Company law and Climate change

PROFESSOR CHRIS RILEY, MODULE CONVENOR FOR COMPANY LAW

TRANSCRIPT

Hello. I'm Chris Riley, and I'm the module leader for company law. I've been writing this blog as world leaders have been meeting in Glasgow, at the COP 26 Climate Conference, to address the urgency of combatting climate change. I want to ask whether UK company law is in a good shape to contribute towards achieving that, or whether it's actually adding to our environmental problems?

UK company law adopts what has been termed a shareholder primacy approach: its overriding goal is to ensure that companies put the interests of their shareholders first. This sort of prioritisation is seen in the core legal duty that is imposed on directors, and is found in section 172 CA 2006. This requires directors to promote the success of the company for the benefit of its shareholders. Since it's generally assumed that shareholders invest to make money, section 172 is understood as requiring directors to focus on maximising shareholder value, primarily through maximising the company's own profits. It's true that section 172 makes clear that, in doing that, directors must also 'have regard to' both:

- the 'impact of the company's operations on the … environment' (s172(1)(d)); as well as
- the long-term consequences of their decisions (s172(1)(a)).

However, it seems clear that directors have to have regard to these matters only in order to work out what is the truly profit maximising thing to do. Environmental responsibility for example is not something which directors must pursue as an end in itself at the expense of profits; it is something to be practised if, but only if, it will result in higher profits for the company.

And there are other features of our company law that reinforce this prioritisation of shareholder interests over a company's environmental responsibilities. So, for example:

- shareholders, and shareholders alone, get to hire and fire the directors.
- The remuneration of the executive directors who will be running the company typically rewards them for increasing shareholder value, not for their stewardship of the environment, so it is rarely in executives' own financial interests to sacrifice a company's profitability in order to protect the environment.
- Likewise, the information that companies must disclose is typically information that is valuable to shareholders wanting to judge the financial performance of their company. They are not required to disclose this sort of information that the public at large might want to know – such as whether the company is combatting, or exacerbating, climate change.
- And finally, the threat of a so called hostile takeover if a company fails to maximise its profits, and thereby its share price, provides another strong incentive on directors to focus fairely on profit maximisation.

So, if company law and corporate governance don't force directors to prioritise environmental responsibility, what, if anything, does require them to do so. Well, the traditional way of forcing directors to act responsibly has been not through company law, but instead through what sometimes call ‘external regulation’, or also ‘command and control’ regulation. That is, for example through environmental laws which specify the things that companies can, or cannot do, and which then impose costs on companies – through penalties, or fines, or higher taxes, or civil liability – if the company breaches those environmental standards. That sort of external regulation does not change company law or challenge the priority which company law gives to shareholders, it doesn’t change their obligation to try to maximise the company’s profits. Instead, that external regulation simply aims to make environmental misbehaviour more costly and therefore hopefully less profitable, and so less attractive, to directors who are still focused on profit maximisation.

There is no doubt that relying only on external regulation is an imperfect way of trying to control companies. There are shortcomings in external regulation that make it only partially effective. The political will may be lacking to introduce effective regulation. Too often, regulators may be playing ‘catch up’ with companies, the company’s directors may know, long before regulators do, about the harm that’s been caused by some of the company’s activities, activities which are profitable, but nevertheless harmful to the environment. External regulation often suffers from loopholes that companies which are focused on prioritising profits above all else, can and will, exploit.

So, is it now time to change company law itself, so that environmental responsibility is given greater importance, in its own right, within companies’ own decision-making structures? Should, for example, section 172 be reformed so that it requires directors to make protecting the environment an end in itself, something that they are obliged to pursue even if that will reduce a company’s profitability? Should for example company boards have to include a director whose role is to be an environmental champion, and who would perhaps be appointed and removable by, and answerable to, somebody other than the shareholders?

The objection to changing company law in those sorts of ways has always been that moving away from shareholder primacy might do more harm than good. This is, surely, the most fundamental, and important, issue that company law, and corporate governance face. It requires us to try to calculate the gains that we might get from moving beyond shareholder primacy against the losses that such a change might cause. How much improvement in environmental responsibility would we get by for example changing the legal duty this imposed on directors? How much economic prosperity might we lose if directors are no longer focused on profit maximisation. These are big questions, and we cannot do justice to them in a short blog. But I think there are some reasons for believing that the gains to be secured by that change away from shareholder primacy are perhaps now larger, and the losses that might be suffered probably smaller, than the traditional defence of shareholder primacy argues.

In terms of the gains, the chances of environmental catastrophe now seem so large and so significant that balancing the pursuit of profit with the protection of the environment seems likely to reap large dividends for the planet. What about the losses? The worry in moving away from shareholder primacy has been that it would result in a loss of too much investment from shareholders. Shareholders are so called ‘residual claimants’, they have no guaranteed return from the company. They risk getting nothing if no profit is made. This vulnerable position makes investment very unattractive, unless shareholders can insist that those running the company at least try to maximise profits for them. However, many larger shareholders are institutional investors, their ownership of shares is spread across most large companies. They are interested in the performance of the economy as a whole, not just in maximising the performance of each individual company in which they invest. If global warming will be as devastating to the economy as some predictions suggest, then these large institutional investors have little reason to want the companies they invest in to maximise profits, if that's at the risk of destroying the economy on which their investments depend.