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On the Path Toward Enlightened Value Maximization? A Snapshot on Stakeholder theory, Sustainability, and Environmental, Social and Governance Performance

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I. Introduction: Seeing the big picture

Companies are the building blocks of the modern world. As the central instrument of economics, the corporation has a long and important role in the production of wealth and has been able to undertake remarkable feats that have transformed our own lives. But obviously there is a downside to this bright picture. The least one can say is that this past decade has been rich in far-reaching events involving corporations - the current economic and financial crisis being the most substantial (for the time being) - that produced many unintended consequences and placed the discipline of corporate governance under a strategic as well as a regulatory microscope. To begin with, the wave of corporate scandals with the prominent collapse of Enron initiated the awareness of the endemic failures of the shareholder primacy approach of corporate governance and led us to recognize that a fundamental rethinking of corporate governance practices and procedures was required. The ‘Enron experience’ confronted us to the short and long-term symbiosis of networks of investors, employees, business partners and customers. We started to recognize that in our globalized world, increasingly complex and fast-changing, many players are interconnected, and that business and society are dependent by nature. On the other hand, recent catastrophic environmental events – for instance the 2010 BP Deepwater Horizon oil spill and Fukushima nuclear plan disaster in 2011 - have also contributed to highlight the fallibility of corporations to address disastrous accidents. These events also contributed to recognize that compromising environmental standards can be quite detrimental to shareholders wealth. Little by little, the perceived problems of corporate governance, the environmental

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1 Schumpeter, ‘Some ideas for restoring faith in firms’, The Economist, March 2, 2013
2 Mayer, C., Firm Commitment; Why the Corporation is failing us and How to restore trust in it?, OUP Oxford, Jan. 2013, 2
4 Different authors suggested that we need other mechanisms of corporate governance. See Jonathan Macey, “The Promises of Corporate Governance”- Chapter 4, 87-121, Princeton University Press, 2008, xv (suggesting that our reliance should shift from board of directors to other mechanisms of corporate governance); see also Fairfax, L.M., ‘The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms’, The Journal of Corporation Law, Spring 2006, 678 (concluding that because corporate rhetoric relies heavily on stakeholder themes, it ultimately reveals its dissatisfaction with the shareholder primacy norm.)
and social disasters coupled with the occurrence of the financial crisis oblige us to admit the causes and effects of the multidimensionality of globalization. As Colin Mayer suggested in his new book ‘Firm Commitment’, ‘the perceived causes of the problems are not specific and the solutions are not individuals’, ‘there is a generic cause and a common response is required’. Though this may sound unconquerable ‘the generic problem is the corporation and the common solution is to fix it and not everything around it.’ But there is one thing more: all these events strike a blow to the confidence that we granted to corporations. Asking fundamental questions is no longer recommended but necessary. What are the core purposes of corporations? Is shareholder value the only objective to achieve for corporations? What do we value from our corporations?

Academic debates on the purpose of business tend to focus on the interplay between the rights of investors versus those of other stakeholders. Backed by the weight of company law and corporate governance practice, strategic management theorists tend to emphasize a single agency theory of the firm predicated on essentially economic principles, neglecting the social and environmental impacts of economic globalization. One cause of this is our own misconception about the nature and role of the corporation, how it interact with society and, how and why business creates (or destroy) value for its various constituencies.

The general trend towards shareholder value since the 1980s was implicated in a wider, systemic failure of the corporate governance system, of which the banking crisis was simply the most visible manifestation. Under these circumstances, a reassessment of the shareholder value based approach to the governance and management of large corporations is urgently required. As a result of recent corporate scandals, and in order to counter to the negative images created by corporate misconduct reflected in Enron, many commentators

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7 Colin Mayer, Firm Commitment; Why the corporation is failing us and how to restore trust in it?, Oxford University Press, Jan 2013.
8 See Firm Commitment Lecture of Professor Colin Mayer, Professor of Management Studies; Voices from Oxford (VOX) Editor, Economics and Business, February 6, 2013 Available at http://www.voicesfromoxford.org/video/firm-commitment-lecture/188
10 Id.
11 Mayer, C., Firm Commitment; Why the Corporation is failing us and How to restore trust in it?, OUP Oxford, Jan. 2013
13 Id.
have acknowledged a growing embrace of stakeholder rhetoric\textsuperscript{14} to eclipse the rhetoric involving the shareholder primacy norm.\textsuperscript{15} This recent corporate surge of stakeholder rhetoric may suggest that businesses increasingly perceive that they need to address stakeholders concerns and that the shareholder primacy norm in its absolute form is inadequate for this end.\textsuperscript{16} As a matter of fact, emerging trends in expanding notions of corporate governance that incorporate concerns beyond just shareholders and recognize the interrelationship between business and society\textsuperscript{17} are gaining ground. Likewise, concerns about the environmental impact of maximizing shareholder wealth are resulting in an important stakeholder issue.\textsuperscript{18} Moreover, since the debacle of the corporate scandals and the financial crisis, investors have become more skeptical with the current investment landscape.\textsuperscript{19} Thus, it is suggested that in order to remain viable, competitive and to cope with emerging concerns, corporations need to normalize longer views of sustainability which encompass numerous stakeholders, rather than simply trying to maximize profits during a current quarter.\textsuperscript{20} Above all, corporate governance should no longer confine its analysis to the nexus between the board of directors, the management and, the shareholders. On the other hand, in the context of our today’s globalized and interconnected world, richer in information and opinion, it is increasingly clear that intangible business assets - intellectual capital, human capital, social capital, natural capital, and so on – and business value cannot adequately be described in purely economic terms.\textsuperscript{21} Similarly, it seems partial to describe other form of intangible value created by business, like reputational value, without some reference to how these relate to economic value over the long term.\textsuperscript{22} A rethinking and

\textsuperscript{16} Fairfax, L.M., ‘The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms’, The Journal of Corporation Law, Spring 2006, 677-678 (asserting that corporate adoption of such rhetoric may signal a growing dissatisfaction with the shareholder primacy norm, particularly in its absolute form.)
\textsuperscript{18} Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, Journal of Leadership and effectiveness, Vol. 1, No. 1, Blue Water Institute, Jan. 2013, 45
\textsuperscript{19} Id.
\textsuperscript{20} Ibid., 47
\textsuperscript{22} Id.
redefinition of the creation of business value may prove to be gainful to bridge these gaps. Though value may be defined by different actors in different ways, the creation of value remains the central motive force of market economies, and by extension the primary purpose of private enterprise.23 A re-focus on value may serve as an integrating tool to reconcile business performance with enlightened shareholder value, a stakeholder approach and a sustainable business model. To this purpose, we should start at the end and determine what we want firms to do, what we really want to value from our corporations and then establish metrics by which we evaluate their performance.24 But before everything else, if a business’s objective is to seek and maximize total value for all its constituents, then it is essential to understand what value means for stakeholders (including shareholders), and what value a company gains (or losses) from how stakeholders perceive its actions.25 Today, how stakeholders view a company, what they expect of the company, and how they understand the company’s impact on society and the environment matters to business value.26 In an age of better public access to information and greater expectations of corporate transparency, it is expected from companies to manage these new concerns and to take risks, but in an unconventional way, to restore trust, and to create value that benefit for both businesses and society. What if the problems we are currently facing are actually questions? This requires a shift of perception and a return to basics questions. For this purpose, I believe that a sound strategy requires an understanding of human nature and the biases that we bring to all decisions.27

This thesis begins by asserting that a reassessment of our fundamentals – shareholder primacy norm, shareholder wealth maximization – is required to shape a more sustainable corporate governance model. I will explore the ins and outs of some aspects of the current corporate governance debate and the failures of the unconventional paradigm (e.g. corporate social responsibility) to fill the gap of the shareholder primacy approach. I will introduce the stakeholder theory and the ‘multidimensional’ approach of corporate

23 Id.
24 Mayer, C., *Firm Commitment: Why the Corporation is failing us and How to restore trust in it?*, OUP Oxford, Jan 2013, 159
26 Id.
27 Ibid., 17
governance as more appealing in a post-Enron and financial crisis era, and I will present the stakeholders rhetoric as initiating a strategic shift in the corporate operating environment. In light of these findings, I will suggest to adapt to the emerging concerns of stakeholders and their expectations by focusing on value creation. For this purpose, I will highlight recent trends in reporting on corporate responsibility, and environmental, social and governance (ESG) performance. I will prove that determining the value of ESG issues to multiple stakeholders is becoming central to how many companies craft their sustainability strategy and report on their performance very much in the spirit of a new vision of the business objective: enlightened value maximization. We will see that ESG performance is influencing shareholder beliefs and behaviors, and this is reflected in changes in share price and cost of capital, and may also be changing the beliefs of corporate leaders.\textsuperscript{28} Our journey will take us into the recent trends in ESG integration - referring to the idea that all types of investors should examine companies’ sustainability practices and performance because they can have a material impact on the financial performance of companies\textsuperscript{29} - in investments, and I will suggest that businesses need to adapt, evolve and transform toward a more sustainable and transparent model. There are many challenges for businesses and their corporate leaders, and this may entail strategic rethinking of the business. Let’s start our big journey...

II. Reassessing our fundamentals

The events of the past ten years, with the 2000’s wave of corporate scandals and the global financial crisis of 2008 raised questions about the assumptions that underpin corporate governance. As the world emerges from one of the worst lapses in corporate judgment, the role and impact of the traditional corporate mantra of maximizing shareholder wealth is being subjected to significant scrutiny.\textsuperscript{30}

\textsuperscript{28} Ibid., 9
\textsuperscript{30} Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, Journal of Leadership and effectiveness, Vol. 1, No. 1, Blue Water Institute, Jan. 2013, 45
1. Questioning the shareholder primacy norm

1.1. Shareholder value and corporate failure: from Enron to the global financial crisis

The case for shareholder value as the lode star of corporate governance was made by financial economists in the early 1980s as a means of minimizing agency costs arising from the separation of ownership and control. These tend still to be framed in open-ended terms which provide management with considerable discretion in balancing the interests of different stakeholders groups. Shareholder primacy became the norm in the 1980s, and novel accounting metrics, measuring corporate performance by reference to ‘economic value added’ and ‘return on capital employed’, expressed the new philosophy very clearly.

For the past few decades, corporate scholars have agreed almost universally that the shareholder primacy norm most accurately captures the corporation’s personality and purpose. The wave of corporate and financial scandals of the 2000’s proved us that the pursuit of such end to its extreme could reach a tipping point and produces many unexpected consequences. As such, few business stories can rival with the fate of Enron and the massive scale of its accounting fraud. With echoes of transparency and reporting problems, Enron was condemned for overstating profits and keeping billions of dollars in liabilities off the balance sheet. Enron was a company ‘laser focused on earnings per share’ to the degree that, in its final stages, the underlying business ceased to matter except as a means of maintaining the impression of high earnings. Ultimately, the company’s own balance sheet position became unsustainable.

31 It should be noted that some ambiguity surrounds use of the term shareholder primacy which can refer to both the shareholder wealth maximization norm and to the view that the balance of power in corporate governance should be set in favor of greater shareholder control, see Harper Ho, V., ‘Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide’, The Journal of Corporation Law Vol. 36:, 2010, 73.


33 Id.

34 Id.

35 Clark, R.C., Corporate Law, 33 Little, Brown, 1986, 282 (discussing the competing shareholder and stakeholder theories)


An explanation for Enron’s collapse holds that Enron’s business model exemplifies the pathology of the ‘shareholder value’ system which became dominant in the US and the UK in the 1980 and 1990s.\(^{39}\) This interpretation goes to the heart of the matter and explains why the Enron case has given rise to concern.\(^{40}\) Indeed, the narrowness of the focus to the relationship between managers, boards, and shareholders and, the objective of ‘shareholder value’ took to its extreme is a major contributing to the fall of Enron.\(^{41}\) Seldom can a company have suffered such rapid and catastrophic failure and embroiled so many stakeholders and networks at one time.\(^{42}\) From this perspective, the fate of Enron is less important that the future of the business model which it came to represent.\(^{43}\)

Society’s mistrust of corporations is widely attributable to failures in the nation’s economic regulatory system and the lapsing ethical standards of the legal and accounting professions.\(^{44}\) That is why the new regulatory framework, Sarbanes-Oxley Act of 2002 (SOX), focused on closing gaps in the legal environment that permitted the infamous, unethical conduct at corporations such as Enron.\(^{45}\) The corporate governance reforms embedded in SOX were mainly initiated to align the interests between managers and the often passive investors by focusing on the independence and composition of the board of directors, auditing and remuneration processes, risk management systems and strict disclosure rules.\(^{46}\)

While SOX seems to be an appropriate legal response to the problems, regulatory bodies alone cannot create a wave of ethical leadership in corporate America.\(^{47}\) Indeed, the separation between regulatory departments and corporations repeatedly placed regulators in conflict with and at an information disadvantage to their regulated companies.\(^{48}\) Moreover, the legal mechanisms through which government must act are an inherently


\(^{41}\) *Id.*

\(^{42}\) *Id.*

\(^{43}\) *Id.*


\(^{45}\) *Id.*


\(^{47}\) See supra note 42

crude, ineffective, costly, and sometimes counterproductive means for controlling corporate behavior, and additionally have a problem of being reactive with a time lag that can result in irreparable damage between recognition of a problem and enactment of legislation.\textsuperscript{49} The lessons of the Enron case were missed in part because its failure, while catastrophic, was confined in its effects.\textsuperscript{50} Enron’s fall was interpreted as an isolated case of corporate fraud or, alternatively, as a corporate governance failure which stemmed from conflicts of interest among senior managers and board members.\textsuperscript{51} But in reality, Enron was simply taking to its extreme the share price maximization strategy which many other companies were to follow in the course of the 2000s.\textsuperscript{52}

The global financial crisis of 2008 also contributed to re-question the traditional corporate mantra of maximizing shareholder wealth. There have been some regulatory actions taken that are designed to bring more scrutiny to corporate leaders and boards of directors. These actions are designed to provide more transparency on corporate decisions and to instill confidence in the investment community.\textsuperscript{53} From the US version of regulatory reaction of Dodd-Frank of 2010 to the UK Companies Act of 2006, added attention has been inflicted into the marketplace.\textsuperscript{54}

1.2. What did we learn from the collapse of Enron and the financial crisis?

Recently, many market analysts and legal commentators have linked the wave of corporate and financial scandals to the short-termism phenomenon, i.e. the tendency of public companies to overweight short-term results relative to long-term consequences when making decisions. The short term orientation of investors and corporate boards is currently one of the key challenges in the corporate governance debate.\textsuperscript{55} Given that short-termism promotes a tendency to overvalue short-term rewards; this invariably leads to an

\begin{thebibliography}{9}
\bibitem{50} Deakin, S., ‘Corporate governance and financial crisis in the long run’, \textit{Centre for Business Research, University of Cambridge Working Paper No. 417}, December 2010, 12
\bibitem{51} Id.
\bibitem{52} Id.
\bibitem{53} Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, \textit{Journal of Leadership and effectiveness}, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 45
\bibitem{54} Id.
\end{thebibliography}
undervaluation of long term consequences.\textsuperscript{56} Concerns emerged with respect to investors acting like traders and influencing corporate managers to make policy decisions based on quarterly earnings statements.\textsuperscript{57} One commentator has flatly stated regarding the 2008 financial crisis that “today’s doctrines of shareholder primacy and managerial self-interest have brought many companies to the brink of self-destruction”.\textsuperscript{58} The argument that managers should be accountable to shareholders alone, leaving other economic and social interests to protect themselves through the interplay of market forces, is the root of the present difficulties in the Anglo-American system of corporate governance.\textsuperscript{59} Corporate governance is not merely about enhancing shareholder value; it is about enhancing economic growth, entrepreneurship, innovation and value creation.\textsuperscript{60} If Enron’s fall is to usher in a new age of enlightenment, a profound reassessment of current orthodoxies is required.\textsuperscript{61} The correct focus of corporate governance therefore should not be on enhancing shareholder value per se, but on how one structures these aspects of corporate governance with a view to attaining the firms’ objectives.\textsuperscript{62} At first, many commentators believed that the failure of individual financial institutions could plausibly be ascribed to poor governance practices in those firms. But there were more immediate factors at play, including ineffective regulation. However, the general trend towards shareholder value was implicated in a wider, systemic failure of the corporate governance system, of which the banking crisis was simply the most visible manifestation.\textsuperscript{63} Therefore, the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements.\textsuperscript{64} Under these

\textsuperscript{58} Caulkin, S., ‘Corporate Apocalypse’, MGMT. TODAY, Jan. 1, 2009, at 50, 52
\textsuperscript{60} Mayer, C., ‘Regulating for value creation: What is the link between market confidence and contractual freedom?’, in Corporate Governance, Value Creation and Growth - The Bridge between Finance and Enterprise, Chapter III, 29-33, OECD, 2012, 29
\textsuperscript{61} See supra note 57
\textsuperscript{62} See supra note 58
\textsuperscript{63} Deakin, S., ‘Corporate Governance and Financial Crisis in the Long-Run’, Working Paper No. 417, December 2010, abstract
\textsuperscript{64} Kirkpatrick, G., The Corporate Governance Lessons from the Financial Crisis, Financial Market Trends, OECD, 2009, 1

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circumstances, a reassessment of the shareholder value based approach to the governance and management of large corporations is urgently required.\textsuperscript{65}

1.3. Shareholders vs. Stakeholders – what lies beyond the great divide?

A long-running debate exists in corporate law between those who believe the corporation’s sole or primary purpose is to maximize shareholder profit, the “shareholder primacy” theory, and those who believe a corporation must honor all of its constituents’ interests, including the concerns of employees, creditors, customers, and society at large, the “stakeholder” theory.\textsuperscript{66} Let’s now highlight what is at stake beyond these concepts and the traditional divide.

In the 1960’s, Milton Friedman postulated that “there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”\textsuperscript{67} Simply put, it means that the sole business objective is the maximization of shareholder value. Yet shareholders are not the only constituents who have a stake in a corporation’s activities contrarily to what the dominant view assumes. Justification for maximization of shareholder value is based on the fact that “shareholders are the only economic actors who make investments in the corporation without any contractual guarantee of a specific return.”\textsuperscript{68} What lies beyond this belief is the view that shareholders are residual claimants; as such they are unusually exposed to the risks of the corporation’s making a profit or loss\textsuperscript{69}, and therefore need special protection which fiduciary responsibilities of directors aim to protect. But this is a false assertion.\textsuperscript{70} Many other parties are unprotected (they do not have contractual claims on the corporation) or very imperfectly protected by contracts (for example employees in

\textsuperscript{65} See supra note 61
\textsuperscript{68} Freeman, R.E., \textit{Strategic Management: A stakeholder approach}, Boston : Pitman, 1984, 24-25
\textsuperscript{69} O’Sullivan, M., \textit{Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany}, Oxford University Press, 2000, 43
\textsuperscript{70} Mayer, C., \textit{Firm Commitment: Why the Corporations is failing us and How to restore trust in it?}, Oxford University Press, 2013
developing countries). What about stakeholders, such as members of a local community who suffer from pollution emitted by the corporation. In addition, the enforceability of contracts is in practice weak. And to be honest, the rules of the game have substantially changed since Friedman won his Nobel Prize, and management practices have been keen to seek to prioritize short-term, quarter-to-quarter share price at the expense of other stakeholder or sustainability considerations - typically ignored unless they bear on that objective.

In the 1980’s, Edward Freeman laid out his stakeholder theory of corporate management, and argued that businesses were facing increasing need to interact with external forces and pressures. Freeman defined stakeholders as any group or individual that can affect or is affected by the achievement of an organization’s objectives. He recognized that in order to be successful, managers needed to adapt to strategic shifts in their operating environment, which required recognizing not only the priorities of the shareholders, but also the needs of external stakeholders – including consumers, employees, suppliers, creditors and regulating authorities to other constituents such as local communities and even the environment. In this sense, the stakeholder theory can be identified as viewing corporate responsibility as a balance of the interests of all corporate constituents, even when that balance does not maximize profits. This reflects the notion that corporations should devote resources to social and environmental issues that affect the broader (even global) society, while refraining from practices that have a negative impact on such issues. Contrarily to

71 Id.
72 See supra note 67
73 Id.
76 Id.
77 Id.
78 Werther, W.B., and Chandler, D., ‘Toward a Responsible Society (CSR)’, in ‘Strategic Corporate Social Responsibility’, Chapter 1, Sage Publications 2012, 7
80 Id.
what has been professed by critics, this conception of the stakeholder model does not require that corporations abdicate their profit-making role.\textsuperscript{81} Nonetheless, a review of the literature analyzing stakeholder theory and CSR philosophies reveals wide disparity in approach.\textsuperscript{82} This level of ambiguity may reflect one reason why its critics tend to dismiss the stakeholder theory as unpersuasive.\textsuperscript{83} By contrast, the shareholder primacy theory, with its tidy focus on one group, appears to be a relatively simple and agile concept to define and apply.\textsuperscript{84} Ultimately if society as a whole cannot agree precisely which values should be advanced, why should it be the responsibility of corporate managers\textsuperscript{85} or directors? Indeed, while theories promoting profit maximization have their flaws with respect to maintenance of long-term corporate sustainability, sacrificing corporate profits in pursuit of nonmarket social goals can make a firm uncompetitive and, ultimately, unsustainable.\textsuperscript{86} But, logically, there must be a middle ground in which refined corporate governance norms can be established to promote sustainable business enterprises for both shareholders and society.\textsuperscript{87}

2. Alternatives to the Shareholder Primacy Approach

2.1. The ‘ill-suited’ unconventional paradigm: the failure of corporate social responsibility

There is an alternative to the shareholder primacy approach to corporate governance and that corporations have broader social responsibilities which include economic, legal, ethical, and discretionary (i.e. philanthropic) considerations.\textsuperscript{88} As a result of the debate on the role of business in society and the ‘supposed’ social and environmental impacts of economic

\textsuperscript{81} \textit{Id.;} see also Harwell Wells, C.A., ‘The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century’, 51 U. KAN. L. REV. 77, 82-96 (2002), at 80 (stating “advocates of corporate social responsibility aim to reform corporate power not eliminate it”).


\textsuperscript{84} Bainbridge, S.M., ‘In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green’, \textit{50 Wash. & Lee L. Rev.} 1423, 1435-38 (1993) (pinpointing the difficulties with adopting the stakeholder model which requires a balancing of various interests).


\textsuperscript{86} \textit{Ibid.}, 453


globalization, notions such as Corporate Social Responsibility (CSR), business ethics, corporate citizenship and sustainable development emerged in the 1980’s. CSR covers the relationship between corporations and the societies with which they interact, and defines society in its wide sense, to include all stakeholder and constituent groups that maintain ongoing interest in the firm’s operations. CSR embraces the range of economics, legal, ethical, and discretionary actions that affect economic performance of the firm. As such, a strategic CSR is concerned with both the ends of economic viability and the means of being socially responsible. Ideas in CSR have been extended into the more rhetoric than practical ‘Triple Bottom Line’ addressing the purposes of businesses in terms of three responsibilities: to create economic, social and environmental value. ‘Triple Bottom Line’ is a paradigm “that a corporation’s ultimate success or health can and should be measured not just by the traditional financial bottom line, but also by its social, ethical and environmental performance”. Recently, the catchier slogan “People, Planet and Profit” became popular to promote the changing behavior required by businesses and management. In addition, sustainability issues were also brought under the spotlight, especially due to the growing awareness of climate change. The well-known definition of the ‘Brundtland Commission’ described sustainability as referring to ‘development that meets the needs of the present without compromising the ability of future generations to meet their own needs’. Demands are placed on those corporations which have a huge impact on economy, society, and the global environment to take, both locally and globally, a leading role in, and responsibility for the construction of the sustainable society. However, this unconventional paradigm advocating a private sector approach to the problem through CSR, sustainability and stakeholder’s values has been equally misconceived. Indeed, the idea of combining economic, social and environmental performance is still difficult to grasp for businesses. Everyone knows there is really one

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89 Werther, W.B., and Chandler, D., ‘Toward a Responsible Society (CSR)’, in ‘Strategic Corporate Social Responsibility’, Chapter 1, Sage Publications 2012, 6
90 Ibid., 10
91 Norman, W., and MacDonald, C., ‘Getting to the Bottom of ‘Triple Bottom Line’, 14 BUS. ETHICS Q, 243, 243, 2004
94 See Mayer, C., Firm Commitment: Why the Corporations is failing us and How to restore trust in it?, Oxford University Press, 2013
bottom line, and many fear that expenditures on CSR and sustainability will have a negative impact on profits. The same cynical – though realistic - approach may apply for business ethics which sounds more like “an instrumental strategy rather than something worth doing for its own sake.” 95 Where all these concepts, though promising, failed is in establishing credible criteria by which these objectives can be delivered and in ensuring an alignment of the interests of socially conscious people with the priorities of their wider communities. 96 Needless to say, notions of CRS and stakeholder theory seem at odds both with traditional notions of corporate obligation and with current corporate conduct. 97 Unsurprisingly, it is in energy production, mining, forestry and oil and gas industries that references to stakeholder approaches, sustainability and CSR are found most frequently, and where phenomena such as corporate transparency and dialogue on environmental and social performance are often best developed. 98 The difficulties experienced by Shell during the 1990s are a great example in terms of catastrophic failures in stakeholder relationship. 99 But because of their reputational and potential economic consequences these failures were addressed in a highly instrumental fashion, with the result that the company regained much of its former license to operate with key stakeholder groups. 100 Thus, with the main exception of Nigeria, Shell no longer experiences severe political difficulties as a direct result of its track record on social or environmental performance. 101 But nowadays, a broader range of stakeholders are raising the bar of business performance, and any stakeholder – including many that may not have been considered stakeholders a few years ago – can act, and many do. 102 Concepts of corporate responsibility and sustainability have gained increasing momentum as

96 Mayer, Colin, Firm Commitment: Why the Corporations is failing us and How to restore trust in it?, Oxford University Press, 2013, 3
101 Id.
measurements of corporate performance, and companies are beginning to embrace the idea that corporate responsibility can be good for business performance.¹⁰³

2.2. Get used to the multi-dimensionality of corporate governance and focus on value creation

Corporate governance arrangements are all about achieving the appropriate balance between the degree of commitment and control to different parties.¹⁰⁴ The implications for the design of corporate governance is that all aspects of corporate governance, design, ownership, shareholder control, board structure and incentives should be focused on getting that balance appropriately related to corporate activities.¹⁰⁵ In a nutshell, corporate governance is about the design of these features of the firm and ensuring that they promote corporate activities and values.¹⁰⁶ There is more to corporate governance than reducing principal-agent problems in order to maximize shareholder value (one dimensional aspect of corporate governance) and trying to attract long-term committed shareholders¹⁰⁷ (two dimensional model). A refocus on growth and value creation, as a three-dimensional approach, would provide a better understanding of the dynamics of corporate governance.¹⁰⁸ The examination of the three-dimensional model’s focus on growth and value creation provides a powerful catalyst for companies implementing a well-functioning governance structure.¹⁰⁹ One of the advantages of this three-dimensional model is that the responsibility for implementing structures that limit agency costs, encourage long-term commitments¹¹⁰, and promoting growth, innovation and value creation lies with the companies themselves. This multi-dimensional approach of corporate governance provides a better foundation to the pursuit of enlightened shareholder value (ESV), which is the idea that corporations should pursue shareholder wealth with a long-run orientation that seeks

¹⁰⁴ Mayer, C., ‘Regulating for value creation: What is the link between market confidence and contractual freedom?’, in Corporate Governance, Value Creation and Growth - The Bridge between Finance and Enterprise, Chapter III, 29-33, OECD, 2012, 31
¹⁰⁵ Id.
¹⁰⁶ Id.
¹⁰⁸ Ibid., 21
¹⁰⁹ Ibid., 1
¹¹⁰ Ibid., 43
sustainable growth and profits based on responsible attention to the full range of relevant stakeholder interests. This both contrasts with the narrow conception of shareholder primacy, and differs from a pluralist management model based on balancing of all stakeholder interests. ESV still recognizes the priority of shareholder interests and does not elevate non-shareholders to the same plane as shareholders, but recognizes that long-term business success depends on regard for the interests of all who contribute to and are affected by corporate activities. ESV is also grounded on a multi-dimensional approach: first, a ‘longitudinal’ or temporal dimension referring to the long-run horizon, and a "latitudinal" dimension that defines the breadth of management’s which rejects a sole focus on shareholder interests and instead embraces a broader approach that includes the corporation’s other stakeholders as well. As such, the combination of a long range, sustainable conception of value coupled with acknowledgement of the importance of stakeholder considerations for achievement of that goal thus resonates with notions of corporate social responsibility (CSR). After all, if the focus is long-term performance, it is obvious that we cannot maximize the long-term market value of a company if we ignore or mistreat any important constituency. On this point, advocates of the economic and social paradigms assert that new technologies and economic globalization are changing the very nature of business, with increasing emphasis being placed on the centrality of knowledge and innovation generated increasingly through networks. The advent of the so-called ‘network economy’ has, in turn, given rise to alternative forms of discourse surrounding the nature and purpose of the firm, business strategy and the process of value creation. While stakeholders in the US continue to struggle with stakeholder advocacy, the United Kingdom

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112 Ibid.
113 Ibid., 3
114 Ibid., 1
115 Ibid., 3
116 Id.
has passed legislation to impact the stakeholder with the Companies Act of 2006.\(^{120}\) This act endorses the ESV approach to management responsibility, and provides specific requirements for reporting information about the company’s environmental impact, employees, social and community issues and other essential contractual arrangements.\(^{121}\) This is, on the one hand, an explicit repudiation of an exclusive focus on shareholder wealth and strict shareholder primacy, and also, on the other hand an alternative to a pluralist vision of CSR that elevates non-shareholders to the same plane as shareholders.\(^{122}\) It is interesting to note that adding stakeholders to the corporate governance process is one way to address issues that can be a risk to the shareholder.\(^{123}\) That is why ESV has been seen as a feasible third way.

Finally, given the growing importance for today’s corporations to report on environmental, social and governance (ESG) performance, a new vision of the business objective emerges. These changing circumstances open the door to enlightened value maximization, which seeks greater alignment between various stakeholders to generate long-term business value.\(^{124}\) To move the ball down the field for improved stakeholder value it is important to clarify that improved stakeholder value is not a substitute for maximizing shareholder wealth. It is designed to complement both the board of director function and senior management performance, and provides an opportunity for management to provide some of their focus to potential negative risks that could adversely impact financial performance.\(^{125}\) Ultimately, improving stakeholder value should lead to an improvement in the firm’s long term profitability and risk profile. The company’s stakeholders do have a long term impact on the company’s financial performance, and they deserve analytical consideration, especially employees and the environment.\(^{126}\)

\(^{120}\) Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, *Journal of Leadership and effectiveness*, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 46

\(^{121}\) Id.


\(^{125}\) Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, *Journal of Leadership and effectiveness*, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 48

Basically, these changing assumptions about the core pillars of corporate governance and the tenets of strategic management suggest a more radical back-to-basics approach of the nature of the corporation and a reconsideration of the ins and outs of shareholder and stakeholder value. While seemingly rooted in corporate practices, shareholder value and shareholder primacy norm dominance ignores several realities.

Nevertheless since 2000’s, though unsurprisingly, corporate discourse reflects a shift from the traditional shareholder wealth maximization discourse to an embrace of rhetoric focused on stakeholders. Traditional corporate organizations have also incorporated stakeholder rhetoric into their principles of corporate governance. Entities such as the Business Roundtable and the Organization for Economic Co-operation and Development (OECD), a group comprised of 30 countries, including the United States, that focus on fostering good corporate governance, also recognize that corporations have some responsibility to stakeholders. Without rejecting shareholder primacy, the corporate rhetoric has moved toward a normative preference for long-term shareholder primacy. Even if shareholder primacy still reflects the reality of corporate practices, the rhetorical embrace of stakeholder principles suggests corporate perception that audiences do not fully endorse the normative claim that shareholder primacy ought to govern corporate conduct. What could lie beyond such rhetoric?

3. Beyond the stakeholder rhetoric

Recently, some corporate scholars, along with many corporate directors and officers, have adopted rhetoric that suggests the stakeholder model has gained broader acceptance. It has done so not only through the permeation of such rhetoric in corporate documents, such as annual reports and mission statements, but also through a proliferation of officers, board committees, and even entire departments dedicated to overseeing and implementing

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128 Ibid., 696
129 See THE BUS. ROUNDTABLE, supra note 84, at 30-33 (noting obligations to employees and the community); see also id. at 33 (noting that the corporation has an obligation to “be a good citizen”);
131 Ibid., 678
132 Ibid., 677
policies that address stakeholder issues.\footnote{Id.} An empirical study based in part of corporate documents and websites showed an increase in stakeholder rhetoric by corporations, business groups, business schools, and corporate scholars.\footnote{Empirical study conducted by Lisa M. Fairfax, see Fairfax, L.M., ‘The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms’, The Journal of Corporation Law, Spring 2006} Nonetheless, because the embrace of stakeholder rhetoric appears inconsistent with the reality of corporate practices, both critics and proponents of the stakeholder theory tend to dismiss this shift to stakeholder rhetoric as relatively insignificant, arguing that the stakeholder rhetoric appears to be mere “window dressing” for the real goal of maximizing shareholder profit.\footnote{Id., 677} But why do corporate agents feel obliged to advance rhetoric at odds with both their own actions and the “prevailing” corporate norm of shareholder primacy and profit maximization?\footnote{Ibid., 678} I tend to believe that it is all about perception. One may assume that the increased endorsement of such rhetoric may only represent a temporary public relations response to the negative press generated by corporate scandals,\footnote{The virtual wave of corporate misconduct typified by Enron and WorldCom generated significant negative publicity for corporations in general. See Fairfax, L.M., ‘Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability under the Sarbanes-Oxley Act’, 55 Rutgers L. Rev. 1, 10, 2002} and catastrophic mishaps. Indeed, history reveals that such rhetoric not only appears in cycles and becomes more pronounced during times of scandal or corporate crisis.\footnote{See ‘The Good, the Bad, and their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior’, 116 Harv. L. Rev. 2123, 2003} Under the classic understanding, rhetoric is a true art that embodies the ability not only to articulate views, but also to use language as a persuasive device to influence a particular audience about the validity of a given position.\footnote{See, e.g., PLATO, GORGIAS 453a, 453d (380 B.C.) in PLATO: EUTHYPHRO, APOLOGY, CRITO, MENO, GORGIAS, MENEXENUS at 237-38 (R.E. Allen trans., 1984) (defining rhetoric as the craft of persuasion); ARISTOTLE ON RHETORIC: A THEORY OF CIVIC DISCOURSE 36 (George A. Kennedy trans., Oxford Univ. Press 1991) (350 B.C.) (defining rhetoric as the “ability in each [particular] case to see the available means of persuasion”)} Based on this view, corporate rhetoric has an intrinsic value: it reflects corporations’ assessments about the type of language their audiences will find acceptable, and hence most persuasive, as a justification for their behavior, and may also be viewed as a corporation’s expression of its highest ideals for its conduct.\footnote{Fairfax, L.M., ‘The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms’, The Journal of Corporation Law, Spring 2006, 700} In this regard, the fact that stakeholder rhetoric emerges during time of crisis strengthens the claim that society and investors find the norm embodied within that rhetoric to be a better expression
of their normative ideal of corporate conduct, a reflection of their “true” ideals. Focusing on the intrinsic value of rhetoric as a persuasive and expressive device, the rise of stakeholder rhetoric reveals normative dissatisfaction with shareholder primacy that extends to customers and employees as well as the business community and investors. By shifting the discourse away from an exclusive focus on shareholders and profit-making concerns and towards a consideration of other interests, the embrace of such rhetoric signals a rejection of at least the core concepts of shareholder primacy. In sum, the embrace of stakeholder rhetoric during corporate crisis should be especially troubling for advocates of shareholder primacy because it symbolizes the failure of the shareholder primacy norm as a constraining influence, while indicating societal belief that the norm may be insufficient to guide corporate conduct during its more critical time periods.

To summarize this first part designed to reassess our fundamentals, this past decade majestically highlighted the fault lines within corporate governance. That reminds us that business, like life, never stands still, and that corporate governance is dynamic and fluid in nature. By taking a holistic view of the corporate governance debate, we are confronted with the disenchantments of shareholder wealth maximization, the pitfalls of the shareholder primacy norm, and the embrace of stakeholder rhetoric which reveals some societal and investor discontent with the prevailing shareholder primacy principle. Ultimately, the growing recognition that there are others besides managers and their shareholders who have an economic stake in corporate activities, and that stakeholders’ interests matter for corporate governance mechanisms and management strategy cannot be further ignored. Instead of seeing all these twists and turns as full of uncertainties and risks, we should take a holistic and pragmatic view, shift our perception and see all these still unsolved problems as challenges. Given that corporations feel increasingly pressured to demonstrate a commitment to ethical, social and environmental values, though it is still tainted with stakeholder rhetoric, one can see that there has been a strategic shift in the

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141 Ibid., 711
142 Ibid., 712
143 Ibid., 702
144 Id.
corporate operating environment. In the context of our globalized and interconnected world, both agency theorists and stakeholder theorists of the firm now have to address several interwoven concepts: corporate social responsibility, sustainable development, climate change, stakeholder approach of strategic management, and enlightened shareholder value. In addition, concerns about the environmental impact of maximizing shareholder wealth are resulting in another important stakeholder issue.\textsuperscript{147}

III. Adapting to the new expectations and focusing on value creation

4. Toward a sustainable business model with corporate reporting?

A convergence of factors has led to what is arguably an unsustainable corporate governance model.\textsuperscript{148} But things are changing faster than anyone would have expected. The transparency and interconnectivity of social media, the rapid increase of shareholder activism groups and lawsuits, the new whistleblowing rules under Dodd-Frank, the significant expansion of the regulatory frameworks, the era of compliance in an attempt to combat fraud and distrust\textsuperscript{149}, are all driving forces which will ultimately create a compelling need to bring more balance between maximizing shareholder wealth and maximizing stakeholder wealth. Businesses today face heightened expectations around their role in society and the world, with turning a profit only one of many criteria by which performance is measured.\textsuperscript{150} In other word, businesses are under the compelling need to adapt, evolve and transform.\textsuperscript{151} Rising in importance is the impact a company has on its stakeholders, society, and the environment. If sustainability is an ideal toward which society and business can continually strive, the way we strive is by creating value, i.e. creating outcomes that are consistent with the ideal of sustainability along social, environmental and economic

\textsuperscript{147} Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, \textit{Journal of Leadership and Effectiveness}, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 45
\textsuperscript{150} Deloitte-Global, ‘Sustainability and Climate change services, Integrated Reporting, A better view?’; 2011, 2
Corporations can redirect their focus to long-term value creation by expanding corporate governance standards to encompass multiple stakeholders and allowing corporations to mitigate their impact on the environment and society so as to increase their odds of long-term survival. To thrive, and tackle the current uncertainties surrounding the corporate governance debate, corporations could more effectively address their bottom line through the three-dimensional approach of corporate governance which focuses on growth and value creation. A refocus on business value creation would be the heart of this strategic shift. As such, a business model that places value creation at its core will allow the concepts of corporate responsibility, sustainable development and a stakeholder approach to management to find their natural homes, whether at a strategic level or a managerial level.

Whether business leaders warmly embrace or actively resist principles of good governance, they may soon have no choice. Too many trends are converging to force directors and leaders to be accountable to the stakeholders that they govern. Globalization, societal expectations, demands for transparency and accountability and regulatory interventions have led to a change in the type and volume of information provided in corporate reports. A decade ago, the notion of programmatically reporting a company’s sustainability information would have been derided as both frivolous and impractical. The proper focus of reporting was thought to be financial measures, the balance sheet, and the bottom line. The effects a company’s actions had on the environment, the community, and the world at large were seen as “warm and fuzzy” considerations, and fundamentally uncountable. But today this no longer the case. Sustainability, climate change and corporate responsibility issues are

157 Deloitte, ‘Sustainability reporting - The emerging challenge’, June 2010, 2
now key components of the corporate agenda. Reports covering non-financial information, such as sustainability, corporate responsibility, triple bottom line, and environmental, health, and safety issues are growing in significance. Creating value from the range of inputs or ‘capitals’ available to an organization is fundamental to successful business; communicating that process to providers of financial capital is one of the key elements of corporate reporting. Criteria have already been established to assist corporations in assessing expanded social responsibility activities. For example, the Global Reporting Initiative has developed a reporting framework in which corporations can detail their economic, environmental, and social impacts; identify their stakeholders and explain how the corporation has responded to the stakeholders' reasonable expectations and interests; and present the organization’s performance in the wider context of sustainability. The Global Reporting Initiative (GRI) has long championed the cause of sustainability reporting, and has been responsible for much of the significant progress over the past ten years. Nowadays, reporting on corporate responsibility and environmental, social and governance (ESG) is becoming central to corporate governance.

4.1. Corporate Responsibility Reporting

Corporate responsibility (CR) reporting is evolving and has become de facto law for business. Companies are increasingly realizing that CR reporting is about more than just being a good corporate citizen; it drives innovation and promotes learning, which help companies grow their business and increase their organization's value. It seems clear, therefore, that companies not yet reporting on their CR activities are under significant pressure to start. This will be increasingly critical; not only to stay competitive in a societal context, but also to gain a better understanding of how CR activities impact and benefit the

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161 Id.; see also “Technical Protocol Applying the Report Content Principles”, GRI 2011
162 Deloitte, Sustainability reporting The emerging challenge, June 2010, 2
business in areas such as cost savings and new business opportunities.\textsuperscript{164} According to a survey conducted by KPMG,\textsuperscript{165} corporate responsibility reporting hits all-time high but lacks financial reporting rigour.\textsuperscript{166} The survey found that CR reporting is now undertaken by 95 percent of the Global Fortune 250 (G250), while the largest 100 companies (N100) in each country surveyed increased reporting by 11 percent since 2008, to 64 percent overall, with developing nations showing fast uptake. However, the global momentum in corporate responsibility demands both higher quality CR information and greater use of assurance to maintain standards and stakeholder confidence.\textsuperscript{167} Indeed, as noted by Wim Bartels, Global Head of KPMG’s Sustainability Assurance, “unlike financial reporting, the disclosure of sustainability metrics to the market is largely unregulated. Restatements are four times higher compared to financial reporting and demonstrate that CR reporting has some way to go.”

4.2. Reporting on Environmental, Social and Governance Performance

Historically, many companies have treated environmental, social and governance (ESG) issues as important but tangential to the core business. In some cases, their motivation was a desire to be recognized as good corporate citizens. In other cases, these issues were viewed as compliance requirements, or perhaps good public relations. But more often than not, ESG issues were managed as secondary activities with only an indirect connection to the core business and bottom line.\textsuperscript{168} But now that’s changing, and these changes have been driven by different factors. To begin with, an increasing number of regulations that require companies to disclose their ESG performance have been adopted globally, including in emerging markets.\textsuperscript{169} Besides, many stock exchanges issue a sustainability index to

\textsuperscript{164} Id.
\textsuperscript{165} The KPMG International Corporate Responsibility Reporting Survey 2011 represents the largest and most comprehensive survey of Corporate Responsibility (CR) reporting trends ever published. 3,400 companies representing the national leaders from 34 countries around the world, including the 250 largest global companies.
\textsuperscript{167} Id.
\textsuperscript{168}http://www.deloitte.com/view/en_GX/global/insights/focus-on-the-issues/driving-enterprise-value/6f4c4fe324fed310VgnVCM1000003256f70aRCRD.htm (last visited June 19, 2013)
\textsuperscript{169} BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 4 (for more information on this point see thesis p30 paragraph 5.1. Regulatory pressure)
specifically encourage corporate disclosure of non-financial performance and ESG indicators in particular.\textsuperscript{170} But what really makes the difference is the growing interest from mainstream investors for ESG information.\textsuperscript{171} In fact ESG criteria have been integrated into mainstream investments more and more.\textsuperscript{172} The drivers of this trend are increasing demand from asset owners and growing awareness that ESG integration - referring to the idea that all types of investors should examine companies’ sustainability practices and performance because they can have a material impact on the financial performance of companies\textsuperscript{173} - can improve long-term financial performance.\textsuperscript{174} Recognizing the growing view among investment professionals that ESG issues can affect the performance of investment portfolios, the UN coordinated the development of the Principles of Responsible Investment (PRI), a framework for investors on how to consider ESG issues when fulfilling their fiduciary (or equivalent) duty of maximizing financial performance.\textsuperscript{175} Thus, as the same time as the idea of responsible investor has spread through the investment community, ESG information has become more mainstream.\textsuperscript{176} Of course regulation has contributed to a greater availability of ESG information, but the entrance of mainstream data providers played a key role as well. The market demand for ESG information has led to the entrance of well-funded financial information providers on the market (including Bloomberg, MSCI, and Thomson Reuters) and to the consolidation of smaller and more segregated data providers.\textsuperscript{177} Bloomberg reports that the number of publicly traded companies listed in its database and reporting on ESG indicators reached 5,217 in 2011, a 75 percent increase since 2008 when it launched its ESG platform.\textsuperscript{178} While there is still a need for more consistent and higher quality data, this source provides a useful platform for investors to analyze corporate


\textsuperscript{172} BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 3

\textsuperscript{173} Ibid., 1

\textsuperscript{174} Ibid., 3

\textsuperscript{175} Id.

\textsuperscript{176} Ibid., 4

\textsuperscript{177} Id.

performance. Bloomberg also reports a 50-percent increase in the number of ESG users in 2011 over 2010. However, it is worth noting that ESG data users still only represent about 1 percent of Bloomberg’s total user base, proof that investors have not yet figured out how to systematically integrate ESG information into their investment decision-making process. Indeed, there are still investors who doubt about the relevance of ESG information, and these doubts have been detrimental to how much companies invest in ESG management, and make it more difficult to argue for mandating disclosure of ESG metrics because they are financially material. Anyway, in the following pages, I will show that investor perception matters greatly, and there is signs that it has been changing.

4.3. What’s next?

The next step in the corporate reporting journey lies definitively in integrated reporting. Integrated reporting, which encompasses element of traditional financial reporting, sustainability reporting, and governance reporting within a single presentation, represents a growing trend that reflects the new expectations underlined above. For instance, the International Integrated Reporting Council (IIRC) is a global, market-led coalition that is responsible for catalyzing further shifts in thinking and behavior designed to reshape corporate reporting for the 21st century. According to Paul Druckman, CEO of IIRC, ‘integrated reporting anchors the reporting process in a more meaningful expression of how value is created which is helpful in attracting investment. It also focuses businesses and investors on the short, medium and long-term factors that are vital to achieving the macro aims of financial stability and sustainability.’ A the heart of Integrated Reporting is the concept of ‘capitals’: a business draws on stocks of capital-financial, manufactured, intellectual, human, social and relationship and natural – and enhances and diminishes them

179 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors, August 2012’, 4
181 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 4
183 Id.
as it pursues the objective of creating value over time. By encouraging businesses to consider and report on how different forms of capital collectively contribute to their ability to create value, integrated reporting has the potential to promote new ways for business and investors to assess values for the benefit of the long-term sustainability of the economy and society. Participating to this initiative remains at the discretion of the companies, but one advantage of adopting such integrated reporting is that it places the organization’s strategy and business model at the centre of communications with providers of capital, better articulating the investment. Given today’s growing demand of transparency, accountability and effective governance, businesses should seize the initiative to disclose these information to their intended audience, their stakeholders.

5. Stakeholders, the new scorekeepers

Driven by the need to improve the short term perspective that shareholder wealth maximization appears to bring to the corporate decision making process, these past few years have shown an enhanced stakeholder influence. Shareholder activism, social media and robust activity by government regulators have ushered in the need for a new era of transparency and effective governance. Nowadays, corporations are amidst of a growing web of stakeholders ‘pressures: the regulators, shareholder activists and other stakeholders such as creditors, environmental advocacy and local communities. There are innumerable examples of how stakeholders impact a company’s operations, from regulatory pressures to consumer boycotts and concerns over labor issues, including those in the supply chains. Stakeholders, as a whole, contribute to an increasing momentum to demand more than just improved financial performance; and shareholders are also demanding improved social and

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185 Id.  
186 Id.  
187 Id.  
188 Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, Journal of Leadership and effectiveness, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 45  
190 See supra note 186  
environmental performance as well. In this snapshot, I will focus on the recent regulatory changes and the additional scrutiny of investors for environmental, social and governance issues. Then it will be suggested to businesses to strategically prioritize their stakeholders.

5.1. Regulatory pressures

There have been some regulatory actions taken (Dodd Frank Act in the US, UK Companies Act 2006) designed to provide more transparency on corporate decisions and to instill confidence in the investment community. But more importantly, several countries require corporations to generate reports or other disclosures about environmental and social behavior. Here are some examples in different countries:

**In the United States:**

2010 - The SEC’s guidelines require corporate disclosure of climate-related risks. For some firms this has resulted in a triple bottom line disclosure, financial, social and environmental. Many analysts view this disclosure as a critical part of their risk analysis.  

2010 - The Dodd-Frank Act requires companies involved with obtaining oil, natural gas, and minerals to be more transparent about payments in countries where they function. Known as Section 1504, the provision requires companies engaged in the commercial development of oil, natural gas or minerals to track and report - by project and by government - all payments that equal or exceed US$100,000, individually or in aggregate. Despite protests and legal challenges from industry and business groups over the rule’s complexity, cost and competitive implications, most experts believe that Section 1504 in some form will be implemented.

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192 Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, *Journal of Leadership and effectiveness*, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 46  
193 *Ibid.*, 45  
194 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 4  
**In the U.K.:**

2010 - The Carbon Reduction Commitment (CRC) requires companies to measure all their emissions related to energy use and report their findings to the Environment Agency.

**In France:**

2001 - The New Economic Regulation Act requires listed companies to disclose data for 40 social and environmental criteria.

2010 - France took another significant step towards mandating integrated sustainability and financial reporting for all large companies with a new law called Grenelle II. The case of France is very interesting because France’s new sustainability reporting law has also the potential to impacts US companies. France has long been an important global champion of corporate sustainability reporting. But Article 225 arguably represents the strongest stance yet taken by any country to require transparency from businesses on the environmental, social and governance front. Article 225 of Grenelle II requires listed companies on the French stock exchanges, including subsidiaries of foreign companies listed in France, and unlisted companies, including subsidiaries of foreign corporations located in France, to incorporate into their annual reports information on “the social and environmental consequences” of their activities, as well as their “societal commitments for sustainable development.” However, Article 225 does not set sanctions if companies fail to comply. Enforcement is left to the shareholders, who may take legal action in such a case.

In addition to the regulators, there is also momentum impacting corporate governance among other stakeholders.

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199 Ernst & Young, ‘How France’s new sustainability reporting law impacts US companies’, 2012, 1
200 See Ernst & Young, ‘How France’s new sustainability reporting law impacts US companies’, 2012
201 Id, 1
202 Id.
204 Ernst & Young, ‘How France’s new sustainability reporting law impacts US companies’, 2012, 1
205 Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, *Journal of Leadership and effectiveness*, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 45
5.2. Additional scrutiny in the boardroom

It is interesting to note that more than two decades of scholarship has considered (and largely dismissed) the possibility that large institutional investors and other shareholders could drive greater corporate accountability to shareholders, much less bring about a new era of corporate social responsibility. However, the rise of shareholder democracy, the growing market power of institutional investors, and changes in the economic and regulatory climate all give cause for a second look. Indeed, since the debacle of the global financial crisis, investors have become significantly more skeptical and less confident with the current investment landscape. In many cases the primary concern is the impact that maximizing shareholder wealth has compromised risk management and other stakeholders. With the near meltdown of the financial system, institutional investors have shifted some of their focus from wealth maximization to enhanced risk management. Therefore, a great source of influence in the area of pro-stakeholder activism is among many institutional investors who are examining risk more carefully and concluding that environmental, social and governance should be more closely linked. Many influential institutional investors now view attention to stakeholder concerns, such as environmental protection, labor and human rights, and related corporate governance reforms, as key to long-term financial gain. Interestingly, these developments come at a time when institutional investors are also well-positioned to bring an enlightened shareholder value (ESV) vision into mainstream U.S. corporate practice. Indeed, enhanced shareholder value can also be achieved through activist shareholders who have the ability to vote on board members and other corporate activity. Recent research indicates that weak support for proposals can often lead to change where activists are voting in opposition. Ultimately board

208 Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, Journal of Leadership and Effectiveness, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 45
209 Ibid., 47
210 Ibid., 46
212 Id.
members who share a propensity for enhanced stakeholder value can be voted in by activist shareholders.\textsuperscript{213} Therefore, there has been momentum impacting corporate governance through an additional scrutiny in the boardroom by large pension funds, mutual funds and social responsibility activists.\textsuperscript{214} Many fund managers are demanding more information on environmental, social and governance risks that are potentially part of the company’s performance or strategy.\textsuperscript{215} Union pension funds and other major public pension funds (along with Tiaa Cref) are focused on sustainability as a risk management approach to securing long term returns necessary to properly fund their pension commitments.\textsuperscript{216} Since ESG issues are not effectively analyzed using standard accounting procedures, they are more qualitative in nature. These issues also tend to be more future oriented and can be helpful in assessing the future risk a company might take on.\textsuperscript{217} Some investors are using the United Nations’ Principles of Reasonable Investment as a means of assessing these stakeholder areas of interest.\textsuperscript{218} The PRI is particularly interesting because its scope covers the investment industry, the supply chain and broadly across social responsibility issues and stakeholder concerns. Unfortunately, the PRI has had limited influence because of a perception that anything that restricts returns cannot maximize wealth.\textsuperscript{219} Nonetheless, many commentators believe we are reaching a tipping point,\textsuperscript{220} where investors’ interest in corporate ESG performance is sufficient to affect valuations.\textsuperscript{221} In addition, shareholders interested in ESG performance today have many more investment options.\textsuperscript{222} Today, there are many sustainable indices issued by private index providers (Domini 400 Social Index, Dow Jones, MSCI) and by world stock exchanges.\textsuperscript{223}

\textsuperscript{213} Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, \textit{Journal of Leadership and effectiveness}, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 48
\textsuperscript{214} Id.
\textsuperscript{215} Ibid., 47
\textsuperscript{216} Ibid., 46
\textsuperscript{217} Id.
\textsuperscript{218} Ibid., 47
\textsuperscript{219} Niklasson, T., and Coninck-Smith, C., ‘Sustainable and Responsible Investment’, SRI, 2010
\textsuperscript{222} Ibid., 7
\textsuperscript{223} Id.
5.3. Strategic consideration for businesses: Know your stakeholders

Nowadays, a wide range of stakeholders are keeping score of corporate impacts on society and the environment, and, by seizing the megaphone of the Internet, challenge corporate leaders to reframe their objectives and beliefs.\textsuperscript{224} Beyond the likelihood of financial impacts due to business interruption, consumer boycotts, or loss of license to operate, there can be reputational or brand damage.\textsuperscript{225} The rise of social media and private politics, where non regulatory agents push an agenda, is beginning to rival the impact of public politics and regulatory processes, including those addressing ESG issues (see figure 1).\textsuperscript{226} While traditional high-profile news media are typically still the first to report a new story, it is the dynamic blogosphere that may pick up the story within a few hours and discuss it at length, which prolongs the focus on a company’s shortcomings.\textsuperscript{227} In this way, ESG issues can gain momentum on social media and continue to erode corporate reputations and investor confidence in corporate management.\textsuperscript{228}

Given that stakeholders groups range from clearly defined consumers, employees, suppliers, creditors and regulating authorities and less clearly defined institutional investors to other amorphous constituents such as local communities and the environment, divergent and even competing interests are foreseeable. For the firm, tradeoffs must be made among these competing interests.\textsuperscript{229} Ultimately, the corporation must identify those stakeholders (internal and external) that constitute its operating environment and then prioritize their strategic importance to the company.\textsuperscript{230} When senior managers consider the interests of their stakeholders, including shareholders, these interests need not to be at odds. Any trade-offs between a company’s various stakeholders ought to be resolved, at least in part, by

\textsuperscript{229} Werther, W.B., and Chandler, D., ‘Toward a Responsible Society (CSR)’, in ‘Strategic Corporate Social Responsibility’, Chapter 1, Sage Publications 2012, 7
\textsuperscript{230} Id.
focusing on long-term value maximization. The key element is alignment, and better alignment can increase market value. The board must be thick-skinned enough to withstand criticism and scrutiny, but its processes, deliberations and decision-making must be transparent enough to be subject to periodic evaluation and healthy debate. Every manager and director understands there will always be competing pressures from multiple constituencies. Employees are prioritizing secure employment, customers are emphasizing frugality, and shareholders are focused on increasing the share price.

Figure 1: Most important risk sources in the next three years (top five)

<table>
<thead>
<tr>
<th>Risk Source</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global economic environment</td>
<td>41%</td>
</tr>
<tr>
<td>Government spending/budget</td>
<td>32%</td>
</tr>
<tr>
<td>Regulatory changes</td>
<td>30%</td>
</tr>
<tr>
<td>Social media</td>
<td>27%</td>
</tr>
<tr>
<td>Financial risk</td>
<td>27%</td>
</tr>
</tbody>
</table>

Note: Respondents could select more than one answer.

Oversimplifying this reality by taking a one dimensional focus is inconsistent with the underlying complexity of the situation. Clearly the reality is decision calculus not additive mathematics. Management needs to consult with representatives of key stakeholders.

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233 Mathern, D.C., ‘Improving Stakeholder Value in Corporate Governance’, Journal of Leadership and Effectiveness, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 48
groups and consider how, when, why and by how much an environmental, social and governance (ESG) issue might impact the business. 234

6. Trends in ESG Integration

6.1. Does ESG performance impact valuation?

Not long ago, business were grounded in the assumption that ESG issues are not financially material, because the impacts are sometimes in the future and of little consequence to current business success. 235 But this assumption is no longer supported by statistical evidence 236 which tend to prove the opposite. There is value in ESG issues, as evidence by a growing shareholders interest and market value effects. 237 The strongest evidence that ESG performance impacts financial performance is found in short-term event studies, which put the spotlight on the link between ESG information and investor interest and decisions. A wide range of ESG events have been studied, including the negative impact on stock returns of corporate criminal activity, to violations of labor and environmental laws and product recalls. 238 News on human rights issues associated with a company have triggered an average $892 million drop in market value, and boycotts and other forms of protest can and do impact stock prices. 239

Statistical analysis of the response to new information on a company’s environmental performance reveals that the average capital market participant is paying attention to non-financial information. 240 A MIT research study of U.S. publicly traded companies over a 30-year time span (1980 to 2009) showed that stock prices dropped an average of 0.65 percent within the two-day window following the release of negative environmental news-possibly

235 Ibid., 17
236 Id.
237 Id.
driven by investor expectations that the company will face diminished cash flows. Furthermore, investors reacted more strongly to negative environmental news with each passing decade.\textsuperscript{241} Positive news on a company’s environmental behavior produced an average increase of 0.84 percent. However, over time, the positive investor response to good environmental news has been tapering off. This suggests that shareholders are increasingly biased against companies with poor environmental performance, and less impressed with, that is to say more demanding of, stronger performers.\textsuperscript{242} Companies like BP have learned the hard way that compromising environmental standards can be quite detrimental to shareholder wealth.\textsuperscript{243} Indeed, BP’s market value has plunged by nearly 36 percent almost two months following the Deepwater Horizon oil spill, and the threat of cutting BP’s annual dividend was present for a while.\textsuperscript{244} Preliminary research indicates that when shareholders activists related to a company’s environmental performance, its financial performance – measured with Tobin’s Q ratio (market value divided by book value assets) – declines.\textsuperscript{245} We can deduce that the \textit{average} investor believes the company is riskier and a less attractive investment.\textsuperscript{246} The empirical evidence to date most strongly suggests that:

1. The average investor (not only the ESG-focused investor) is paying attention to ESG when things go wrong and the company is in the limelight and usually under duress.
2. It is likely that the investor reaction to negative ESG events will continue to increase as more investors pay attention and increasingly understand what these events can mean for a company.
3. Disclosure of ESG performance can partially protect against drops in shareholder value when things do go wrong.

\textsuperscript{243} Mathern, D.C., ‘Improving Stakeholder Value In Corporate Governance’, \textit{Journal of Leadership and effectiveness}, Volume 1, Number 1, Blue Water Institute, Jan. 2013, 46
\textsuperscript{244} Wearden, G., ‘BP oil spill: Shares fall further’, \textit{The Guardian}, 2 June 2010. Available at http://www.guardian.co.uk/business/2010/jun/02/bp-oil-spill-shares-fall-further
Nonetheless, the impact of ESG performance on financial valuation must be mitigated. Two notable recent review papers suggest that past conclusions on a potential long term financial impact of ESG management should be interpreted with caution because many researchers use faulty methods or questionable data.\textsuperscript{248} Based upon a set of papers using what the researchers deem more credible methods, they find that over longer time periods ESG performance affects financial performance (both accounting measures and stock returns), but that on average the impact is minimal.\textsuperscript{249} Anyway, one thing is sure, ESG issues can impact company financial performance tied directly to its operations or products, or indirectly through stakeholders actions along the entire value chain.\textsuperscript{250} For example through direct operations risk (environmental, social), supply chain risk and product risk (for instance governance, board composition and independence but also product performance, recalls, boycotts).\textsuperscript{251}

### 6.2. ESG Integration on the rise among mainstream investors

Despite the relentless short-termism pervasive in the current economy, mainstream investors are increasingly interested in ESG integration.\textsuperscript{252} Today, both sell-side (broker dealers) and buy-side firms (hedge funds, insurance firms, pension funds, and money managers) are interested in ESG performance and are trying to integrate ESG data in valuation model.\textsuperscript{253} This interest is evidenced by the growing size of the market potential for responsible investment (RI), the greater availability and use of ESG data, and the effective


ESG performance is often correlated with other drivers of stock performance (e.g. industry competition, risk, regulatory stringency, market value, and intangibles such as R&D, brand, and marketing). Researchers often do not correctly control for these interfering factors, leading to questionable results. See Abagail McWilliams and Donald Siegel, “Corporate social responsibility and financial performance: correlation or misspecification?,” Strategic Management Journal 21, no. 5, 2000


\textsuperscript{250} Ibid., 101

\textsuperscript{251} Ibid.

\textsuperscript{252} BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 2

rise of ESG integration into investment decisions. First, as underlined previously, an increasing number of investors are showing interest in ESG integration and are adopting RI policies. Since 2005, the number of signatories to the UN Principles for Responsible Investment (UN PRI) has grown steadily and reached 1,085 in July 2012, including 258 asset owners and 651 investment managers. Second, there has also been change regarding the growth in data on corporate ESG performance, along with greater data accessibility. Asset owners see ESG integration as an opportunity to generate long-term performance while fulfilling their fiduciary duty, and investment managers see it as a way to improve the financial performance of their investment portfolio. Two factors have been identified as driving mainstream investors’ expanding interest in ESG integration:

- **Rising demand from asset owners**

The primary driver is the growing demand from asset owners. Globally, asset owners, including pension funds and insurance companies are leading the way by adopting ESG integration strategies for their entire portfolios. In particular, an increasing number of pension funds are putting ESG integration at the top of their agenda. In the United States, 85 percent of investors cite “client demand” as the main reason for integrating ESG into their investment decisions. In Europe, 81 percent of institutional investors believe that ESG integration is in the interest of fiduciary duty. On the other hand, investment management firms increasingly see sustainable investment as an opportunity to grow their practices by staying ahead of the curve, differentiating themselves from their competitors, and most importantly, better meeting the needs of their clients.

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254 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 3
256 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 3
257 Ibid., 2
258 Ibid., 5
259 Id.
ESG indicators seen as increasingly material

The secondary driver is the growing importance of ESG indicators as an increasingly important material tool in assessing a company’s performance. According to the International Integrated Reporting Council (IIRC), an increasing percentage of an entity’s market value can be attributed to intangible assets. Between 1975 and 2010 intangible assets increased from 17 percent of market value to 80 percent for S&P 500 companies. Basically, ESG indicators provide ways to measure the performance of these intangible assets. Research shows that investors perceive strong ESG indicators as a gauge for good risk management and strategic planning. As a result, companies with strong ESG performance have a higher capacity to adapt to change, lower their capital constraints, and lower their cost of capital. Most importantly, an increasing number of studies suggest a neutral to positive relationship between strong ESG indicators and long-term financial performance.

In a nutshell, an increasing number of mainstream investors are embracing the idea of RI and more and more often considering ESG information when making investment decisions. In particular, an increasing number of investors with long-term perspectives, including pension funds and insurance companies, see ESG integration as an opportunity to enhance their financial performance. The only market condition that remains certain is change itself. There is a growing recognition that how stakeholders view a company, what they expect of the company, and how they understand the company’s impact on society and the

263 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 5
265 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 6
268 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 6
environment matters to business value. While the preponderance of evidence seems to indicate that maximizing shareholder wealth has not been subordinated to maximizing stakeholder wealth, the winds of incremental change cannot be ignored. But if a business’s objective is to seek and maximize total value for all its constituents, then it is essential to reconsider what value means for stakeholders, and what value a company gains (or losses) from how stakeholders (including shareholders) perceive its actions.

7. Starting at the End: Rethinking Value Creation

7.1. Values and Values

The concept of value in itself bears inconsistencies. What we value depends on what we perceive as important in function of the information that we have. Besides, it also depends on what we think deserve to be valued, and as such it depends on our perception. Things do not have any intrinsic value. They only bear the value that we attach to them in consideration of our set of beliefs and opinions, and of our way of measure them. That is why, logically, value may be defined by different actors in different ways. In “The Economic Analysis of Accounting Profitability”, the authors made the straightforward point that value and profit have no absolute meaning, but can only be considered against a well-defined alternative. The exclusion of certain data – like our failure for account of ‘the depreciation of the world’s stock of natural capital’- and the over-reliance on number and indexes are one of the most significant problems of how we measure share price performance and company valuations. As noted by Colin Mayer, ‘determining likely future impacts is hard, attaching values to them still harder, and evaluating the appropriate rate at which discount the future costs back to the present well-nigh impossible’. As a consequence, there are essentially no mechanisms for ensuring that companies internalize the effects of

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274 Mayer, C., Firm Commitment; Why the Corporation is failing us and How to restore trust in it?, OUP Oxford, Jan. 2013, 162
their costs on the environment. The problem is not one of how to define or measure values to which we attach significance, but how these values can be re-established in markets where patterns of ownership are no longer conductive to the promotion of interests other than those of the shareholders. The challenge lies not in determining values of activities that are traditionally regarded as immeasurable, but in identifying the things that we really value.

In practical terms, a business can, and should, adopt a broader approach to value maximization for a wide range of stakeholders, not just shareholder value. The process of defining and creating value is fundamentally pluralistic and iterative, i.e. socially constructed within value based networks associated with firms, and thus the business firm is a key player in the construction of what we may one day recognize as a viable, sustainable society. Therefore, business value is created in a context that is based on what both the company and its stakeholder value. The values of the corporation can and should be many. Specifically, enlightened value maximization incorporates value created for employees (through human rights policies), for the community (through investment in the community, for suppliers (through resource efficiency gains), and for the environment (through ecosystem enhancement and protection), among others. Of course, there is no one-size-fits-all strategy, and each company’s strategic objectives will vary according to its industry, business model, value proposition, product portfolio, and competitive playing field. What is required is the re-establishment of values which stakeholders value as the primary objectives of corporations. As noted by Colin Mayer, ‘the condemnation of multiple

275 Ibid., 161
276 Ibid., 194
277 Ibid., 161
278 See Jensen, M. ‘Value maximization, stakeholder theory, and the corporate objective function’, Business Ethics Quarterly 12 no. 2, 2002
281 Mayer, C., Firm Commitment; Why the Corporation is failing us and How to restore trust in it?, OUP Oxford, Jan 2013, 193
283 Id.
284 Mayer, C., Firm Commitment; Why the Corporation is failing us and How to restore trust in it?, OUP Oxford, Jan 2013, 193
targets confuses simplicity of execution with completeness of principles’; ‘the corporation should have a simple set of objectives but a broad set of values by which it judges their implementation.’ The recent corporate embrace of stakeholder rhetoric represents an expression of the discourse corporations believe audiences, such as the judiciary, regulators, and other stakeholders find most palatable. Business value can be regarded from different perspectives. Shared vision, shared values, shared goals and shared rewards are the best ways to close the gap between those who lead and those who are led.

7.2. Stakeholder value from the perspective of stakeholders and prospect theory

Understanding stakeholder perception of value and seeking to cope with them is paramount. Stakeholder value is a moving target, and stakeholder perception of value itself is not based solely upon social constructs, such as whether the company follows the UN Declaration of Human Rights. Stakeholders may also be biased regarding a company’s ESG performance, viewing it through their own lens based on how they perceive risk. Stakeholder judgment is likely to be based on perceptions of how a company’s actions either add or destroy value. As a result, in addition to the challenge of identifying what level of performance stakeholders really care about, i.e. the reference point, companies have to consider that stakeholders are likely to look at ESG performance from constantly shifting vantage points, or ‘reference states.’ Without a deeper understanding of stakeholder

285 Id.
290 Ibid., 1
291 Id.
292 Ibid., 10
judgment, a company risks being adrift in a vast sea of information, facing difficulty in crafting strategic response and mapping a course to long-term business value creation.\textsuperscript{294} Asking key questions is capital. How do stakeholders perceive better or worse performance on a variety of ESG issues? Given this perception, how will they respond to changes in ESG performance? Before answering this question, we have to initiate an inter-disciplinary analysis and use the works done in behavioral sciences. Decades of scholarly work in behavioral economics and finance find that certain cognitive biases — summarized in prospect theory — are prevalent in any number of situations a human being can find herself in.\textsuperscript{295} Stakeholders, like all humans, make their judgments based on predictive cognitive biases and emotional reactions.\textsuperscript{296} Obviously, contrarily to what suggested Friedman with his rational agent model, we make decisions that are in reality not always rationally optimal. In sum, our perception is biased by the information that we have and how we decipher it. These biases can help us understand how stakeholders perceive a company’s ESG performance.\textsuperscript{297} One of the most important tenets of prospect theory relative to stakeholder judgment of corporate ESG performance lies in what we term ‘reference dependence’. People do not judge value in terms of absolute states or outcomes, but rather in terms of gains and losses relative to a reference point.\textsuperscript{298} Two additional tenets of prospect theory create other challenges for managers who expect recognition from their stakeholders: loss of aversion (losses hurt more than gains feel good, because people have a hard time giving up something) and diminishing sensitivity (each incremental change in gains or losses is valued less).\textsuperscript{299} The first tenet implies that stakeholders tend to be more concerned when a company’s ESG performance falls relative to a preferred level. The second tenet implies that a company’s that improves its ESG performance from a very low level, e.g., increase energy efficiency, will be rewarded more than another one that is already performing at a higher

\textsuperscript{297} Id. 
\textsuperscript{298} Id. 
\textsuperscript{299} Ibid., 11
level of energy efficiency and makes a similar sized improvement.\textsuperscript{300} Therefore, prospect theory tells us that the highest value gain is likely when a company moves from a below threshold ESG performance to above, as stakeholders value this transition highly.\textsuperscript{301} Due to “diminishing sensitivity”, companies need to work harder for each incremental gain in stakeholder value.\textsuperscript{302}

Sometimes, stakeholder’s demands, such as the ideal of carbon neutrality, can be very disruptive, because they fundamentally challenge the company’s business model.\textsuperscript{303} One example is the ‘zero-state’ situation, such as the local community in water-scarce areas questioning the very presence of the company.\textsuperscript{304} It is very difficult for companies to overcome these types of zero-state situations, where stakeholders are expressing a value set that is defined by absolutes, right or wrong.\textsuperscript{305} Stakeholder support for the precautionary principle\textsuperscript{306} is also an expression of such a value set. It is wise to acknowledge that such situations will arise and may require changes in corporate strategy.\textsuperscript{307}

An assessment of what level of ESG performance is better or worse cannot be judged relative to the company’s internal standard or its past performance, because it does not include value creation for multiple stakeholders.\textsuperscript{308} With an understanding of prospect theory, and stakeholders’ reference points and reference states, it should become easier to predict and prevent long-tailed risks.\textsuperscript{309} Therefore, stakeholders do not merely challenge the business model; they identify opportunities for value creation.\textsuperscript{310}

\textsuperscript{300} Id.
\textsuperscript{301} Ibid., 15
\textsuperscript{302} Id.
\textsuperscript{303} Ibid., 13
\textsuperscript{304} Id.
\textsuperscript{305} Id.
\textsuperscript{306} Under the precautionary principle the burden of proof that any action or policy will not cause harm the public or the environment falls on those taking the action, even where scientific consensus is lacking.
\textsuperscript{309} Id.
\textsuperscript{310} Id.
IV. Evolving toward a sustainable business model

8. Business on Sustainability

Companies will have increasingly to adapt to the new rules, map all the risks and opportunities, and seize the initiative to ultimately seek stakeholder value. But do business leaders reflect this in their beliefs and behavior?

8.1. How do business leaders perceive the importance of sustainability?

The perceive importance of sustainability is resonating with business leaders. A recent Deloitte survey of 208 global CFOs from 10 countries found that over 70 percent are currently fully or periodically involved in all aspects of sustainability strategy and governance at their firm. The majority believe that sustainability factors have an impact on compliance and risk management, and foresee changes in financial accounting and reporting. A survey of UN Global Compact member CEOs found that 93 percent view sustainability as a critical driver of their company’s future success, and up to 81 percent responded that sustainability is an important factor in strategy and operations. By 2020, these CEOs expect sustainability to be fully integrated into corporate capabilities, processes, and systems, and across global supply chains and subsidiaries. Motivated to build their company’s brand, trust and reputation, these CEOs believe sustainability activities can positively impact their company’s valuation by driving revenue growth and reducing costs. Similarly, 70 percent of 3,000 surveyed corporate executives say that sustainability is permanently on their management agendas, despite current economic uncertainty. Driven by investors, NGOs, consumer preferences, and rising social media platforms, two-

311 Ibid., 8
312 Deloitte, ‘Sustainable Finance: The risks and opportunities that (some) CFOs are overlooking’, 2011. CFOs were surveyed in Australia, Brazil, China, France, Germany, India, South Africa, UK and US. Participating companies had average annual revenue of $17 billion; none has annual revenue below $2 billion.
314 UN Global Compact/Accenture, ‘A New Era of Sustainability: UN Global Compact – Accenture CEO Study 2010’, survey of 766 CEOs around the globe and extensive interviews with 50 of the world’s leading CEOs.
316 Id.
317 ‘Sustainability nears a tipping point’, MIT Sloan Management Review and Boston Consulting Group, winter 2012
thirds of respondents believe that a commitment to sustainability is necessary to remain competitive. Likewise, three-quarters of respondents to another recent global survey believe companies should consider socially responsible investors and NGOs when crafting their sustainability strategy (see figure), with good reason.

![Figure 2: Influencers of sustainability strategy and policy](image)

Sources: GlobalScan/SustainAbility Survey 2012

One thing is sure, finding value in ESG management is becoming central to how many companies craft their sustainability strategy and report on their performance, very much in the spirit of enlightened value maximization (as explained above). However, how companies approach ESG and report their performance varies greatly. Like often when we are facing something unknown, doubts emerge. The connection between sustainability and financial performance is still opaque for corporate leaders. Most CEOs surveyed have

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319 GlobeScan/SustainAbility survey 2012. 642 sustainability experts, the majority with more than ten years of experience in sustainability, from corporate, government, non-governemmetal, academic/research, service/media, and other organizations in 77 countries, complete dan online questionnaire from December 2-19, 2011.
321 Ibid., 10
difficulty communicating the value proposition for ESG management to financial analysts.\textsuperscript{324}

The least one can say is that there are many challenges for corporate leaders.

### 8.2. From ESG risks to ESG shocks

ESG issues are particularly vexing because they can arise anywhere in a company’s value chain.\textsuperscript{325} Many ESG risks - labor protests and safety concerns or ecosystem damage - are embedded in vast corporate supply chains, where they are getting more attention.\textsuperscript{326} The empirical record most strongly supports the conclusion that the value of ESG management or lack thereof, is clearest after the fact, when the crisis has hit.\textsuperscript{327} In addition, many ESG events have knock-on effects.\textsuperscript{328} Indeed, an ESG event at one company can also negatively affect returns of its industry peers,\textsuperscript{329} and large scale ESG events, such as explosion and spills, can trigger an industry wide paradigm shift.\textsuperscript{330} For example, the 1984 Bhopal chemical accident resulted in the US Emergency Planning and Community Right-to-Know Act (EPCRA)—including mandated reporting of toxic chemicals to the EPA’s toxic chemicals inventory (TRI), the chemical industry’s Responsible Care program, and widespread scrutiny of chemicals emissions by investors, advocacy groups, and academics.\textsuperscript{331} Another great example lies in the environmental debate and intense scrutiny around the environmental effects of offshore oil and gas drilling following the spill in the Gulf of Mexico.\textsuperscript{332} The 2010 BP Deepwater Horizon oil spill posed near-term economic risks to the Gulf of Mexico region and raised questions about appropriate policies to mitigate catastrophic oil spill risks.\textsuperscript{333} In light of the 2010 BP Deepwater Horizon oil spill, two recent regulatory policy program working

\textsuperscript{324} Id.
\textsuperscript{325} See supra note 320, 106
\textsuperscript{328} Id.
\textsuperscript{331} Id.
\textsuperscript{332} See Ernst & Young, ‘Climate change and susuatainability in the oil and gas sector’, Oil & Gas Alert- Update on Sustainability, January 2011, 1
papers\textsuperscript{334} analyzed how to improve policies related to deepwater oil and gas drilling in order to mitigate catastrophic oil spill risk.\textsuperscript{335} Both papers analyze the flaws in current policies related to deepwater drilling, and demonstrate the need to provide incentives for firms to increase the safety of drilling operations.

These worst-case scenarios show that focus on catastrophes can serve as an important point of reference for those managers intent on building a more resilient company.\textsuperscript{336} Empirical research generally finds that catastrophes from which companies have difficulty recovering are marked by the following:\textsuperscript{337}

- An initial negative response of over 10 percent of market capitalization and significant financial loss in the first two or three months after the event
- A large number of fatalities
- Sustained underperformance based on management response to the catastrophe (revealing that quite often the direct losses associated with catastrophes are dwarfed by investor loss of confidence in management’s ability to deal with the situation and its aftermath)\textsuperscript{338}

The key is the realization that what underlie many of these crises - and resulting large shareholder value shifts - are a company’s strategy, execution of core business processes, and whether it is adapting to changes in the business environment, and not merely operational or financial risks.\textsuperscript{339} One thing is sure; ESG events can trigger a shift in the business environment requiring a strategic rethink and enhanced risk assessment.\textsuperscript{340} As companies have worked their way out of the recession, they are spending much more time


\textsuperscript{335} See Mitigating Oil Spill Summary, ‘Mitigating Catastrophic Oil Spill Risk’, Harvard Kennedy School, Mossavar-Rahmani Center for Business and Government. Available at http://www.hks.harvard.edu/m-rcbg/rpp/Working%20papers/Mitigating_Oil_Spill_Summary.pdf


\textsuperscript{339} Oxford Metrica, Ernst & Young, and New World Research, ‘Risks that Matter: Sudden increases and decreases in shareholder value and the implications for CEOs’, 2002

on managing risk than they have in the past.\textsuperscript{341} Risk assessment, management and mitigation have been elevated to the top priorities of governance.\textsuperscript{342} Adding stakeholders to the corporate governance process is one way to address issues that can be a risk to the shareholder.\textsuperscript{343}

9. Implications for companies and corporate leaders

In light of the previous findings, there are many challenges for companies and their corporate leaders. On one hand, business leaders have to understand how to leverage ESG information in order to capture the value derived from ESG management. On the other hand, they have to take advantage of the evolutions regarding ESG integration in mainstream investments in order to attract investors with long-term perspectives and reverse the pervasive culture of ‘quarterly capitalism’.

9.1. Leveraging ESG Information

To capture value derived from ESG management, corporate leaders can demonstrate to their investors how they are getting ahead of ESG risks in their day-to-day management and building resilience before the next ESG shock.\textsuperscript{344} There are three implications for managers: First, a record of ESG disclosure matters because it can help mitigate the immediate impact of an ESG shock when it occurs.\textsuperscript{345} As such, ESG disclosure is valuable because it helps a company demonstrate that it is managing its risks and has a track record of paying attention to its ESG performance.\textsuperscript{346} Those that disclose more ESG information are more likely to enjoy a lower cost of capital according to academic research.\textsuperscript{347}

\textsuperscript{343} See Sullivan, Long term thinking creeps into UK plc, \textit{Financial Times}, May 29, 2011
\textsuperscript{345} Id.
\textsuperscript{346} Ibid., 101
\textsuperscript{347} Dan Dhaliwal, Oliver Zhen Li, and Albert Tsang, ‘Voluntary nonfinancial disclosure and the cost of equity capital: The initiation of corporate social responsibility reporting’, University of Arizona, The Chinese University of Hong Kong, 2010.
Second, the severity of an ESG shock depends in large part on post event management, and the duration of the shock often hinges on long-term changes that a company implements to minimize the risks of future ESG events.  

This leads to the third implication and opportunity: To increase and maintain investor confidence, managers need to show how they are prepared to respond to ESG shocks and prevent them from turning into a longer-term problem. This means disclosure of ESG outputs (e.g., reporting of emissions) and clearer explanation of how ESG risks - the often unintended consequences of various ESG outputs - are identified, assessed in terms of their materiality to business value, and managed.

9.2. Attracting Long-Term Investors

There are real opportunities for listed companies to attract investors with long-term perspectives by enhancing and communicating about their ESG performance. To appeal to these investors, companies should: 1) foster greater sustainability and long-term value creation by avoiding short-termism and by further integrating ESG into their business model and strategy, and 2) develop a proactive ESG communication strategy by communicating about ESG issues that matter to investors and by improving their ESG communication channels. As a matter of fact, long-term investors constitute a more attractive investor base for listed companies because they allow companies to establish a foundation for sustainability, align investment and business cycles, and reduce costly share turnover.  

While short-termism has made the public equity market more volatile and widened the gap between corporations’ market price and their actual value, long-term investors offer...
companies the opportunity to realign their strategies with the real needs of their business. That is why long-term investors provide a genuine added-value for companies.

In response to the growing concern over short-termism, an increasing number of business leaders and institutional investors are calling for a new approach to capitalism that fosters long-term economic creation: sustainable capitalism or long-term capitalism. Research shows that firms focusing on the short-term have a short-term-oriented investor base, higher stock price volatility, and as a result higher cost of capital. In order to move toward ‘sustainable capitalism’, companies should seek to avoid short-termism and to integrate ESG into their business model. Research shows that companies can capitalize on their sustainability efforts by communicating about the connection between ESG and financial performance in a more proactive manner. That is why, to appeal to investors with long-term perspectives, companies should develop a proactive ESG communication strategy.

V. Conclusion

This journey brought us towards many different concepts, theories, expectations, perceptions and beliefs. But one thing emerges clearly form this; corporations should be prepared to change. Through a holistic view of the corporate governance debate, we are confronted with the disenchantments of shareholder wealth maximization, the pitfalls of the shareholder primacy norm, and the embrace of stakeholder rhetoric which reveals some societal and investor discontent with the prevailing shareholder primacy principle. The more we recognize the multi-dimensionality of corporate governance, the growing importance of sustainability, and the relevance of considering stakeholders’ perspectives of value; the more the debate on ‘the core pillars’ of corporate governance evolves and finds new roots that fit better with the realities of today’s businesses. The changing nature of the corporate operating environment suggests that shareholder value can be maximized, in the long run,

355 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 7
358 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 7
359 Id., 8
360 Id.
when managers act in the best interests of those who also have a stake in the success of the corporation - such as employees, suppliers, customers, and society.\textsuperscript{361} If corporate activities promote a healthy society, that society, in return, can support an environment of business growth.\textsuperscript{362} Some even suggests that for a corporation to be truly sustainable it will have to adopt a stakeholder, rather than a shareholder value based approach; where stakeholder engagement and collaboration are necessary conditions for a sustainable business model.\textsuperscript{363} Basically, stakeholders do not merely challenge the business model; they identify opportunities for value creation.\textsuperscript{364} To increase stakeholder value, there will need to be a concerted effort put forth by large institutional investors and corporations that have seen their shareholder wealth maximized over the long run by utilizing a focus on the environment, social responsibility and active governance.\textsuperscript{365} Finding the value of ESG issues is becoming paramount and companies that factor ESG risks into their planning, and manage accordingly, have the potential to fare better and lend credence after all to the notion of ESG performance as worthy of market recognition.\textsuperscript{366} Finally, it appears that the great divide between shareholder and stakeholders interests is becoming slightly narrower,\textsuperscript{367} and that is reflected by the fact that a growing number of stakeholders might have a material impact on the company and thereby impact valuations.\textsuperscript{368} The key challenge for the future of corporate governance is to determine how to best optimize the contributions of shareholders, stakeholders, management and corporate boards to enhance confidence in the system and improve long term financial performance.\textsuperscript{369} The trends around ESG integration in

\begin{footnotes}
\item[363] Wendy Stubbs & Chris Cocklin, ‘Conceptualizing a Sustainability Business Model,’ 21 ORG. & ENv’T 103, 122, 2008
\end{footnotes}
mainstream investments offers companies opportunities to attract long-term investors while, at the same time, reducing their shareholder turnover, aligning their investment strategy with the real needs of their business, and laying down the foundation for a sustainable future. Our journey just began...

370 BSR, ‘Trends in ESG Integration in Investments, Summary of the Latest Research and Recommendations to Attract Long-Term Investors’, August 2012, 10
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