

The Stakeholder Responsibility of Corporate Boards

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Executive Summary

- The interests of stakeholders (besides shareholders) have become quite prominent to necessitate their recognition by corporate boards;
- Apart from legal requirements, global trends point towards greater stakeholder engagement as a means to enhance the reputation of companies;
- Corporate law reform in India has introduced duties of directors on boards to act in the interests of stakeholders such as employees, community and the environment;
- However, significant challenges emerge, and practical considerations need to be addressed;
- Corporate boards would do well to adopt measures to engage with stakeholders.

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I. The Basic Question: Whose Interests Should Corporate Boards Serve?

An existential (but problematic) question in corporate governance relates to the very purpose for which companies are incorporated and managed. Are companies to be run solely for the purpose of maximizing the profits of the shareholders? Do governance norms insist upon protecting – or even recognizing – interests of non-shareholder constituencies? Do the directors of a company owe any duties and responsibilities to act in the interests of anyone other than shareholders?

Theoretically speaking, these thorny questions have been the subject matter of rival claims. On the one hand, the shareholder theory visualizes the shareholders as owners of the firms, thereby requiring companies to be run in a manner that maximizes their value. On the other hand, the stakeholder theory adopts a broader perspective and requires companies to be managed on a sustainable and inclusive basis so as to consider the interests of non-shareholder constituencies.

The Stakeholder Group

- Investors
- Lenders/creditors
- Employees
- Trade unions
- Customers/users
- Supply chain
- Joint venture partners/ alliances
- Local communities
- Governments
- Regulatory authorities

Source: Global Corporate Governance Forum

This debate plays out more specifically in the context of duties owed by directors of companies. Legislatures around the world have sought to define the duties of corporate boards to take into account the interests different models. In India too, the Companies Act, 2013 casts a duty on directors of Indian companies to act in the best interests of various stakeholders. Here we examine the approach followed in India in the context of global developments, examine some difficult questions emerging for Indian corporate boards and seek to provide some practical suggestions on how they may incorporate stakeholder interests in their decision-making process.

To be sure, the concept of stakeholder responsibility is closely linked with the issues of corporate social responsibility (CSR) and corporate philanthropy, both of which have received some form of recognition under the Companies Act, 2013. However, here we confine ourselves to the responsibility of directors to account for the interests of stakeholders, and leave the other two concepts for another day.

II. Global Developments and Models

Historically, corporate boards lacked guidance on whether they ought to consider the interests of non-shareholder constituencies. If anything, the view was that shareholder interests were paramount. This view is best described in two classic cases as follows:

US

Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919): It was clarified that the business of a company is carried on primarily for its shareholders, and that directors cannot divert profits for other purposes (such as to benefit customers).

UK

Parke v. Daily News Ltd, [1962] 2 Ch 927: A company going into liquidation was not allowed to gratuitously pay amounts to employees who were dismissed, as that was found to prejudice the interests of shareholders.

However, such a shareholder-centric approach has been overtaken by more explicit recognition of stakeholder interests. For example, several states in the US have enacted constituency statutes that permit directors to consider non-shareholder interests in their decision-making process. Continental European countries have gone a step further in operationalizing stakeholder representation on corporate boards through the process of codetermination, by which employee representatives are given a place on supervisory boards of companies so that employees' voices are heard and they participate in business decisions.

For our purposes, an important development relates to the enactment of the Companies Act of 2006 in the UK, which introduced the concept of "enlightened shareholder value" (ESV) in section 172. The ESV approach takes the position that the ultimate objective of a company is to generate optimal shareholder value, which is also the best means of securing protection of all interests and thereby overall prosperity and welfare. In other words, it conceives of a merger of interests of stakeholders and shareholders by adopting the position that if the company acts to preserve stakeholder interests, then that would necessarily bring about enhancement of shareholder value. In other words, a "sustainable" shareholder value approach will ensure that any diminution in value suffered by shareholders in the short term (due to the accommodation of stakeholder interests) will be more than made up by the longer term prospects of protecting and promoting shareholder interests. This can be seen as one way of harmonizing the interests of various stakeholders of a company, although it creates a hierarchy by placing shareholder interests on top.

More recently, the UK Government has taken steps to strengthen the voice of stakeholders, particularly employees and customers, at the board level in large companies. In November 2016, it issued a Green Paper in which it suggested several options to achieve the objective. These include:

- creating stakeholder advisory panels for boards to hear directly from key stakeholders;
- designating existing non-executive (independent) directors to ensure that voices of specific interested groups are heard at the board level; and
- appointing individual stakeholder representatives to company boards.

Based on an extensive consultation process and recognizing that each of the above methods have their benefits and disadvantages, the UK Government decided to implement measures to operationalize the ESV approach contained in section 172 (as discussed above), essentially by strengthening the reporting requirements so that there is transparency on how corporate boards are having regard to stakeholder interests as required by that statutory provision.

In light of these developments, it would be useful to consider the position in India on the extent to which corporate boards are required to recognize broader stakeholder interests, and the opportunities and challenges it creates.

III. Stakeholder Model in India

It is clear that directors ought to act in good faith for the benefit of the company. Since the company is a separate legal personality, there is often the question as to who represents the interests of the company. Historically, company law in India did not directly address this question. The Companies Act, 1956 did not spell out directors' duties and, more importantly, in whose interests the directors ought to act. While it was generally understood that companies had to cater to shareholder interests, other stakeholders too received some amount of recognition under corporate law. For example, employees enjoyed certain rights under company law, such as preferential payments in case of a winding up of the company, and the right to be heard in case of significant transactions such as mergers. Creditors too had rights to convert their loans into equity and also appoint nominee directors on boards of debtor companies. These can be attributed to the fact that India's corporate law had been shaped by India's socialistic origins whereby the role of corporate law extended beyond merely the protection of shareholders.

While stakeholder interests were arguably vaguely articulated under the previous position, the Companies Act, 2013 extends the stakeholder principle of corporate governance further while codifying directors' duties, and setting out the specific role of independent directors.

Companies Act, 2013

Section 166. Duties of directors.-

(2) A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.

Schedule IV. Code for Independent Directors.-

II. Roles and Functions

The independent director shall:

(5) safeguard the interests of all stakeholders, particularly the minority shareholders;

(6) balance the conflicting interest of the stakeholders.

III. Duties

The independent director shall:

(12) acting within his authority, assist in protecting the legitimate interests of the company, shareholders and its employees.

Even if there was a doubt under previous legislation as to the extent to which stakeholder interests are to be considered by directors of a company, that has been put to rest in the new legislation. In other words, shareholders are not the only constituency that deserves the attention of directors; other constituencies such as employees and even the community and the environment are to be considered by the directors in their decision-making process.

This therefore clearly reinforces the stakeholder principle into corporate law. This is also consistent with the historical understanding of corporate law in India that extended beyond shareholder protection, but it is also buttressed by other provisions of the Act such as those relating to CSR, which enlarge the boundaries of constituencies deserving the attention corporate law and corporate boards.

Certain other requirements under corporate legislation recognize stakeholder interests in other ways. For example, the Companies Act as well as the listing regulations prescribed by the Securities and Exchange Board of India require large listed companies to constitute a Stakeholders Relationship Committee, but its role is mostly confined to addressing the grievances of security holders from a procedural standpoint (e.g. transfer and transmission of securities). Another example relates to the appointment of public interest directors in stock exchanges, with a view to represent the interests of investors in capital markets. These are more specific manifestations of the stakeholder engagement principle.

IV. Challenges for Indian Boards

While the stakeholder approach is certainly advantageous from a broader philosophical perspective, it could give rise to a number of practical issues that may arise in Indian boardrooms. Here we set out some of these practical concerns that require further consideration depending upon specific situations that may arise from time to time.

First, directors may be confronted with a conflict between the interests of the shareholders and those of other stakeholders. In that case, whose interests ought to be preferred? For example, if a decision is made that benefits customers or employees, then they may potentially breach the duty to act in the interests of the shareholders. The Companies Act, 2013 has preferred to adopt the pluralist approach by providing recognition to both stakeholders and shareholders, without necessarily indicating preference to either. In a more practical sense, this means that the directors carry the burden of making the difficult choices in determining the hierarchy of differing interests in a given set of circumstances.

Second, there could potentially be conflicts among the interests of various stakeholders themselves. While shareholders' interests are generally homogenous (except largely for differences that could arise between the controlling shareholders and the minority shareholders), stakeholders could possess vastly differing interests that may require prioritization among themselves. This results in added determination and adjudication responsibilities on the board.

Third, shareholders' interests are more tangible and measurable than stakeholder interests. Shareholder interests are represented largely by financial parameters of a company that indicate corporate performance (with the most common resultant indicator being the share price of a company) as well as other indicators that may represent corporate governance. Conversely, stakeholder interests are somewhat more intangible and subjective in nature causing decision-making to be more difficult for the board.

Finally, even if some of the aforesaid practical considerations can be addressed through focused board measures and processes, the Companies Act, 2013 does not seem to provide for remedies against breach of directors' duties to take into account stakeholder interests. Generally, for a breach of directors' duties, the company could initiate a legal claim against directors. If it fails to do so, shareholders have the right to bring a derivative action against the directors on behalf of the company. However, other stakeholders do not have similar legal claims against companies or boards for breach of duties to act in their interests. Hence, their rights may not be justiciable in nature thereby questioning the extent of their efficacy.

V. Conclusion and Way Forward

The Companies Act, 2013 has brought about a paradigm shift in India in expressly requiring corporate boards to act in the interest of non-shareholder constituencies. However, as discussed, above, a number of open areas remain in the implementation of the idea. The duties of directors in relation to stakeholders are not clearly articulated, and stakeholders do not appear to have any means of enforcing their rights and remedies. In these circumstances, similar to the movement in the UK, it might be necessary for the government to consider clearer and tangible methods of implementation of stakeholder responsibility of corporate boards in India. Until appropriate changes are effected, it would augur well for corporate boards to establish their own mechanisms to address stakeholder interests. The concepts of "stakeholder management" and "stakeholder governance" are only likely to gain greater traction, and it would be important for companies to prepare themselves to move in that direction.

Practical Measures to be Established by Corporate Boards

- Develop a stakeholder relationship policy by identifying stakeholder engagement as a core policy;
- Introduce reporting measures by which there is greater transparency in the recognition of stakeholder interest by corporate boards;
- In specific circumstances, boards may insist on a stakeholder due diligence;
- Possible meetings between boards (or independent directors) with key stakeholders (or their representatives);
- Integrate stakeholder management issues in discussions with shareholders (e.g. at annual general meeting);
- Consider the appointment of stakeholder representatives on corporate boards (e.g. stakeholder director).

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