Traidcraft
Response to Company Law Reform White Paper

1. Traidcraft

Traidcraft is one of the UK's leading fair trade organisations, selling food, household products, soft furnishings and clothing from nearly 100 producer groups based in 31 countries in Africa, Asia and Latin America. Traidcraft was established in 1979 and is comprised of two operational organisations: Traidcraft plc and Traidcraft Exchange, a registered charity.

Traidcraft plc is a medium-sized company, which had a turnover in 2003/04 of £13.8 million and made a profit of £348,000 after tax. Traidcraft plc has recently raised £3.25 million in a successful share issue. Traidcraft Exchange is a development charity whose work spans capacity building amongst producers in developing countries, market access, policy development and advocacy. Through its Policy Unit, Traidcraft Exchange seeks to influence government policy and business practice in the North and the South to the benefit of the poor in the developing world.

Traidcraft through engagement with a worldwide network of producers and partner organisations who work with some of the world's poorest communities, has first-hand knowledge of the conditions under which trade can be a powerful force for sustainable economic and social development. Company Law also has a role to play in promoting accountable and equitable trading relationships.

Traidcraft's experience as a mission-driven fair trade organisation provides a model of corporate governance for modernising company law. The success of Fair Trade in coupling profitability and economic effectiveness with international development objectives makes it a particularly valuable model to improve the corporate governance of mainstream businesses so that they have a better impact. In particular Traidcraft has had experience of collecting information to understand Traidcraft's social impact. This is done through 'social accounts' which involves consulting with stakeholders and then feeding those views into Traidcraft's management decision making and reporting into Traidcraft's governance. Traidcraft is a pioneer of social accounting in the UK; having published the first independently audited plc report in 1993[1]. Since then, the methodological approach (which Traidcraft developed initially with the New Economics Foundation) has been adopted and adapted by many larger organisations. It has also helped shape the AA1000 standard operated by the Institute of Social and Ethical AccountAbility (ISEA).

Traidcraft initiated the Just Pensions[2] project in 2001 to highlight international development risks pertinent to investment and to capitalise on recently introduced UK regulation that Pension Fund's Statement of Investment Principles should disclose whether they consider social, environmental or ethical aspects. Involvement in the Just Pensions' project, has highlighted the limitations of shareholders' ability to hold companies to account for their social and environmental impacts, and therefore the importance for including social and environmental obligations directly within directors duties set out in company law.

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[1] For the most recent Social Accounts, see www.traidcraft.co.uk
[2] www.justpensions.org

This submission is based on Traidcraft plc's experience as a social enterprise, feedback from Traidcraft Exchange's overseas partners and the experience of the Just Pensions' project which all point to the importance of directors having a duty to minimise their company's social and environmental impacts.

2. General comments on Company Law in relation to the impact of companies on society.

The Government, as custodian of UK society, is under an obligation to act in the interests of all sectors of society, not just in the interests of the powerful or wealthy, (who are well resourced in presenting their arguments). Traidcraft believes that all UK Government policy and legislation must be directed towards achieving, or be consistent with, its international public policy commitments to sustainable development for all. These include international instruments ratified by the Government such as the Universal Declaration of Human Rights, the ILO Core Conventions, and the Millennium Development Goals.

Companies, particularly large multinational corporations, wield enormous influence and have a huge impact on our everyday lives, yet are often largely unaccountable to the individuals and communities they affect. As one of the world's largest economies and a large foreign direct investor, the way British companies carry out their businesses directly affects the lives of millions all over the world.

There is much force in the view that companies must accept certain restrictions on their freedom to act in return for the benefit of incorporation and limited liability.

a. Business must be *required* to consider their wider impacts

The business sector clearly has an essential role to play in moving society towards sustainable development. Without the full participation of corporations, the goal of sustainable development will remain forever out of reach, as will the achievement of human rights for all.

For global peace and security, companies must be regulated to act in accordance with accepted standards of good behaviour. Voluntary Corporate Social Responsibility ultimately fails, because it is inherent in the nature of voluntary initiatives that not all companies will comply. Those companies who cause the most harm and most need to change their behaviour are those least likely to do so whilst CSR remains a voluntary option.

In addition, companies who do take their social and environmental responsibilities seriously may often face a competitive disadvantage when compared to businesses that simply act vis-à-vis the financial bottom line. The absence of a level playing field in turn acts as a deterrent to companies who may wish to consider their wider impacts but are reluctant to incur the necessary costs whilst their competitors choose not to do so.

The Government is uniquely placed to ensure that companies act in the long-term interests of society as a whole and Traidcraft firmly believes it has a responsibility to do so. The reform of UK Company Law offers an historic opportunity to make companies truly responsible for their social impacts by requiring companies and their directors to bring environmental and social considerations into their decision-making processes.

Unfortunately, the Company Law Reform Bill misses this opportunity in continuing to focus primarily upon the financial success of the company, with regard to the interests of the wider public being not only subordinate but optional.

b. Enlightened Shareholder Value does not apply to most companies' experience

In Chapter 3 of the Company Law Reform White Paper "Enhancing Shareholder Engagement and a Long-Term Investment Culture", it is stated that:

> "…directors must promote the success of the company for the benefit of its shareholders, **and this can only be achieved by** taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers [emphasis added]"

In Traidcraft's view, this is disingenuous. The 'enlightened shareholder value' argument is a variation of the business case argument for Corporate Social Responsibility (CSR). There are plenty of companies, arguably the majority, who are successful financially, yet, pay scant regard to social and environmental considerations.

Whilst a business case can be made for CSR in high-value, branded markets where players have a strong public presence, this does not apply to companies operating in low-value markets or with companies that have no visible presence. Traidcraft would submit that the vast majority of businesses do not have high public visibility and for them there is no financial advantage to be gained by acting ethically, especially if their competitors do not have to. To the contrary, the legal requirement on directors to maximise profits actually encourages such companies to externalise costs as far as possible, leading to severe exploitation of suppliers and labour, and environmental degradation.

Even where companies have a high public profile and are strongly branded, the business case for CSR will not always be sufficient in itself to achieve socially responsible company behaviour. Despite major concerns, often coupled with public campaigning on environmental or social issues, companies such as Tesco, Asda, BP and Shell have failed to substantially reduce their negative impacts on a variety of stakeholders.

3. General Comments on Directors' Duties

Where a company fails to comply with the law the only possible penalty is financial, either a fine or payment of damages. This may not provide a sufficient deterrent, especially for large and/or wealthy companies. Corporations carry out a "cost/benefit" analysis in deciding what actions to take. If the cost of compliance with legal obligations exceeds the likely cost of any breach, the company may choose to ignore the law.

In reality, a company is a shell; it is activated and managed by people, i.e. the directors who control the company. If individual directors are not subject to a legal mandate requiring them to consider social and environmental matters, and are not held personally accountable when they fail to do so, those issues are likely to be ignored and overlooked.

This principle has been recognised by the Government in enacting health and safety and environmental protection legislation, which impose personal liability on company directors in certain circumstances. If convicted, a director may be fined or imprisoned. Clearly the

Government recognised that only holding the *company* responsible for breaches of the law was insufficient to achieve the level of compliance desired in these areas. The same concerns are true in relation to a company's wider impacts on people and society. Where directors are covered by insurance they may not pay sufficient attention to their company's impacts. An appropriate element of personal liability is therefore necessary to ensure that due diligence is followed in evaluating and minimising negative impacts on society.

Traidcraft believes that the imposition of robust directors' duties is therefore essential in the context of ensuring UK business does not undermine HMG's public policy commitment towards societies both in the UK and overseas.

4. Comments on Part B Chapter 1 of the Company Law Reform Bill

Traidcraft welcomes the government's recognition of the importance of businesses' relationships with suppliers and customers, its impacts on the community and the environment and considering the needs of employees. However the "enlightened shareholder value" approach does not go nearly far enough to promote meaningful corporate accountability for social and environmental impacts.

Fundamentally, it is based on the false premise that shareholders are the party best placed to hold directors to account if they fail to have sufficient regard to wider interests such as environmental and human rights concerns. To the contrary, those matters may in fact conflict with a shareholder's direct financial interests. In addition, evidence shows that shareholders generally fail to consider matters beyond financial value. They tend to act passively, secure in the knowledge that many directors are rewarded in proportion to the financial success of the company.

In many small companies the directors and the shareholders are one and the same. The statement in Chapter 3 of the Company Law Reform White Paper "Enhancing Shareholder Engagement and a Long-Term Investment Culture", that shareholders "are the means by which the directors are held to account" is misconceived in the case of those companies. Use of the "enlightened shareholder value" model means that in practical terms, it will not be possible to hold directors to account where they are also the sole shareholders in a company.

In Traidcraft's view, the draft Company Law Reform Bill falls short in five key areas:

a. Duties must be owed to stakeholders, not just shareholders

The duty set out in B3 (3)(b) to take account of employees, suppliers, customers, the community and the environment is subordinate to the duty to promote the success of the company for the benefit of its members as a whole. The unsatisfactory situation thereby continues where directors continue to owe their duties solely to shareholders and have no legal obligations to other stakeholders who may be vitally affected by corporate actions. Further, the duty to shareholders equates to a duty to maximise profits, which will frequently conflict with environmental and social considerations. As the duty is presently embodied, financial considerations remain paramount and it is therefore difficult to envisage any real improvement in directors' behaviour to society and the environment as a

result of the Company Law Reform Bill, despite the clear public policy need for improved business impact.

The Government rejected the idea of a pluralist approach to company law, whereby directors would have multiple duties, primarily on the grounds of logistical expediency and concerns about complexity of enforcement. Traidcraft disagrees with this view and believes there is a strong case for extending directors' obligations to stakeholders. At a recent workshop for Social Enterprise directors[3], the participants, all of whom are company directors, unanimously agreed that in principle directors should owe duties to stakeholders as well as shareholders. The experience of Social Enterprise Directors shows that it is possible to successfully balance the financial, social and environmental interests of a variety of stakeholders. Learning is available from this experience. Legal enforcement mechanisms need to be developed rather than shied away from.

Traidcraft believes there is no logical or moral justification for limiting the matters that directors are required to consider to only the interests of shareholders. Shareholders give only one form of capital to a company, financial capital. However, companies use other forms of capital to deliver value – environmental, human and social. Stakeholders deliver just as much value for a company as shareholders yet the current model of company law offers financial value for a few and often little benefit for society. Surely the moral imperative is in favour of ensuring that directors pay as much attention to the interests of stakeholders as they do to shareholders?

b. Directors must be required to inform themselves about the social and environmental impacts of their company's actions

There is no requirement in the Company Law Reform Bill for directors to actively take steps to inform themselves about the environmental and social impacts of their company's actions. This leaves it open for directors to "bury their heads in the sand" in relation to non-financial impacts.

There are several options open in addressing this issue. Traidcraft favours one of two alternatives. Firstly, all the company's directors could be expected to have "constructive knowledge" of their company's social and environmental impacts, making them liable for a breach where a reasonable and diligent company director would have known of the position, regardless of their actual level of knowledge in a particular situation. There is a precedent for this in the construction industry where a planning supervisor is appointed and has responsibility regardless of his or her actual level of knowledge[4].

Another possibility is to appoint individual directors, each with responsibility for a certain area, say for example, employees, or the company's environmental impacts within a particular geographic location. That director would be responsible for informing him or herself accordingly of the company's impacts on that group of stakeholders. An example of this type or approach is the German system where company boards include an employee representative.

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[3] Workshop on Directors' Duties – Learning from Social Enterprises co-ordinated by Traidcraft – 25th May 2005, London

[4] Construction (Design and Management) Regulations 1994

On either approach, consultation with stakeholders must be an essential requirement of the duty to become informed about the impact of their company's actions.

c. The requirement to "take account (where relevant)" must be clarified

The directive in the Bill is to take into account certain factors "*where relevant and so far as reasonably practicable*".

Traidcraft agrees that directors should only be required to take into account relevant factors and that these include the interests of employees, suppliers, customers and others, and the company's impacts on the community and the environment. However, exactly what is envisaged by the phrase "take account of" is obscure and no guidance is given as to when such matters might be considered relevant and when not. Directors are therefore likely to be confused regarding their responsibilities in this area. Traidcraft believes it would be useful for the DTI to provide clear guidance to assist directors who may be unfamiliar with incorporating social and environmental considerations into decision making as to when such matters will be relevant and how they should be considered.

In the absence of such guidance there is a risk that directors will be able to avoid responsibility for disregarding social or environmental considerations by simply claiming that they didn't consider a particular issue to be relevant.

It is unsatisfactory to tie the test of relevance simply to the financial success of the company. In an area where a company operates a particular decision may be hugely relevant to the local community and environment, however, it may not be considered relevant, or only marginally relevant, to the overall financial performance of the company. Where the company has an impact that is significant to a particular stakeholder, the directors must be required to consider the interests of that party.

Inherent in the requirement in B3 (3)(b) for directors to take account of "any need of the company" to have regard to the wider matters listed is the implication that a company might in some circumstances have no need to consider the interests of its employees, suppliers, the community or the environment. Therefore, a director will be able to justify a failure to mitigate the company's impacts on the wider community on the basis that s/he didn't believe the company had any need to take such factors into account as they did not affect the company's financial bottom line.

d. Directors must be required to take reasonable steps to minimise the company's negative impacts

Directors are only required to "take account of" the listed factors, and to "consider" the impact of its operations on the community and the environment. There will be widely differing views of what "take account of" and "consider" actually mean as both are vague phrases with no legal meaning. However, it is clear that the draft Bill imposes no obligation on a director to alter a company's behaviour to minimise known negative impacts of corporate actions, nor is a director made in any way accountable for such negative impacts. This makes the new duties effectively worthless, undermining HMG's intention that directors do consider social and environmental impacts.

Traidcraft believes that HMG needs to translate its public policy commitments on human rights, sustainable development into expected standards of behaviour for companies. These would then form the minimum standard of behaviour and could be codified into directors' duties. It is key that minimum standards are set in relation to key impacts of companies. Once minimum standards have been reached we would expect directors to continue to minimise the negative impacts of their operations. Where minimum standards are not set we would expect the onus to be on directors to minimise negative impacts of their company's activities.

In order to promote the interests of society as a whole, companies must be required to take all reasonable steps to minimise their known negative impacts, and where they fail to do so, the directors must be held accountable. This obligation should be proportionate to the size, resources and financial means of the company (including related companies) and to the scale and significance of the negative impact.

e. <u>Duties must be enforceable by stakeholders as well as shareholders</u>

In order for a duty to be meaningful it must be enforceable *practically* as well as legally. Section 309 of the Companies Act 1985, which requires company directors to have regard to the interests of the company's employees in general, is widely ignored. It is essential that the new rules be framed in such a way that they are enforceable.

By leaving it solely to shareholders to bring an action for breach of duty, directors will in practice be unaccountable in relation to those duties. Litigation is expensive, stressful, prolonged and inherently risky and very few shareholders will possess the resources to bring an action seeking to hold a director to account, even if they were otherwise minded to do so. Often an individual shareholder will not be able to establish that s/he has suffered any losses even if it is proven that a director has failed to comply with their duties. There is therefore little incentive for anyone other than a very wealthy and philanthropically minded shareholder to seek to enforce the director's duties. Since there are currently problems in shareholders' ability to enforce directors' duties to the company, the current approach should not be used when developing a mechanism to enforce directors' duties in relation to a company's social, economic and environmental impacts. The current situation is that shareholders (for whose benefit directors are presently said to owe their duties to the company) cannot directly enforce the performance of directors' duties to the company. They can only take action in limited circumstances where the company itself refuses to do so and is therefore essentially under the control of the "wrongdoers".

In addition, as stated earlier in many small companies the directors and the shareholders are one and the same. It will not be possible to hold directors to account where they are also the sole shareholders in a company.

Reliance upon an "enlightened shareholder" to bring a claim alleging that a director has failed to comply with his or her duties is particularly problematic where British companies operate overseas. An UK-based shareholder is even less likely to be aware of negative impacts of the company actions in overseas locations.

Following on from the proposition that directors must owe duties to stakeholders as well as shareholders, is the need for mechanisms to enable stakeholders to enforce those duties. In the first instance, Traidcraft suggests that issues of concern be brought to the attention

of the company and the directors who ought to respond within a reasonable period of time. Stakeholders need to be able to bring a legal claim if they are unsatisfied with the company's response.

Traidcraft believes there is a strong case for also permitting NGOs or public interest groups to bring an action to an UK court against a company director for breach of duty. Stakeholders who are unsophisticated or have few resources may be unwilling or unable to issue legal proceedings despite having a strong prima facie case. The interests of the environment and the community will necessarily have to be represented or co-ordinated by a public interest organisation. The risk of incurring liability for the company's legal costs in defending the action if a claim fails ought to deter unmeritorious claims. Or to set a different test for presenting cases permission from the Attorney General could be sought before bringing such an action. Traidcraft would like to emphasise the relative disadvantage stakeholders face in bringing cases, and therefore the importance of not setting a disproportionately high bar for stakeholders seeking justice. Companies not only have greater resources than marginalised groups negatively impacted by the company, but they also hold key bits of information needed about the scale of their impacts which is necessary to hold the company to account.

It is proposed that company directors will no longer be required to provide their home address. Traidcraft considers that this is a retrograde step moving away from corporate accountability and increasing the already substantial obstacles to enforcement of directors' duties. It undermines even the limited benefits of the "enlightened shareholder value" approach. Without this information, redress against a director who has breached his or her responsibilities is likely to be unobtainable. This is particularly relevant where the company has been dissolved, which is sometimes done in order to avoid liability for negative impacts upon stakeholders. Many jurisdictions require legal documents to be personally served on a defendant and the lack of a home address will make this impossible in the majority of cases.

Directors must continue to be required to provide their home address to Companies House. Even if there are reasons why this is not made readily available to the public, the details would at least be available to legal and enforcement agencies.

The Companies (Audit, Investigations and Community Enterprise) Act 2004 is also of concern. The fact that it allows directors to be indemnified by the company against liability to third parties fundamentally undermines the principles of accountability. As long as directors are not personally liable for the impacts of their company's actions on third parties, corporate behaviour is unlikely to change.

f. <u>The duties must be linked to the Operating and Financial Review (OFR) reporting requirements</u>

Whilst it is doubtful whether the OFR will actually meet the objectives of the "enlightened shareholder value", Traidcraft is of the view that the purpose of the reporting requirements must be clear and linked to the overall directors' duties.

The OFR should be used to report on the negative social or environmental impacts of a company's business policies and activities, and what steps the directors are taking to

mitigate such impacts in accordance with their duty to do so. Where no steps are being taken, the report must explain why. The OFR would thus be a valuable management tool for directors rather than just another document required to be produced for shareholders.

5. Summary of Recommendations

Traidcraft welcomes HMG's intention to improve businesses' consideration of their relationship with suppliers and customers as well as businesses' impact on society and the environment. However Traidcraft is concerned that the current drafting of directors duties will not lead to an improvement of companies' impacts on society and the environment (which is / are clearly needed from a public policy perspective) because these considerations are subordinate to shareholders' interests and are unenforceable.

To summarise, Traidcraft makes the following recommendations to the Government:

a. Directors must owe duties to stakeholders as well as to shareholders.

b. Directors must specifically be required to:

   i. inform themselves of their company's impacts on stakeholders
   ii. factor such considerations into their decision-making process
   iii. take all reasonable steps to minimise negative company impacts
   iv. report on their company's negative impacts and what is being done to minimise them.

c. Directors' duties must be enforceable by stakeholders as well as shareholders.