbyist for ExxonMobil revealed that the company had supported a carbon tax since 2009, knowing that it could never pass. See R Meyer, 'Carbon Tax, Beloved Policy to Fix Climate Change, Is Dead at 47' *The Atlantic* (20 July 2021) <https://www.theatlantic.com/science/archive/2021/07/obituary-carbon-tax-

oversimplification is an example of crude legal formalism.[28] It not only overlooks decades of law and society research, describing regulation and a regulatory process that few, if any, lawyers would recognise,[29] but also elides all the nuances of Ronald Coase's seminal work in law and economics, nuances which led him to the pessimistic conclusion that regulatory failure means that externalities are, and will remain, 'ubiquitous'.[30]

Simply assuming away most externalities either on the basis that they are solved by aspirational statements of corporate purpose within the current corporate governance regime, that investors want to eliminate them, or that effective regulation could or should be introduced is simply not plausible. Arguments that aspirational purpose will eliminate externalities that are not internalised out of self-interest are surely no more plausible than the argument that CSR resolves problems of social cost.[31] Despite Edmans' best efforts to defend the status quo, purpose-motivated social or environmental initiatives appear little different from CSR, that is, a way of marketing companies to more discerning employees and customers. As a critic of aspirational purpose put it, '[a]gain, these come without external oversight or transparency of regulation. Purpose, after all, is the stuff of trust and collaboration: it comes from within.'[32] A similar critique can be made of the way in which the largest asset managers brandish their ESG credentials: this is primarily a means of marketing 'greenwashed' products to institutional and retail investors. Beyond headline stewardship policies, which largely focus on forcing sustainability-related disclosures (begging the question of precisely who will act on that information), the largest asset managers adopt proxy policies that support the very shareholder primacy practices, such as takeovers, share buybacks and remuneration linked to the share price that drive short-termism and unsustainable economic activity.[33]

To conclude, Teubner highlighted long ago that instrumental regulation, which is supposed to backstop failures of aspirational purpose and investor preferences, faces a trilemma. The law 'is either irrelevant, or produces disintegrating effects on the social area of life or else disintegrating effects on regulatory law itself'.[34] Put more simply, the instrumental regulation constantly demanded as a solution tends to be easily evaded, under-inclusive, incoherent or unenforceable. Rather than having an exogenous meaning, the meaning of regulatory law is negotiated between companies, advisors and enforcers so that 'formal criteria drive out

beloved-climate-policy-dies-47/619507/>. Meyer notes that the carbon tax turns industries into foes, because they all consume energy, and makes a political coalition impossible.

[28] M Suchman and L Edelman, 'Legal Rational Myths: The New Institutionalism and the Law and Society Tradition' (1996) 21(4) Law and Social Inquiry 903.

[29] See e.g. K Krawiec, 'Cosmetic Compliance and the Failure of Negotiated Governance' (2003) 81(2) Washington University Law Review 487, 522-24.

[30] Coase (n 3) 26.

[31] A Johnston, 'Facing up to Social Cost: The Real Meaning of Corporate Social Responsibility' (2011) 20(1) Griffith Law Review 221-44.

[32] M Hengeveld, 'Big Business has a New Scam: the "Purpose Paradigm"' *The Nation* (2019) <https://www.thenation.com/article/archive/big-business-has-a-new-scam-the-purpose-paradigm/>. Hengeveld argues purpose is about retaining the best and brightest employees whilst still pursuing profit.

[33] A Johnston, 'From universal owners to hedge funds and indexers: will stewardship drive long-termism and sustainability?' in I Chiu and H-C Hirt (eds), *Investment Management, Stewardship and Sustainability* (Hart 2022, forthcoming).

[34] G Teubner, 'Juridification: Concepts, Aspects, Limits, Solutions' in G Teubner (ed), *Juridification of Social Spheres : A Comparative Analysis in the Areas of Labour, Corporate, Antitrust, and Social Welfare Law* (De Gruyter 1987) 21.

substantive objectives'.[35] This gives businesses plenty of leeway to create social and environmental costs around the world, whilst company law and corporate governance fail to ensure adequate accountability to the victims. Efforts to address climate change against a backdrop of complex global supply chains surely entail moving beyond simply insisting that instrumental regulation could – let alone does – solve the problems we face.

RELYING ON MARKETS AND SHAREHOLDERS TO INTEGRATE SUSTAINABILITY INTO CORPORATE GOVERNANCE

Moving beyond instrumental regulation and aspirational purpose as ways of addressing the social costs of business, we now turn to the role of the market. Reliance on the beneficial influence of market forces on companies is a mainstay of corporate governance, and the 'comply or explain' principle in particular. Whether we are discussing the influence of investor activism or exit on management decision-making, or the influence of employment or consumer markets on how far companies take account of their social costs in their decision-making, belief in the self-correcting properties of markets is very strong here: market actors will use their rights in law to steer companies towards long-term sustainability. As Aviva puts it, 'the private sector – especially finance – can do more in this space. At its heart, this involves promoting enlightened self-interest in the business sector: after all, if business isn't sustainable then society is at risk; and if society isn't sustainable then business is at risk.'[36]

UK policymakers have been trying, with little success, to encourage shareholder engagement with companies since the early 1970s.[37] Since 2008, and despite the contribution of shareholders to excessive risk-taking in the build-up to the Global Financial Crisis,[38] policymakers have doubled down on engagement, rebranding it as 'stewardship' and touting it as the solution to whatever particular corporate governance failure has grabbed the public's attention. In the 2010 and 2012 iterations of the UK's Stewardship Code, it was a lack of 'long-termism', whilst in the 2020 Stewardship Code it was the need for 'sustainable benefits for the economy, the environment and society'. Whatever the problem, shareholder engagement has been advanced as the solution. Since the revised Shareholder Rights Directive of 2017, the EU has (somewhat surprisingly) followed the UK's lead in expecting shareholders to drive long-termism, relying on institutional investors to improve the 'financial and non-financial performance of companies, including as regards environmental, social and governance factors.'[39]

In essence, then, mainstream corporate governance prescriptions rely on shareholders correcting the dysfunctions of the shareholder primacy corporate governance system, which prioritises the short-term financial interests *of shareholders*. Amongst institutional investors,

---

[35] Suchman and Edelman (n 28) 932-33, 938.
[36] Aviva (n 13) 3.
[37] A Johnston, R Belinga, and B Segrestin, 'Governing Institutional Investor Engagement: From Activism to Stewardship to Custodianship' (2021) Journal of Corporate Law Studies 3-4.
[38] J de Larosière (chair), *Report of the High-level Group on Financial Supervision in the EU* (2009) para 24 ('shareholders' pressure on management to deliver higher share prices and dividends for investors meant that exceeding expected quarterly earnings became the benchmark for many companies' performance').
[39] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, preamble para 14.

asset owners such as pension funds have a wide choice of asset managers, ranging from activist hedge funds and private equity through active ESG specialists to passive index funds. However, many asset owners are chasing yield and/or lower cost asset management, as they seek to discharge liabilities taken on when interest rates were much higher.[40] This seems likely to push them towards the high yields promised by hedge funds and private equity, neither of which are much known for their pro-sustainability stance, or towards low-cost indexers, which some claim are becoming akin to universal owners, but whose proxy policies tend to focus primarily on corporate governance practices intended to increase shareholder value.[41] Arguably even more fundamentally, the misalignment in the investment chain between the long-term interests of end beneficiaries and short-term financial incentives of asset managers has been repeatedly highlighted in high level reports over the years, yet never corrected.[42] Perhaps it is not surprising that both asset owners and asset managers appear happy with high levels of distribution to shareholders in the form of dividends and buybacks, and that they are happy to sell out to any takeover bidder offering a significant premium. Everyone meets their targets at the end of the day. If the stewardship agenda is going to make a meaningful contribution to changing practice, then a 'market for stewardship' will have to develop.[43] Yet privately provided ESG ratings have come under fire,[44] and it is far from clear that individuals saving for their retirement will be able to identify truly sustainable investment options or take steps to put pressure on their pension fund managers to do so.

Nevertheless, an ever-expanding body of reporting norms has developed to assist shareholders to play this anticipated role, including, notably, qualitative reporting under the EU's Non-Financial Reporting Directive, which requires companies to address 'as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.'[45] Whilst this EU initiative was no doubt pathbreaking, a 2019 report concluded that on topics such as climate change and employee and social matters, 'only a minority of companies provide information specific enough to understand company policies.' Indeed, apart from a minority, 'quality and comparability of companies' sustainability reporting is not sufficient to understand their impacts, risks, or even their plans.'[46]

The 2017 Recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) represent a fascinating attempt to encourage institutional investors to take

---

[40] D Millon, 'Shareholder Social Responsibility' (2013) 36 Seattle University Law Review 911, 930-33.
[41] Johnston (n 33).
[42] P Myners, *Institutional Investment in the United Kingdom: A Review* (2001); John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making* (2012).
[43] FRC and FCA, 'Building a regulatory framework for effective stewardship', DP 19/1 (January 2019) 3.11.
[44] Note for example the critique of MSCI Inc.'s market-dominating ESG ratings, which (like CRFD) focuses on 'the potential impact of the world on the company and its shareholders', with little account taken of emissions and companies able to make many changes that have little to do with environmental sustainability in order to receive an ESG rating upgrade. C Simpson, A Rathi, and S Kishan, 'The ESG Mirage' *Bloomberg* (December 2021); C Simpson and A Rathi, 'How to Get an ESG Rating Upgrade' *Bloomberg* (21 December 2021).
[45] Directive 2014/95/EU, OJ L 330/1, 15.11.2014.
[46] Alliance for Corporate Transparency, *An analysis of the sustainability reports of 1000 companies pursuant to the EU Non-Financial Reporting Directive* (2019) 10, 13 <http://allianceforcorporatetransparency.org/assets/2019_Research_Report%20_Alliance_for_Corporate_Transparency.pdf>.

sustainability more seriously.[47] Abandoning the conventional approach to sustainability reporting, which requires companies to disclose their impacts on their environment, TCFD encourages companies (and institutional investors) to produce disclosures about their vulnerability to the physical and regulatory risks associated with climate change. Perhaps the most interesting aspect is the way the TCFD deals with radical uncertainty about the trajectory of climate change by encouraging companies and investors to disclose outcomes under different hypothetical scenarios. The primary aim of TCFD is ensuring financial stability by allowing companies and investors to protect themselves by allocating their capital in accordance with the physical and transition risks they anticipate; a secondary effect may be to increase pressure on companies and investors to behave in a more sustainable manner.

Compliance was originally voluntary, but is already mandatory in the UK for certain institutional investors[48] and for listed (and high turnover) companies with more than 500 employees.[49] It seems likely that other jurisdictions will follow suit, with both the US and the EU publishing proposals recently.[50] Whilst the result is likely to be more pressure for disclosure of scenario analyses, there are significant obstacles to these disclosures exercising significant influence on institutional investors. In addition to the misalignment of incentives in the investment chain and quest for yield referred to above, there are serious questions about comparability and standardisation that extend far beyond those associated with the NFRD. There is also a question about whether boards and executives with strong incentives to prioritise shareholder value will conduct scenario analysis in good faith if disclosures might pose a threat to the share price. One final important question is whether investors will respond these disclosures with activism or divestment, and whether stigmatisation and a shift in market norms will prevent other investors opportunistically buying up shares or divested assets.[51]

There is a lot at stake in the interaction between TCFD and the stewardship agenda. They could mutually reinforce each other if asset owners and managers anticipate physical and regulatory risk and put pressure on companies to transition more quickly to sustainability. Alternatively, some shareholders could actually reallocate capital towards less sustainable and declining, but more short-term profitable, industries, as has certainly happened in the past in relation to investments in ‘sin stocks’ such as tobacco. Overall, then, TCFD is to be welcomed, but it remains far from clear that it will lead to greater sustainability. It attempts to reduce the complex and radically uncertain problem of sustainability to mere information asymmetry,

[47] *Recommendations of the Task Force on Climate-related Financial Disclosures*, Final Report (June 2017) <https://www.fsb-tcfd.org/publications/final-recommendations-report/>.
[48] FCA, ‘Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers’, Policy Statement PS 21/24 (December 2021) <https://www.fca.org.uk/publication/policy/ps21-24.pdf>.
[49] See s414CA Companies Act 2006, inserted by *The Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations* SI 2022 No 31 of 17th January 2022 (requiring companies falling within scope to include a non-financial and sustainability information statement that complies with inter alia the TCFD disclosures included in s414CB(2A) in their strategic reports).
[50] On 21 March 2022, the SEC published a proposal that modelled disclosure rules on the TCFD. See SEC, ‘The Enhancement and Standardization of Climate-Related Disclosures for Investors’ <https://www.sec.gov/rules/proposed/2022/33-11042.pdf>. The EU’s proposed Sustainability Reporting Directive is discussed further below.
[51] For further discussion of TCFD and its limits, see A Johnston, ‘Climate-Related Financial Disclosures: What Next for Environmental Sustainability?’ (2018) University of Oslo Faculty of Law Research Paper No. 2018-02 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3122259>.

assuming that the market will cure its own failures, as the self-interest of TCFD-informed investors leads them to steer their assets towards the companies they believe will prosper under climate change. As before, corporate management will have space to take sustainability into account as long as the market believes this contributes to shareholder value.

Most recently, the European Commission has published its proposal for a Corporate Sustainability Reporting Directive (CSRD) amending the NFRD.[52] This aims to improve the quality of sustainability information and its comparability for a range of users, beginning with the public interest entities that are subject to the NFRD, but eventually applying proportionate standards to listed SMEs. If adopted, undertakings will be required to briefly disclose their business model and strategy, including sustainability risks and opportunities, plans to ensure compatibility with the sustainability transition and the 1.5°C limit embedded in the Paris Agreement, how stakeholder interests are considered, how the undertaking impacts on sustainability matters, and the implementation of the strategy. In addition, there should be disclosure of sustainability targets, the role of boards and management in relation to sustainability, sustainability policies, a description of the due diligence process followed, along with impacts and prevention or remediation, and principal risks to the undertaking related to sustainability matters.[53] The Commission will adopt delegated acts to provide sustainability reporting standards,[54] and it is envisaged that these will take account of existing reporting standards such as TCFD both to avoid fragmentation and to drive convergence at global level.[55]

This proposal is clearly to be welcomed and will push companies towards greater compliance with TCFD and other reporting standards, as well as producing more readily comparable sustainability strategies. If it is complemented by mandatory due diligence (discussed further below), the outcome will be even richer information for shareholders and others about sustainability risks and impacts. Yet whilst civil society may put greater pressure on companies to become more sustainable, it remains far from clear that institutional investors have the right incentives to act on this information by demanding that companies adopt and implement strategies that align with the long-term demands of sustainability.

COMPANY LAW ALREADY CREATES SOME SCOPE FOR SUSTAINABILITY CONSIDERATIONS

In a mammoth and very important article, Elhauge argues that neither regulation nor economic (market) sanctions will drive socially desirable behaviour on the part of companies. As he puts it, 'belief in the perfection or even perfectibility of law is misplaced. Instead, even the most efficient and socially optimal legal rules will fail to cover much undesirable conduct.'[56] Likewise, 'economic sanctions are inevitably imperfect. Thus, we cannot assume that enlightened self-interest will suffice to optimize behavior.'[57] How then are companies to be led

[52] COM(2021) 189 final, Brussels, 21.4.2021.
[53] New Articles 19a and 29a for insertion into Directive 2013/34/EU, revising and superseding the NFRD amendments to the Accounting Directive (n 45).
[54] New Article 19b.
[55] Preamble, para 37.
[56] E Elhauge, 'Sacrificing Corporate Profits in the Public Interest' (2005) 80(3) New York University Law Review 733, 802.
[57] ibid 751-52.

towards greater sustainability? What is required, he argues, is 'a regime of social and moral sanctions that encourages each of us to consider the effects of our conduct on others even when doing so does not increase our profits.'[58] Shareholders cannot be relied on for this because 'the corporate structure largely insulates all shareholders from the ordinary social and moral sanctions that a sole proprietor would feel.'[59] Hence, argues Elhauge, it is better to rely on managers, who 'would be subject to social and moral sanctions, pressures, and processes that would tend to counteract their accountability to shareholders… Managers will know what the corporation is doing and see its effects sufficiently to experience moral guilt for causing any ill effects that violate moral norms.'[60]

Elhauge explains the judicial leeway given to corporate managers to sacrifice profits under the business judgement rule (BJR) on this basis.[61] At the same time, he argues, this latitude under the BJR will be limited because of 'managerial accountability to shareholders who are underresponsive to social and moral sanctions [and] will create countervailing incentives for excessive stinginess.'[62] In addition, excessive generosity is constrained 'not by the law but by product market competition …, labor market discipline … , and capital markets (the stock and stock options held by managers will be less valuable if they sacrifice profits too much and may even prompt a takeover bid).'[63]

Elhauge's argument is a really important one, but, like Blair and Stout's seminal claim that existing US corporate law provides support for team production by giving boards latitude to act as mediating hierarchs,[64] it arguably pays too little attention to the wider corporate governance system.[65] Whilst Elhauge is surely correct to emphasise that takeovers are regulated so that they tend not to prevent profit sacrifice in the United States,[66] that is emphatically not the case in the UK, and, equally, there are other powerful practices driving the social norm of shareholder primacy in the US, including executive pay in particular. In their comparative analysis of company law around the world, Sjåfjell and others concluded that most systems of company law give management considerable scope to take account of sustainability, but that this discretion is not being used, primarily because of the constraints of the social norm of shareholder primacy.[67]

This being the case, there are two possibilities. The first is that corporate governance could undergo wholesale reform to change the priorities of corporate boards and managers. This might include changes to regulation of executive remuneration, requiring it to be linked to sustainability criteria (which is touched on in the final section), as well as changes to takeover

[58] ibid.
[59] ibid 758.
[60] ibid 800.
[61] ibid 777.
[62] ibid 807.
[63] ibid 808.
[64] M Blair and L Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Virginia Law Review 247-328.
[65] D Millon, 'New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law' (2000) 86(5) Virginia Law Review 1001-44.
[66] Elhauge (n 56) 810.
[67] B Sjåfjell, A Johnston, L Anker-Sørensen, and D Millon, 'Shareholder primacy: the main barrier to sustainable companies' in B Sjåfjell and B Richardson (eds), *Company Law and Sustainability: Legal Barriers and Opportunities* (CUP 2015).

regulation and board structures. Such changes will probably ultimately be essential if climate change is to be stopped, but largely lie beyond the scope of this chapter. The second is that corporate governance could be procedurally tweaked in various ways to give greater priority to sustainability in corporate decision-making, but without resulting in managerial unaccountability.

INTEGRATING SUSTAINABILITY INTO CORPORATE DECISION-MAKING

The discussion so far has highlighted the limitations to using the law and the market to push or encourage businesses to internalise their social costs. In this section I suggest that using the firm to internalise externalities must now be considered seriously. The challenge here is to find ways of creating scope for management, amidst the constraints of shareholder primacy corporate governance, to take account of sustainability within a framework of accountability. So the question is, what kind of reforms would be likely increase the integration of sustainability into corporate decision-making?

Colin Mayer places great faith in corporate purpose guiding companies to produce 'profitable solutions to problems of people and planet'.[68] He argues that 'corporate law should prioritize purpose', with companies embedding their purposes in their articles and demonstrating how their conduct achieves them.[69] Whilst Mayer views this as a 'simple step',[70] it unfortunately begs more questions than it answers from a legal perspective. Who would define the purpose? Would it be sufficiently clear to be justiciable? Who would enforce it? What would the sanction be? Who would change it? The British Academy report, *Policy & Practice for Purposeful Business*,[71] only hints at answers to these questions. Alongside existing shareholder enforcement possibilities, regulatory institutions should be established 'with the capability and powers to hold directors to account, alongside implementation mechanisms to engage stakeholders in the process.'[72]

Turning to more concrete examples, France introduced a much more fully developed legal regime for company-specific purposes in the Loi Pacte of 2019, although gaps clearly remain. In addition to adopting an optional aspirational purpose (or *raison d'être*[73]), a *société à mission* will specify one or more social and environmental objectives in the articles and set up a body, containing at least one employee, responsible for monitoring execution of the mission and reporting to the board. Implementation should also be verified by a third party body. Directors' duties were also revised, requiring them to manage the company in its own interest, whilst considering the social and environmental impact of its activities.[74] At the same time, directors are obliged to observe the articles and develop a strategy that pursues the goals specified in the mission; they could be sued by the shareholders for failure to honour the commitment (and

---

[68] C Mayer, *Prosperity: Better Business Makes the Greater Good* (OUP 2018) 12.
[69] ibid 23, 202.
[70] ibid 225.
[71] British Academy, *Policy & Practice for Purposeful Business: The final report of the Future of the Corporation programme* (British Academy 2021).
[72] ibid 26.
[73] Art 1835 of the French Civil Code (as amended by *Loi Pacte*).
[74] ibid Art 1833.

other stakeholders could potentially take legal or other action if public commitments are not honoured).[75]

Despite this prominent example, the legal impact of embedding a purpose in the articles remains uncertain both in France and elsewhere. Whilst China is no doubt a highly heterogeneous example, listed companies there are required to adopt a company-specific purpose. Yet corporate purposes have never been used by courts there to adjudicate challenges to decision-making.[76] Li-Wen Lin argues that these firm-specific purposes serve more as a 'signalling or branding device' than a binding commitment.[77] Even in jurisdictions with more enforcement mechanisms, and even if a regulator was appointed to enforce these clauses, significant questions about the justiciability of purpose clauses that are couched in 'broad and vague' language would remain; as Lin puts it, 'the contractual nature of the purpose statement is far from self-contained and self-enforcing.'[78]

A much more fully fleshed out reform proposal has been developed by the Sustainable Market Actors for Responsible Trade Project at the University of Oslo, led by Beate Sjåfjell, and of which I was a member. That proposal began by redefining the overarching general purpose of companies to be sustainable value within the planetary boundaries. The board would then have a duty to promote the interests of the undertaking so as to fulfil this overarching purpose, adjusting the business model and developing a strategy to implement it throughout the business and its global value chains. Companies should, at least every three years, carry out a sustainability assessment, including due diligence, with the board then identifying 'ongoing negative sustainability impacts' and the principal risks to which they give rise. The board should then bring the company into compliance with the law and implement 'an ambitious continuous improvement process'. In addition to potential liability of the company and the directors for breach, compliance with these requirements would be a condition of continued registration, and there should also be public enforcement of company law more generally.[79]

Against the backdrop of these debates, the European Commission proposed to carry out analytical and consultation work on requiring boards to develop and disclose a corporate sustainability strategy, including appropriate due diligence throughout the supply chain, measurable sustainability targets and possible clarification of directors' duties.[80] I worked with Jeroen Veldman and Filip Gregor to develop a proposal that would put legal flesh on the policy bones of the European Commission's Sustainable Finance Action Plan. We proposed that boards should be obliged by law to ensure that the company develops, discloses, and implements a forward-looking sustainability strategy. That strategy should identify and address

---

[75] For further discussion, see B Segrestin, A Hatchuel, and K Levillain, 'When the Law Distinguishes Between the Enterprise and the Corporation: The Case of the New French Law on Corporate Purpose' (2021) 171 Journal of Business Ethics 1-13.
[76] L-W Lin, 'Say on purpose: lessons from Chinese corporate charters' (2019) 19(2) Journal of Corporate Law Studies 251, 271.
[77] ibid 253.
[78] ibid 253, 271.
[79] B Sjåfjell, J Mähönen, T Novitz, C Gammage, and H Ahlström, 'Securing the Future of European Business: SMART Reform Proposals' (2020) University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2020-11 <https://ssrn.com/abstract=3595048>.
[80] European Commission, 'Action Plan: Financing Sustainable Growth' (COM (2018) 97 final, Brussels, 8.3.2018), Action 10.

material environmental and social issues and significant impacts connected to the company's business model, operations and supply chain. The issues and impacts would be identified through a legally mandated due diligence process. The strategy should set out verifiable targets for preventing or mitigating risks and impacts and commit to making resources available. The board would also be responsible for monitoring ongoing implementation of the sustainability strategy and reporting and signing off on the strategy in the non-financial report. Failure to implement the strategy would be a breach of directors' duties which could be enforced by the shareholders or by the relevant national regulatory body if non-implementation caused serious harm to third parties or unlawful harm to the environment. This duty would be complemented by a requirement that a specified percentage of executive remuneration be linked to measurable targets in the sustainability strategy.[81]

Underlying our thinking were the following considerations. We believe that the process of defining, embedding, complying and enforcing a company-specific purpose is just too complex, and risks losing sight of the goal, which is corporate decision-making that better aligns with the sustainability imperative. We think that whether or not a corporate board has drawn up, disclosed and complied with a sustainability strategy is more likely to be justiciable than a vague corporate purpose. It is also, when combined with a legal obligation to carry out due diligence, more likely to be effective in steering decision-making in a sustainable direction. We believe that this type of procedural regulation would create greater scope for boards and management to use their existing discretion in law to integrate sustainability, but without resulting in unaccountability: they would be accountable for implementing the strategy that they committed to. Moreover, we think that boards and managers are much better placed than regulators to identify unsustainable practices and serious impacts and draw up ways in which they can be made more sustainable and mitigated, regardless of where in the world they occur. Whilst we recognise the inherent limits of procedural regulation, namely that managers currently have powerful incentives to serve short-term shareholder value, and so may engage lawyers to produce verbose but vague documentation that meets the formal criteria, we envisage a mandatory process of due diligence gradually ratcheting up the commitments made by companies in their strategies. Moreover, the largely procedural nature of our proposal makes it more politically feasible than wholesale corporate law and governance reform (although we suspect that this will ultimately be necessary too).

As we noted, a legal obligation to conduct and report on due diligence would be an essential complement to this proposal. The Commission has now published its long-delayed draft Directive on Corporate Sustainability Due Diligence, which is intended to provide a basis for reporting under the draft CSRD, which would require companies to disclose the due diligence process followed (discussed above).[82] If adopted, large companies will be obliged to conduct due diligence to identify actual or potential adverse human rights and environmental impacts arising from their own or their subsidiaries' operations, as well as impacts related to their value chains, and then prevent or mitigate potential impacts and bring actual impacts to an end, monitoring their procedure and communicating this to the public.[83] This mandatory procedure

[81] A Johnston, J Veldman, and others, 'Corporate Governance for Sustainability' (2020) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3502101>.
[82] COM (2022) 71 final, Brussels, 23.2.2022.
[83] ibid Art 4.

would then feed into the CSRD discussed above, with companies disclosing the information generated through and in response to this process in their sustainability reports. They will also be required to adopt a plan, drawing on reasonably available information (presumably emerging from due diligence) to ensure that the 'business model and strategy' published under CSRD is compatible with transition to a sustainable economy and limiting warming to 1.5°C.[84] Finally, supervisory authorities in each Member State would monitor compliance, receive complaints, require remedial action and potentially impose administrative sanctions, and companies would also be subject to civil liability for damages under Member States' legal systems for failure to prevent, mitigate or bring impacts to an end.[85]

Whilst the proposal is still only in draft form, three main points are worth emphasising here as they relate directly to the integration of sustainability.

First, Article 15 requires companies to link variable remuneration to the business model and strategy for transitioning to sustainability and limiting global warming to 1.5°C (as proposed to be required by the CSRD), at least 'if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability.' This is a welcome measure: remuneration is a potentially powerful way of incentivising integration, and it is much better to link it to elimination of impacts identified in the strategy than to vague ESG criteria that may have little relevance to actual or potential impacts. However, the scope of application must be wider, requiring all companies that use variable remuneration to link a specified percentage to achievement of ascertainable targets in the business model and strategy, as we recommended above.

Second, Article 25 provides that Member States should ensure that the directors' duty to act in the best interest of the company requires them to take account of the consequences of their decisions for sustainability matters, including human rights, climate change and environmental consequences in the short, medium, and long-term. The Member States of the EU differ widely in their understanding of the scope of the 'best interests of the company', ranging from pluralism to monism (shareholder value in a legal sense).[86] This provision does not intend to change that understanding, which is a core part of company law. Rather it allows directors in pluralist jurisdictions to weigh this consideration alongside others in determining what the company's interest requires, whilst in monist jurisdictions, it may be taken into account as a means to the end of shareholder value. Most fundamentally, however, most jurisdictions apply a variant of the business judgement rule so that courts defer to managers on this question, albeit that some courts operate a very strong presumption of good faith while others are more willing to enquire into the reasons for or rationality of the decision.[87] Liability is therefore unlikely to be a meaningful constraint; it would be preferable to link directors' duties to good faith implementation and revision of the business model and strategy in order to avoid leaving implementation entirely to managerial discretion and so imposing direct responsibility for this important obligation on nobody. This would also align directors' remuneration incentives and

[84] ibid Art 15.
[85] ibid Articles 18, 20, 22.
[86] Sjåfjell, Johnston, Anker-Sørensen, and Millon (n 67) 94-107.
[87] ibid 114-18.

duties in the same direction, making implementation of the published strategy much more likely.

Finally, it is regrettable that the scope of due diligence is limited to breaches of the international human rights and environmental instruments set out in the Annex to the proposal. This limitation mirrors that of the German *Lieferkettensorgfaltspflichtengesetz* (Supply Chain Due Diligence Act), which was passed in June 2021 to take effect from January 2023. It arises from the possibility of corporate liability for failure to mitigate or prevent and is justified on the basis of legal certainty. However, it also removes more general sustainability considerations from the scope of due diligence and means that the proposals miss out on one of the key benefits of combining due diligence with a sustainability strategy: as companies produce and disseminate information about their environmental and social costs, this can lead to social and moral sanctions where the company's proposed response is not viewed as adequate. This is in line with Elhauge's suggestion that managers are more susceptible than shareholders to pressure to address social costs. Managers remain accountable, but the frame of that accountability is shifted to encompass wider social and environmental externalities. This makes it all the more important that implementation of the business model and strategy are strongly incentivised through remuneration and stronger directors' duties than are currently included in the proposal.

Whilst the Commission's proposal is very welcome and represents the beginning of a new approach to corporate governance, due diligence and sustainability strategies are no panacea: they are simply first steps on the road to greater corporate sustainability and a move beyond the flawed binary choice between instrumental regulation and market forces. In other words, they attempt to use the firm as a governance mechanism for the problem of social cost without undermining managerial accountability.

CONCLUSION

Debates about corporate sustainability have been stuck in a loop for too long. It is time to move beyond insisting that regulation or market forces will solve the problem. Managerial discretion can be used to steer the activities of companies in a more sustainable direction without resulting in unaccountability. Now that this has been established in principle, researchers and policymakers must work to refine the design of procedural regulation so that more externalities fall within the purview of managers. At the very least, the firm can then take its place alongside the market and the law in solving the problem of social cost.

Selected Bibliography:

Coglianese C and Lazer D, ‘Management-Based Regulation: Prescribing Private Management to Achieve Public Goals’ (2003) 37(4) Law and Society Review 691

Elhauge E, ‘Sacrificing Corporate Profits in the Public Interest’ (2005) 80(3) New York University Law Review 733

Johnston A, Veldman J, and others ‘Corporate Governance for Sustainability’ (2020) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3502101>

Johnston A, ‘From Universal Owners to Hedge Funds and Indexers: Will Stewardship Drive Long-Termism and Sustainability?’ in I Chiu and H-C Hirt (eds), *Investment Management, Stewardship and Sustainability* (Hart 2022, forthcoming)

Johnston A, ‘Governing Externalities: The Potential of Reflexive Corporate Social Responsibility’ (2012) University of Cambridge Centre for Business Research Working Paper No. 436/2012

Lin L-W, ‘Say on Purpose: Lessons from Chinese Corporate Charters’ (2019) 19(2) Journal of Corporate Law Studies 251

Segrestin B, Hatchuel A and Levillain K, ‘When the Law Distinguishes Between the Enterprise and the Corporation: The Case of the New French Law on Corporate Purpose’ (2021) 171 Journal of Business Ethics 1

Sjåfjell B and Bruner CM (eds), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (CUP 2019)

Sjåfjell B, Johnston A, Anker-Sørensen L and Millon D, ‘Shareholder primacy: the main barrier to sustainable companies’ in B Sjåfjell and B Richardson (eds), *Company Law and Sustainability: Legal Barriers and Opportunities* (CUP 2015)

Sjåfjell B, Mähönen J, Novitz T, Gammage G and Ahlström H, ‘Securing the Future of European Business: SMART Reform Proposals’ (2020) University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2020-11 <https://ssrn.com/abstract=3595048>