

RESEARCH HANDBOOK ON CORPORATE  
LEGAL RESPONSIBILITY

For my family

# Research Handbook on Corporate Legal Responsibility

*Edited by*

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**Edward Elgar**

Cheltenham, UK • Northampton, MA, USA

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Published by  
Edward Elgar Publishing Limited  
Glensanda House  
Montpellier Parade  
Cheltenham  
Glos GL50 1UA  
UK

Edward Elgar Publishing, Inc.  
136 West Street  
Suite 202  
Northampton  
Massachusetts 01060  
USA

A catalogue record for this book  
is available from the British Library

### **Library of Congress Cataloguing in Publication Data**

Research handbook on corporate legal responsibility / edited by Stephen Tully.  
p. cm. — (Elgar original reference)

Includes bibliographical references and index.

1. Tort liability of corporations. 2. Criminal liability of juristic persons. 3. Social responsibility of business. I. Tully, Stephen. II. Series.

K1329.5.H36 2005  
346'.0664—dc22

2005046142

ISBN 1 84376 820 8 (cased)

Typeset by Cambrian Typesetters, Camberley, Surrey  
Printed and bound in Great Britain by MPG Books Ltd, Bodmin, Cornwall

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# Contents

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<i>List of figures, tables and boxes</i>	vii
<i>List of contributors</i>	viii
<i>List of abbreviations</i>	xii
<i>Foreword</i> Michael S. Baram	xv
<i>Preface</i> Stephen Tully	xvii

## PART I THEORIES AND CONCEPTS OF CORPORATE RESPONSIBILITY

1 The theoretical background: the nature of the actors in corporate social responsibility <i>Nicholas H.D. Foster</i>	3
2 Comparative corporate governance developments and key ongoing challenges from Anglo-American perspectives <i>Bryan Horrigan</i>	20
3 The fiduciary duties of directors: a proposal for improving corporate governance in Latin America <i>Cándido Paz-Ares</i>	54
4 Directors' duties within the United Kingdom <i>Rebecca Parry</i>	73
5 Regulating the approach of companies towards employees: the new statutory duties and reporting obligations of directors within the United Kingdom <i>Simon Goulding and Lilian Miles</i>	88
6 Protecting supplier interests through English company law <i>Christopher Ruane</i>	105

## PART II SUBSTANTIVE GROUNDS FOR CORPORATE LEGAL RESPONSIBILITY

7 'Never say never jurisprudence': comparative approaches to corporate responsibility under the law of torts <i>Stephen Tully</i>	125
8 Corporate criminal responsibility <i>Celia Wells</i>	147
9 Corporate criminal liability in the United States <i>Joseph F.C. DiMento and Gilbert Geis</i>	159

vi	<i>Research handbook on corporate legal responsibility</i>	
10	Moral indifference and corporate manslaughter: compromising safety in the name of profit? <i>Simon Pemberton</i>	177
11	Reforming the doctrine of attribution: a Canadian solution to British concerns? <i>Darcy L. MacPherson</i>	194
12	Sustainable waste management: the challenge for businesses in Wales <i>Lorraine B. Frater</i>	215
 PART III ALTERNATIVE ACCOUNTABILITY MECHANISMS		
13	In the dark all cats are grey: corporate responsibility and legal responsibility <i>John Sabapathy</i>	235
14	Whistleblowers: the critical link in corporate accountability <i>Dana L. Gold</i>	254
15	The Dutch Corporate Governance Code: self-regulation or interactive legislation? <i>Jellienke Stamhuis</i>	271
16	The influence of NGOs on the normative framework for business and human rights <i>Rory Sullivan</i>	286
17	The interaction between corporate codes of conduct and international law: a study of women and children in the textile industry <i>Olga Martin-Ortega and Rebecca M.M. Wallace</i>	302
 PART IV REGIONAL AND INTERNATIONAL INITIATIVES TOWARDS CORPORATE LEGAL RESPONSIBILITY		
18	A multilateral contribution to corporate standards of behaviour: the ILO's declaration on multinational enterprises <i>Kee Beom Kim</i>	319
19	Corporate environmental liability within the European Union <i>Catherine Wijnants</i>	334
20	Corporate responsibility: the UNEP experience <i>Monique Barbut and Cornis van der Lugt</i>	349
21	Corporate accountability: an NGO perspective <i>Craig Bennett and Helen Burley</i>	372
22	International aspects of corporate liability and corruption <i>Gemma Aiolfi and Mark Pieth</i>	395
	<i>Index</i>	413

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## Figures, tables and boxes

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### Figures

1.1	The enterprise	6
1.2	The legal entity	8
2.1	Board structure, board effectiveness and corporate financial performance	31
2.2	Interaction of ‘board effectiveness’ elements	32
2.3	Alternative ‘board effectiveness’ model	33
2.4	Formal and informal corporate governance factors	33
20.1	Visual tool to define a reporting boundary	364

### Tables

6.1	Legal strategies for the regulation of ‘principal–agent’ relationships	106
16.1	Examples of corporate exposure to human rights violations	287
20.1	The benefits of implementing cleaner production	352

### Boxes

16.1	Recommendations of the UN Human Rights Sub-Commission on Companies and Human Rights	294
20.1	Awareness and Preparedness for Emergencies at Local Level (APELL) Programme of UNEP	367
21.1	So what is ‘reasonable’ and what is ‘significant’?	389

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## Abbreviations

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ACCA	Association of Chartered and Certified Accountants
ALI	American Law Institute
APELL	Awareness and Preparedness for Emergencies at the Local Level
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
ATCA	Alien Tort Claims Act
BAT	best available techniques
BPEO	best practicable environmental option
BRASS	Centre for Business Relationships, Accountability, Sustainability and Society (UK)
CA	Company Act
CA	Court of Appeal
CBCA	Canada Business Corporations Act
CBI	Confederation of British Industry
CCA	Centre for Corporate Accountability
CCA	Commercial Company Act
CEDAW	Convention on the Elimination of All Forms of Discrimination against Women
CEO	chief executive officer
CER	corporate environmental reporting
CESR	corporate environmental and social responsibility
CFO	chief financial officer
CGC	Corporate Governance Council
CLERP	Corporate Law Economic Reform Program
CLR	Company Law Review
CoE	Council of Europe
CORE	Corporate Responsibility Coalition
CSR	corporate social responsibility
DEFRA	Department for the Environment, Food and Rural Affairs (UK)
DTI	Department of Trade and Industry (UK)
EC	European Community
ECOSOC	Economic and Social Council (UN)
EIA	environmental impact assessment
EPA	Environmental Protection Act
ESD	ecological sustainable development
ESRC	Economic and Social Research Council (UK)

ETI	Ethical Trading Initiative
EU	European Union
EWC	European Waste Catalogue
FBI	Federal Bureau of Investigation (USA)
FOEI	Friends of the Earth International
FSC	Forest Stewardship Council
GAP	Government Accountability Project (USA)
GBE	government–business enterprise
GCA	General Corporations Act
GRI	Global Reporting Initiative
HL	House of Lords (UK)
HSE	Health and Safety Executive (UK)
ICC	International Chamber of Commerce
ICJ	International Court of Justice
IGO	international governmental organisation
ILO	International Labour Organisation
IOE	International Organisation of Employers
IPCC	Intergovernmental Panel on Climate Change (UN)
IPPC	Integrated Pollution Prevention and Control
IRS	Internal Revenue Service (USA)
ISO	International Organisation for Standardisation
JpOI	Johannesburg Plan of Implementation (WSSD)
MNC	multinational corporation
MNE	multinational enterprise
NGO	non-governmental organisation
NIEO	New International Economic Order
OECD	Organisation for Economic Cooperation and Development
OFR	operating and financial review
OHCHR	Office of the High Commissioner for Human Rights
OSHA	Occupational Safety and Health Administration
plc	public limited company
RSC	Revised Statutes of Canada
SASF	semi-autonomous social field
SD	sustainable development
SEC	Social Economic Committee (The Netherlands)
SI	statutory instrument
SME	small and medium-sized enterprise
SRI	socially responsible investment
TEU	Treaty of the European Union
TNC	transnational corporation
UK	United Kingdom
UN	United Nations

UNCED	UN Conference on Environment and Development
UNCTC	United Nations Centre on Transnational Corporations
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
UNEP FI	UNEP Finance Initiative
UNGA	UN General Assembly
USA	United States of America
WAG	Welsh Assembly Government
WBCSD	World Business Council for Sustainable Development
WSSD	World Summit on Sustainable Development
WTO	World Trade Organisation

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# Foreword

*Michael S. Baram*

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Corporate activity and influence have grown to unprecedented levels within nations and across borders, with many consequences for human wellbeing. Among the consequences are harms to health, safety and the environment which were foreseeable and avoidable. In addition, campaigns to advance human rights and ensure sustainable use of natural resources for the benefit of future generations are frustrated by corporate indifference. Yet another form of harm has reached great proportions in recent years: breach of public trust as evidenced by revelations of corporate corruption, bribery, misuse of public funds, and other criminal practices undertaken with disregard for law and ethical principles.

As a result, there is widespread concern and expression of outrage about corporate culture and behaviour, which in turn causes many to question the adequacy of our laws and other means of social control over corporate enterprise. And ultimately, questions are raised about the moral sense of our society, which shapes our laws and their means of implementation.

These harms and concerns motivate this book, a remarkable collection of informed perspectives on corporate legal responsibility, expert analyses of what the law is, and thoughtful arguments on what the law ought to be. Unlike traditional treatments which dwell on corporate responsibility to those who have a direct financial stake in its business activities as shareholders, the focus herein is on corporate responsibility for preventing harm to workers, consumers, the public and the environment, for enhancing human rights, for accomplishing sustainable development, and for restoring and keeping public trust.

Although the chapters address diverse topics and issues, common themes lead to a coherent and compelling view of what is wrong, why and what needs to be done. Ample evidence is provided about harms caused by corporate negligence, ignorance, indifference, and knowing disregard for law and foreseeable risk. Thoughtful analyses of legal theories, laws and regulations which comprise the legal framework for corporate governance and accountability in various nations are cogently presented and illuminate the types of reforms needed. And appeals are made for adopting enlightened concepts of human wellbeing and corporate governance into law in a manner which ensures their infusion into corporate culture.

In this undertaking, the authors have had to confront unresolved issues and ambiguities, deeply rooted in western nations, regarding the status and role of the corporation in society, and individual and organisational accountability. They respond to the well-known eighteenth-century lament that the corporate wrongdoer ‘has no soul to be damned, and no body to be kicked’ (attributed to Edward, Baron Thurlow (1731–1806), Lord Chancellor of England, in Coffee, 1981, p. 386). They contest the narrow thesis of the law and economics school 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 engages in open and free competition’ (Friedman, 1962: 133–6). And they choose the progressive view that ‘it is absurd to regard the corporation simply as an enterprise established for the sole purpose of allowing profit making . . . Every corporation should be thought of as a social enterprise whose existence and decisions can be justified only insofar as they serve public or social purposes’ (Dahl, 1975: 18–19).

In their analyses and recommendations, the authors have also pragmatically considered competing national policies which frequently have the effect of diluting laws intended to promote corporate social responsibility. In the real world, progressive nations are not monotheistic. They worship economic growth and the rapid advance of risky new technologies and business ventures while at the same time espouse and try to improve environmental quality, business ethics and human wellbeing. Too often, in legislative, judicial and regulatory forums, primacy is given to the former and its corporate agents, thereby weakening constraints on corporate behaviour and encouraging corporate excess. It is to the credit of the authors that consideration of these dysfunctional circumstances has increased the value and utility of their analyses of self-regulatory systems, corporate law, civil and criminal liability doctrines, diverse types of regulation and enforcement mandates, and international resolutions.

Thus, an important agenda for legal research and law reform is provided, and the cause of advancing the standards of corporate behaviour for societal benefit is well served, by this book.

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# Preface

*Stephen Tully*

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This preface will not aspire to summarise what follows but merely attempts to locate each chapter within an overall narrative around the issue of corporate legal responsibility, sensitise readers to degrees of corporate responsiveness, point out evolving models of regulation or novel organisational forms and draw attention to distinctive stylistic features. It is evident that prospective liability remains a fundamental business consideration, perhaps second only to competitive pressures arising from the marketplace for the influence exerted over commercial behaviour. Recent years have seen, for example, the passage of the Sarbanes–Oxley Act in the United States following in the wake of the Enron collapse, the *Prestige* oil tanker disaster off the Spanish coast during 2002 and the Global Compact emanating from the United Nations. Their common thread is the proposition that corporations must bear a responsibility commensurate with their prominent social role, significant operational impacts and substantial economic privileges. That said, the notion of corporate legal responsibility is one of considerable vintage. Indeed, the merchants of antiquity well-appreciated the necessity for contractual enforcement and the orderly conduct of commercial affairs prior to the emergence of the modern nation state.

In the contemporary era the question of legal responsibility is being swept aside by renewed interest in so-called ‘corporate social responsibility’. It is currently fashionable to call upon companies to ‘go beyond legal compliance’ in a diverse range of social, economic and environmental fields. The terminology of ‘must’, ‘should’, ‘can’ and ‘will not’ have begun to accrete along a continuum of ‘responsibility’. Milton Friedman famously rejected corporate social responsibility for usurping investor funds and distracting managers from the business of profit-making. Since implementing social welfare agendas was the responsibility of good government, it was sufficient for corporations to act within the boundaries established by law. One may add that the social responsibility agenda frequently overlooks the limits of voluntarism in a market context. Law, by contrast, is uniquely applicable to all businesses, irrespective of size, location or business sector, and thereby guarantees a level competitive playing field in certain respects. Law as such also carries the additional virtue that coercive enforcement measures may be employed by governments, thus ensuring a minimum floor through which market laggards are not

permitted to fall. Chapter 9, by DiMento and Geis, recalls that criminal law, for example, cannot be detached from the mechanics of national enforcement institutions. By drawing attention to what companies should be doing, the current corporate accountability agenda devotes lesser attention to what firms are in fact obligated to do.

It is in this respect that the *Research Handbook on Corporate Legal Responsibility* makes such a valuable contribution as a telling reminder that legal responsibility is both the beginning and end point for corporate social responsibility. For entrepreneurs to assume unanticipated responsibilities in circumstances where administrative structures are weak, corrupt or ineffective is disproportionate and misguided from a practical point of view. That said, the prospect of non-governmental organisations (NGOs) exercising those regulatory functions formerly undertaken by governments is persuasively addressed in considerable detail by Sullivan (Chapter 16). The adoption by corporations of private voluntary initiatives in the nature of codes of conduct, guidelines, performance standards or certification schemes which encourage greater decision-making transparency through public reporting or independent verification may be no substitute for (and could ultimately weaken) law's authority. Community expectations which circumscribe the propriety of commercial conduct are authoritatively delineated in law. Strict legal compliance is therefore the litmus test underlying sustainable financial profit for any given company, the supreme indicia of public trust and determinative of the social licence to operate. Or is there more to the relationship between social and legal responsibility than first meets the eye? The contribution made by Foster to this volume (Chapter 1) is particularly instructive on how the historical evolution of the juristic personality of corporations has a recurring relevance for current debates.

This handbook brings together the work of more than 20 leading academics, practitioners, campaigners and policy-makers from North America, Europe and Australia. I am quite satisfied that collectively the chapters cover the full gamut of issues associated with corporate legal responsibility and deservedly highlight some of the flavour of its multifaceted complexity. Each contributing author takes contemplative stock of the rudimentary cases or materials pertaining to his or her field but also identifies prominent institutions or leading sources of information to which interested readers may refer. The aggressiveness with which each author addresses corporate legal responsibility varies: some chapters are valuable as introductory pieces whereas others exhaustively critique particular legal doctrines or legislative amendments. Any questions raised in one chapter are frequently complemented by answers contained within another. All authors were mandated to describe the broad theoretical framework pertaining to their speciality, provide an overview of its historical evolution, accurately portray the contemporary legal position, assess

the advantages and disadvantages of a particular approach and identify influential public policy considerations with a view to predicting future developments. Beyond the similarities demanded by ‘house style’, no attempt was made to impose any particular editorial expectations. That said, both well-established commentators and newly-emergent voices were expected to present a comprehensive account of relevant information in a succinct style which is comprehensible to the layperson as much as the well-informed. The outstanding legal review contained in the chapter by Wells (Chapter 8), for example, is the epitome of clarity in the expression of extremely complex ideas.

The thought-provoking chapters contained within this handbook are timely and necessary contributions to an ever-growing domain. Indeed, this compilation confirms the emergence of a distinct subdiscipline which draws together threads from other well-established and related fields (particularly economics, strategic management, accounting and sociology) around a common question. Thus the peculiarly legal responsibility of corporations need not be a field dominated exclusively by lawyers. Emphasis properly lies upon the term ‘responsibility’ and not merely in the sense of accountability but also in respect of the actual or envisaged commercial role. That said, the contribution made by this volume is distinctively (and unreservedly) legal. It may be recalled that corporations are incorporeal entities that owe their very existence to the law and whose behaviour is governed by that discourse. The treatment of substantive legal topics such as tort (Tully: Chapter 7) or criminal law (MacPherson: Chapter 11) is noteworthy for recourse to the comparative method. Furthermore, the utility of empirically grounded research is convincingly demonstrated in the contribution made by Frater (Chapter 12): commercial attitudes to such nebulous concepts as sustainable development employed to underpin legal frameworks become spurs to greater operational efficiency in the context of waste management practices.

The handbook illustrates that conceptual precision is required for a multiplicity of interrelated theories, whether they be governance, stakeholder or partnership, and our understanding of regulation is no exception. It is by no means a given that corporate economic responsibility, corporate environmental responsibility or corporate social responsibility can (or indeed should) be ensured through corporate legal responsibility. The character of law as a reactionary response to deviant commercial practices is considered at length by Aiolfi and Pieth (Chapter 22) with reference to bribing foreign public officials. Whereas law as prescription is government led, the challenge of moulding clumsy legal doctrines around market dynamics suggests the idiosyncrasies and limitations of a strictly instrumentalist approach. Consider, for example, the prospects of criminal law seeking to temper the profit motive with worker or consumer safety, a question thrown into stark relief in the chapter by

Pemberton (Chapter 10). Perhaps Sabapathy's (Chapter 13) sceptical conclusion for the role of law has considerable justification, particularly in view of the 'legal acrobatics' required to hold corporations to account. Law can also be considered to be the byproduct of a process of communication or dialogue whereby various actors conclude negotiated outcomes. The unfolding account in the chapter by Stamhuis (Chapter 15) illustrates how novel processes such as interactive regulation blur the boundaries between self-regulation and command-and-control approaches. For some corporations, lawmaking becomes an opportunity to assume a leading role in shaping the architecture of corporate governance.

Given the undeniable legal deficiencies which have been identified by the critical assessments contained in the present volume, one may also wonder whether law reform should properly constitute the all-too-frequent solution. The truth of the matter is that tinkering with the nuts and bolts of law is often easier said than done. Consider, for example, recent efforts such as the Company Law Review within the United Kingdom in light of the systematic critique offered in the chapter by Parry (Chapter 4). The scope for legal innovation as an interim measure for resolving contemporary dilemmas is a point well made by Ruane (Chapter 6). The chapter prepared by Paz-Ares (Chapter 3) goes one step further to evaluate the phenomena of cross-pollinating national legal systems with respect to director duties in Latin America. It is therefore a continuing role and responsibility for legislators, courts and lawyers to design and enforce a stable and predictable legal environment which is simultaneously conducive to economic progress and social growth. To facilitate rather than unduly hinder market operations, legal standards must be reliable, relevant and above all workable. The initiatives adopted by inter-governmental institutions in the labour and environmental fields and evaluated in the chapters by Kim (Chapter 18), and Barbut and Van der Lugt (Chapter 20) are particularly informative in this regard.

Although the handbook clarifies the strengths and weaknesses of the applicable legal framework, it is still, however, far from an exhaustive coverage. This is partly due to the severe restrictions of length imposed upon contributors but also because, as observed above, significant strands of corporate responsibility are discernible within a broad range of subjects. The interdisciplinary nature of corporate legal responsibility naturally lends itself to worthwhile perspectives from accountants, auditors, sociologists and political scientists. As much is suggested by the insights offered through a gender perspective in the chapter by Martin-Ortega and Wallace (Chapter 17) as well as the enlightening pragmatism of activists such as Bennett and Burley (Chapter 21) confronted with the task of countering corporate power. Additional commercial opinions on how executives tackle the challenges posed by legal compliance and the temptations of regulatory avoidance would

be welcome, as well as informed discussion on the process of translating legal constraints into management strategies. What is really going on within the boardroom? Although corporate perspectives are presented or implied in several chapters, it is also worth remembering that corporations are not homogeneous. 'The firm' is frequently perceived as a ravenous one-dimensional ogre and the struggling corner store or inspired entrepreneur is often neglected. Such questions could frame a subsequent research agenda and readers will observe that the handbook omits a chapter entitled 'Conclusions'. Instead they will encounter the origins and development of various legal approaches, given an accurate sense of the way in which law addresses the question of corporate accountability and are provided with several analytical examples. For example, the chapter by Wijnants (Chapter 19) is a frank assessment of the likely impact of European environmental law upon commercial behaviour from the perspective of a legal practitioner.

The ongoing need to tweak an imperfect fit between occasionally conflicting policy objectives and legal frameworks means that the regulatory environment will evolve as much as the amorphous corporate form. However, the fundamental concepts surrounding corporate legal responsibility will remain immutable. The fixed points on this particular compass include the core *raison d'être* of the corporation, its fundamental organisational structure and the significance of the national legal context. The fourth consideration is the question of responsibility to whom, an overarching theme for all the contributors to this handbook. Any classical treatise on corporate legal responsibility would ordinarily be expected to cover the interface between corporations and traditional rights-holders such as employees, shareholders, suppliers and consumers. However, a more nuanced depiction of 'responsibility' within the routine day-to-day working relationships of any given firm must also convey the concept of an 'extended enterprise'. This handbook imaginatively extends the web of relationships beyond mere contracting to encompass novel 'stakeholders' such as public interest organisations, commercial peers, industry bodies and the wider community. Although these actors self-evidently drive the regulatory agenda, the challenge of broadening the notion of corporate responsibility with all due deference to legal efficacy and policy priorities is ably illustrated in the chapter by Goulding and Miles (Chapter 5). Consider also the consequences for corporate accountability when an employee crosses the divide to become an enforcement mechanism in the contribution made by Gold (Chapter 14). Horrigan (Chapter 2) encapsulates extremely well the sense of what overall is at stake:

Acting primarily in the interests of shareholders and without regard to or even at the expense of the interests of other stakeholders, including those who might have contributed something directly to the prosperity of the corporation, such as employees, financiers, creditors and people using the corporation's products, must

be justified within a coherent conceptual framework of corporate relationships and the responsible exercise of corporate power.

With this objective in mind, readers need not start at the beginning and work their way methodically through to the end. Such a process would be interesting for revealing differing perceptions of the role of law, an author's assumptions on the nature and purpose of the corporation and their grasp of the subtle distinctions at play between liability, accountability and responsibility. The nature of a continuing dialogue is such that none of the views expressed herein are necessarily endorsed by any other contributor. As a reference work, readers are encouraged to dip into each self-contained chapter as they see fit. The structure of the handbook is as follows. Those chapters which sketch out the broad theoretical and conceptual background such as corporate legal personality, corporate governance and directors duties are located in Part I. Part II evaluates the substantive grounds for corporate responsibility under civil and criminal law within the North American and Commonwealth jurisdictions and critiques legal techniques such as the doctrine of attribution. Part III offers several insights into different mechanisms of corporate accountability such as novel regulatory processes (interactive regulation, codes of conduct and social reporting), risk management and the influential role of NGOs. Finally, Part IV presents distinctively international perspectives on topical questions of corporate legal responsibility (corruption, labour standards, environmental protection and sustainable development) and includes an analysis of several ongoing initiatives from international organisations.

The *Research Handbook on Corporate Legal Responsibility* is a collection of works illustrating the similarities and differences in the attempts made by lawyers and others to come to terms with a very exacting problem. As a useful guide in this ever-evolving dimension of modern business reality, this volume will enjoy a wide and engaged readership. Corporate legal responsibility is, and will remain, an important arena for the scholarly research community, students, legal practitioners, policy-makers and most importantly corporate executives.

Finally, I take this opportunity to individually thank each of the hard-working and committed contributors without whom this handbook would not have materialised as well as Luke Adams, Kate Emmins, Nep Athwal and Caroline McLin and all their colleagues at Edward Elgar for their constant support and encouragement.

# PART I

## THEORIES AND CONCEPTS OF CORPORATE RESPONSIBILITY





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# 1 The theoretical background: the nature of the actors in corporate social responsibility

*Nicholas H.D. Foster*<sup>1</sup>

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## **Introduction**

The aim of this chapter is to provide a brief overview of the theoretical background to the corporation ('corporate law theory') and its impact on the study of corporate social responsibility. Corporate law theory examines such issues as the definition of the corporation, the nature of, reasons for, and means of, its existence, and the ways in which it functions. These questions are surprisingly difficult and controversial. The chapter starts by explaining the key distinction in corporate law theory and the nature of the two most important phenomena. It then provides a historical summary. The next section describes and critiques some influential theories, both old and new. The chapter ends with an application of the theoretical background to corporate social responsibility.

## **Real and legal entities**<sup>2</sup>

The usual first step in a theoretical discussion is the definition of the subject matter. In other words, we look for the answer to the question: what is a corporation?

This question has two fundamental flaws. First, it assumes that the word 'corporation' denotes one 'thing'. In fact it denotes two, *enterprises* (a subcategory of *real entities*) and *legal entities*. The difference between them (explained below) is the key distinction in corporate law theory. So let us change our approach in order to take account of this distinction, and ask two questions rather than one:

1. What is the enterprise?
2. What is the legal entity?

This is an improvement, but a second flaw remains, the way in which the questions are phrased. If we call the term to be defined 'Y', they are of the form: 'Y is X?', where X is another 'thing' to which Y is equated. This definitional technique works when X and Y are 'things' of the same type, but it is ineffective when they are not, which is the case here. It is rather like trying to define a frog by reference to a picture rather than by reference to categories of similar animals. In fact, it is worse, because at least a frog and a picture are of

#### 4 *Research handbook on corporate legal responsibility*

the same kind in that they are both physically separate real-world objects, whereas this is not the case with either the enterprise or the legal entity and the terms used to define them.

It is impossible to appreciate these difficulties, let alone resolve them, without understanding the nature of the entities concerned. For the moment, taking on trust the claim that the normal definitional technique does not work, we shall use an alternative approach and consider the factual situations which obtain when the relevant words are used. Once this has been done, we shall return to the definitional issue.

##### *The real entity and the enterprise*

This subsection is divided as follows:

- *Stage 1*: an examination of the differences in outcomes between organised and unorganised groups;
- *Stage 2*: a discussion of reification; and
- *Stage 3*: a consideration of the effect of the combination of the elements examined in Stages 1 and 2.

*Stage 1* Let us conduct a thought experiment. Imagine instructing the passengers in a railway carriage to build a house by the end of the year. No house will be built. The passengers will just shrug their shoulders at the strange behaviour you encounter in the public transport system. Now imagine giving the same instruction to people who have a structured, organised relationship with one another, some with access to finance, some with expertise in construction, and so forth. Assuming all goes well, the house will be built. In other words, an organised group of people can realise outcomes which cannot be achieved by an unorganised group. So one significant distinction between organised and unorganised groups is a *difference in outcomes external to the group* ('external outcomes').

There are also significant differences between the behaviour of the members of each group. The behaviour of the people in the railway carriage exhibits a significant degree of diversity, that of the people in the second group a much greater degree of coherence and consistency. In an organised group: 'behaviour and accompanying perspectives are to some extent regularized and predictable' (Jackall, 1988: 112 cited in Metzger and Dalton, 1996: 575). So another significant distinction between organised and unorganised groups is a *difference in outcomes internal to the group* ('internal outcomes').

The sum of the two differences can be argued to constitute the 'reality' of the organised group. This phenomenon has been referred to as: 'the manifestation, by the whole, of effects which go beyond the sum of the individual contribution of the component parts' (Lizée, 1994: 515). It led Dicey to write:

When a body of twenty, or two thousand, or two hundred thousand men bind themselves together to act in a particular way for some common purpose, they create a body, which by no fiction of law, but the very nature of things, differs from the individuals of whom it is constituted. (Dicey, 1903–04: 513)

*Stage 2* We perceive the world as made up of tangible, physically separate, unitary objects, real-world things. Our language reflects this perception and is therefore made up of words which refer to these objects (examples include: ‘house’ and ‘dog’). Reification is the treatment of a broad range of quite different phenomena (examples include: ‘courage’, ‘battle’ and ‘problem’) as if they were such objects. The literal meaning is ‘the making of a thing’ (from the Latin words *res*, ‘thing’ and *facere* ‘to make’). The *Shorter Oxford English Dictionary* definition is: ‘to convert mentally into a thing’. Reification is a basic technique, so embedded in our modes of thought and expression that we are usually unaware of it, a kind of blindness which can be misleading (Parsons, 1979).

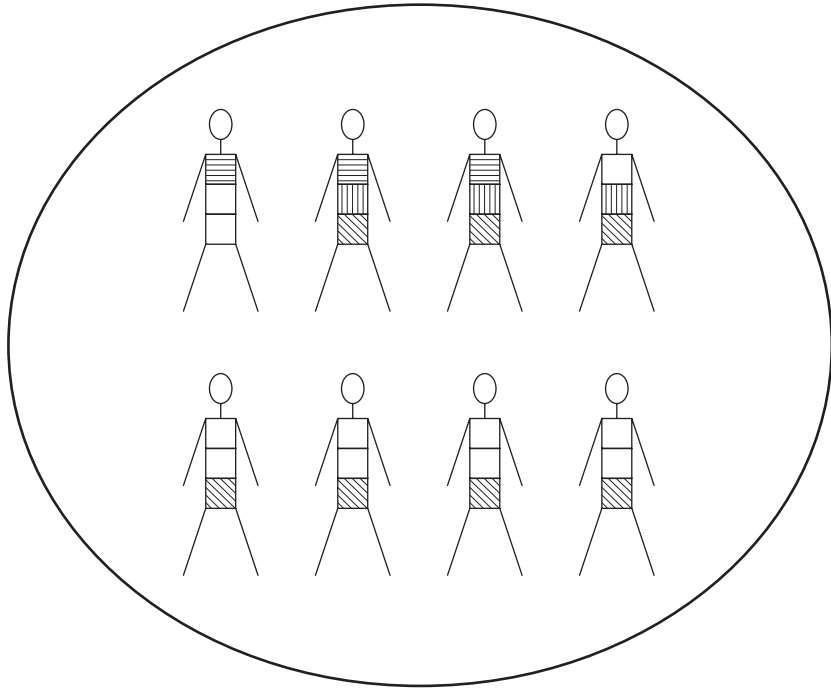
*Stage 3* The differences in external and internal outcomes exhibited by organised groups give an impression of unity and of similarity to real-world things. This impression makes it convenient and reasonable to use a kind of shorthand, and talk of such groups as if they were actually real-world things. In other words we reify the phenomenon by using some word such as ‘corporation’ to refer to ‘its’ numerous component members, linguistically and conceptually treating them as a single object.

Notably, such groups are similar to those real-world things known as humans, so in the reification process we tend to equate organised groups to people. There are numerous manifestations of this tendency, one of which is the word ‘corporation’ itself, the literal meaning of which is ‘body-ness’ (from the Latin *corpus*, meaning ‘body’), even though a body is one thing ‘it’ does not have.

There are terminological problems with words such as ‘company’ and ‘corporation’ (see further below), so the term ‘real entity’ is used herein to denote such groups. The term ‘enterprise’ is used to denote those real entities which have commercial profit as a goal. Note that the enterprise does not depend on the law for its ‘existence’. As Berle put it:

Clearly it is not the law . . . that supplies the life blood and beating heart of those vast mechanisms. If the law . . . declared that they did not exist, the entities would be found to be not fictitious, but factual . . . In vain would some lawyer complain that the directors could no longer fix policy, or the president give orders . . . The huge machine would keep right on rolling. This is the essence of an institution, and not of a legalistic creation. (Berle, 1954: 18–19)

We might represent the enterprise as shown in Figure 1.1.



*Note:* The shading denotes roles in the organisation: horizontal lines: capital contribution; vertical lines: management; diagonal lines: employees. Relationships between the participants are omitted.

*Figure 1.1 The enterprise*

### *The legal entity*<sup>3</sup>

Consider once again the people who build houses. Imagine that those people decide to ‘form a company’ called ‘The Housing Company Limited’. What actually happens? Some forms are filled in, signed and sent to Companies House with a cheque; the staff at Companies House satisfy themselves that the forms comply with the Companies Acts; they print a certificate; and they effect a change in an electronic storage medium. Now ‘a corporation exists’.

In the world of ‘brute reality’, though, our world of physical things, little has changed. Nothing exists now which did not exist before, not even in the sense of the ‘existence’ of a real entity. This seems to have been what Lord Hoffmann meant when he said: ‘there is in fact no such thing as the company as such, no *ding an sich*, only the applicable rules’.<sup>4</sup> The ‘legal entity’ is a pure abstraction, a creation of the imagination. It is truly: ‘an artificial being, invisible, intangible, and existing only in contemplation of law’ (Marshall, CJ in

*Trustees of Dartmouth v Woodward* (1819) 17 US (4 Wheat), 518 at 636). However, in the mental universe controlled by the legal system (that is, lawyers), the legal relationship of the people ‘in The Housing Company Limited’ to one another and their relationship to people ‘outside The Housing Company Limited’ are now different from what they were before the ‘company was formed’. Therefore different ‘conclusions of law in particular cases’<sup>5</sup> will apply to all concerned. And since the law affects ‘brute reality’, differences in conclusions of law (which we might call changes in legal outcomes) effect changes in outcomes in the real world.

As an example of those differences, take two people, Anne, a shareholder in Anne Limited, a legal entity with limited liability, and Bill, in business as a sole trader. If Anne Limited cannot pay its creditors, Anne will not, all other things being equal, be legally obliged to do so. However, in a similar situation, Bill will be so legally obliged and must pay the creditors to the extent of all his assets.

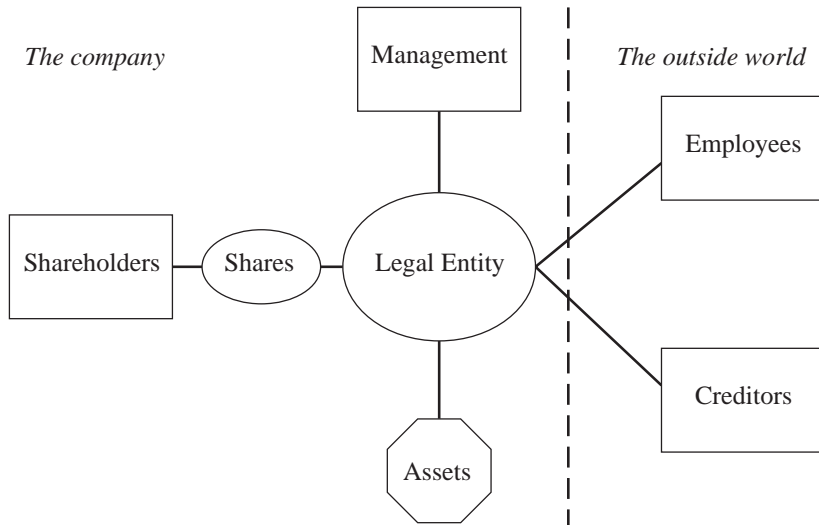
We refer to these differences in legal outcomes and the differences in real-world outcomes which result therefrom as the ‘existence’ of the legal entity. There is some similarity between the enterprise and the legal entity in that neither exists as a physical unit, and both depend for their ‘existence’ on a difference in outcomes. However, the differences in outcomes which provide the enterprise’s existence come from real-world, if usually intangible differences in organisation, structure, hierarchy and so on, which lead to a direct effect in brute reality. The differences in outcomes which provide the legal entity’s ‘existence’ are entirely dependent on the existence of a legal system in which conclusions of law have been changed.

The legal entity is based on the enterprise, but the latter’s complex structure is made easier to handle by treating roles as if they were people. In the enterprise an individual can play numerous roles. In the legal entity, they are artificially separated out. So if one person contributes capital to the enterprise, manages its affairs, and receives a salary from it, she becomes three ‘people’ in the legal entity, one for each of her roles (shareholder, director and employee), each with different rights and obligations. The legal entity might be represented as shown in Figure 1.2.

### *Back to the definitional issue*

We can now return to the claim made at the beginning of this chapter that the normal technique of defining Y by reference to X cannot work where enterprises and legal entities are concerned. We shall examine the claim by looking at the *Shorter Oxford English Dictionary* definition of a company: ‘a body of persons combined or incorporated for some common object’.

We do not know whether the word company means ‘enterprise’ or ‘legal entity’ so we shall look at both possible meanings in turn. Taking ‘company’



*Figure 1.2 The legal entity*

to mean ‘enterprise’, we have seen that the use of the word is a kind of shorthand, denoting the differences in external and internal outcomes associated with an organised group. The use of the words ‘body’ and ‘combined’ is presumably intended to convey the message that an enterprise is, like the body, made up of many parts organised in such a way that it is legitimate to consider those parts as one unit. But it attempts to do so by defining Y, a ‘thing’ of one type (the enterprise, a thing which has no unitary physical existence and which ‘exists’ by virtue of differences in potential outcomes) by reference to X, a ‘thing’ of another type (a physically separate, real-world unit). It follows that it can only give a vague, shadowy impression of the true situation.

Taking ‘company’ to mean ‘legal entity’, we have seen that the use of the expression denotes (i) the differences in legal outcomes which derive from the fulfilment of certain formal requirements; and (ii) the differences in real-world outcomes which derive from the differences in legal outcomes. The definition gives no indication of this (the only hint that the legal system might be somehow involved is the word ‘incorporated’). It simply equates the legal entity to a ‘body of persons’. But there is no sense in which this can be correct, because Y is a reification of changes in legal outcomes, whereas X is a reification of changes in real-world outcomes produced by the organisation of a group of flesh and blood individuals. These problems are avoided by using the technique employed above.

## Some history

### *The development of the idea of the legal entity*

How did this situation come about? Real entities have ‘existed’ ever since humans started to act together and treated the resultant coordinated groups as units. The idea of the legal entity developed gradually over many centuries in response to the changing role and importance of those real entities.

The Romans developed a few ideas (notably the *universitas*), but the first major developments took place in the Middle Ages when the existence of various real entities such as the Church and the boroughs confronted lawyers with practical problems. How could ‘the Borough of Kingston-Upon-Thames’ own property? How could it enter into a contract, sue and be sued? What were the relationships between the participants? The lawyers of the time used the conceptual tools available to them in order to solve these problems. A notable such tool was the concept of the ‘person’. Lawyers were used to the idea that some individuals were persons in the eyes of the law while others, such as children or monks, were not. Since the real entity has many characteristics in common with an individual (a similarity then expressed in terms of the *corpus mysticum*, the ‘mystical body’ of the real entity) the natural solution was to use this idea and regard the corporation as a *persona ficta*, a ‘made-up’ person. The idea was easy to accept because all Christians were familiar with the view of the Church as one ‘body’. They encountered it every time they heard Mass.<sup>6</sup> The legal status of a person, when attributed to a real entity, was called ‘corporate legal personality’.

But the only way in which the law can alter reality is by altering legal relationships. So the only way that the lawyers could grant ‘legal personality’ to a real entity was by changing the legal relationships between the participants inside the real entity and the relationships between those participants and the outside world. Unfortunately, the lawyers expressed what they did in terms of ‘forming a company’, inadvertently creating considerable confusion.

### *Going separate ways: the mismatch*

The concept of the legal entity was invented to deal with the legal problems created by real entities. It would seem that for many years the difference in the bases of the existence of the two entities was not realised, and no distinction was made between the enterprise and the legal entity formed for its benefit. Indeed, it was assumed that they formed one thing, an assumption which has led to endless difficulties. As long as enterprises and similar entities were not particularly numerous or economically important, and the creation of legal entities was expensive, time-consuming and rare, this way of thinking persisted.

However, once enterprises became common, and formation of legal entities

by registration became cheap and easy, practitioners quickly grasped the distinction and exploited the possibilities on behalf of their clients. In England, judicial recognition of the distinction was given in *Salomon v Salomon*, a recognition expressed in the famous dictum: 'The company is at law a different person altogether from the subscribers to the memorandum'. Or in our terminology: 'The legal entity is a different person altogether from the enterprise' (*Salomon v A Salomon & Company, Limited* [1897] AC 22, 51 (HL)). This recognition led to the present panoply of uses of the legal entity unrelated to the enterprise, such as one shareholder, shell, shelf, dormant and special-purpose companies, the subsidiary, the holding company and the corporate group (the last now being the usual legal representation of the enterprise).

### **Theories old and new<sup>7</sup>**

As the law developed, some theoretical explanations and justifications were offered. A selection is examined in this section.

#### *Terminology*

One of the major problems in this area is terminology. So far we have encountered some terms devised and defined for the purposes of this discussion. An explanation of the remaining principal terms is set out here. 'Company' used to be a general term for any real entity. It is still sometimes used in this sense, but in the United Kingdom and most jurisdictions which derive their law from England its commonest sense is that of a kind of legal entity; another is that of the shareholders regarded as a whole. 'Corporation' used to be a general term straddling real and legal entities. In the United Kingdom, recent usage is associated more with public bodies; in North America, it has become the equivalent of the UK 'company', both in its sense as an enterprise and as a legal entity. In economics usage, 'firm' denotes the enterprise; in legal parlance, it means a partnership. 'Theory' is misused. It covers a rag-bag of principles, doctrines, hypotheses and true theories. In the summaries below, the terminology used in those theories will, despite its failings, also be used in their description.

#### *The older theories*

Only the principal theories are discussed. Numerous others exist which have not affected the mainstream of corporate thinking.<sup>8</sup> We have already seen that before the greater use of legal entities in the nineteenth century few people, if any, were aware of the key distinction. It is not surprising, therefore, that none of the theories make it. In order to avoid repetition, this fact will be mentioned only when it is necessary to do so in order to explain other problems.

*Fiction* 'A corporation is a fictitious, artificial, legal person or entity' (Phillips, 1994: 1064). This theory inextricably muddles up the enterprise with



the legal entity. The only interpretation of it which (i) makes sense and (ii) makes it worth saying, is that it is a statement of the idea that legal competence can be granted to real entities by pretending that they are flesh and blood persons. If we interpret it as referring to enterprises it is wrong because, as we have seen, enterprises do not owe their reality to the law and there is no necessary connection between an enterprise and a legal entity. If we apply it to legal entities it is unobjectionable, but does not tell us much.

*Concession* Only the state can grant the privilege of legal personality. If the 'theory' refers to real entities it is wrong because they can exist with no concession from the state. If it refers to legal entities it is no more than a declaration that the state will not allow them to exist without its permission.

*Contractual* The corporation is a set of contractual relations among those individuals. It has been claimed that a necessary consequence of this notion is that corporations are intrinsically private. In addition to the failure to make the key distinction, the theory is based on a faulty technique, the definition of the 'corporation' by reference to one of its characteristic elements, contract. Such an approach cannot work. It is an illegitimate use of metonymy (the depicting of Y by reference to X, a striking part or manifestation of Y). Taking the example given by the *Shorter Oxford English Dictionary*, 'sceptre' can be used to mean 'authority'. It is permissible to use metonymy for certain purposes, such as literary or stylistic effect. It is quite another thing, and wrong, to state that Y is X, that the sceptre actually is the authority, that the contractual relations actually are the 'corporation'. Both the enterprise and the legal entity 'are' much more than a set of contracts. In any event, as we have seen, a better way of understanding the enterprise and the legal entity is to jettison the 'define Y in terms of X' approach and look at what is actually happening in both situations.

*Association* In similar vein, it is sometimes said that the corporation is no more than an association of individuals. If the enterprise is meant, saying that it is reducible to individuals ignores the difference in potential outcomes between an organised and an unorganised group. If it refers to the legal entity it is wrong.

*Institutional* The corporation is: 'part of the social organization and . . . a social institution'.<sup>9</sup> If 'corporation' means 'enterprise', then the statement fails, because it is an attempt to define Y by reference to one alleged characteristic of Y. If 'corporation' means 'legal entity' it is wrong because a legal entity cannot be part of social organisation, it can only be a construct of the legal system.

*Gestalt entity* The corporation is a kind of gestalt entity, greater than the sum of its parts: ‘corporations are real, naturally occurring beings with characteristics not present in their human members’ (Phillips, 1994: 1062). It has been claimed that, since it is a being like a human person, it too should have a legal personality. If this idea refers to the real entity, it goes too far. Enterprises are similar enough to human beings to make it understandable, and even in some circumstances efficient, to treat them as units. This does not mean that they are some sort of life-form. This idea cannot apply to the legal entity.

### *Some newer ideas*

These theories and others were much discussed between about 1890 and 1930. The subject then fell out of fashion and nowadays corporate legal personality is ‘no longer a standard topic in taught jurisprudence’.<sup>10</sup> The fall was attributed in the United States to an article by the philosopher John Dewey and the then dominant fashion of American Realism, in which little importance was attached to legal concepts (Dewey, 1926). ‘The realist attack on conceptualism in legal thought simply displaced corporation theory’ (Mark, 1987: 1481). In 1932, a very influential new idea was put forward by Berle and Means. The corporation separated ownership of assets from their management: ‘Physical control over the instruments of production has been surrendered in ever growing degree to centralized groups who manage property in bulk, supposedly, but by no means necessarily, for the benefit of the security holders’ (Berle and Means, 1932: 8 cited in Johnston, 1993: 220).

Insofar as anyone discussed corporate theory, it was Berle and Means’ idea which filled the gap left by Dewey’s demolition of the older discussions (Bratton, 2001: 754). In the past few years, corporations have become even more important than before, largely as a consequence of globalisation and widespread privatisation. This increased importance has led to concerns about many aspects of their activities, including their influence on the environment, their accountability and their governance. Such concerns have in turn resulted in a revival of interest in theory, led by law and economics scholars. It has included a reassessment of the older ideas (see, *inter alia*, Horwitz, 1985; Hager, 1989; Phillips, 1994). Some well-known newer theories are discussed below.<sup>11</sup>

*Transaction costs* In business you can either: (a) take on people as employees, creating a hierarchical, control relationship among the participants; or (b) contract with them at arm’s length as independent providers of services, creating a series of horizontal relationships among the participants. If (a) is cheaper than (b), you choose (a). In so doing, you create a firm. Firms exist because people engaged in business may in some circumstances save transaction costs by internalising production within a single organisational form. This idea, first put forward by Coase in a 1937 article, has been much developed since.<sup>12</sup>

*Agency costs* In a firm, the ownership of the shareholders' assets is separated from their management, which is undertaken by the directors. The directors (the agents of the shareholders) could abuse their position, so it is necessary to ensure that the directors are honest, conscientious and zealous in promoting the interests of the shareholders. The costs associated with this process are 'agency costs'.

*Property* Scholars such as Grossman, Hart and Moore have considered the significance of property rights in the decision whether to create a firm or use a series of independent contracts. According to Hart:

In a world of transaction costs and incomplete contracts, *ex post* residual rights of control will be important because, through their influence on asset usage, they will affect *ex post* bargaining power and the division of *ex post* surplus in a relationship. This division in turn will affect the incentives of actors to invest in that relationship. Hence, when contracts are incomplete, the boundaries of firms matter in that these boundaries determine who owns and controls which assets. (Hart, 1989: 1766)

*Corporate law as standard terms* Corporate law is solely a provider of standard terms which serve to reduce transaction costs:

[T]he primary utility of corporation law lies in providing a set of standard, implied contract terms, for example, governing credit, so that business firms do not have to stipulate these terms anew every time they transact, although they could do so if necessary. (Posner, 1976: 506)

*Asset partitioning* Efficiency is increased by dividing the assets of shareholders into two groups: (a) those which belong to the shareholders in their personal capacity; and (b) those which belong to the 'legal entity'.<sup>13</sup> Business creditors are given rights in priority to the other creditors of the shareholders over (b). This characteristic: 'is the only essential contribution that organizational law makes to commercial activity, in the sense that it is the only basic attribute of a firm that could not feasibly be established by contractual means alone' (Hansmann and Kraakman, 2000: 393). The advantages include a reduction in monitoring costs because creditors only have to monitor the creditworthiness of the legal entity, not that of the numerous owners.

*The team production model* Everyone involved in the public corporation has: 'made firm specific investments and have given the exclusive power to allocate outputs and resolve disputes to the board of directors'.<sup>14</sup>

*Autopoietic analysis*<sup>15</sup> Autopoietic (self-organisation) theory began as an attempt to explain living systems as wholes, rather than as reactions among

their component parts. Some scholars, notably Luhmann (1986), extended it to social systems. Teubner has applied it to legal systems generally and to corporations in particular. Autopoietic systems are made up of ‘self-referential circles [which] loop together in such a way as to form new elements which constitute a new system’ (Teubner, 1993: 43).

*Other approaches* Numerous other approaches exist, stressing, *inter alia*, the role of employees, the importance of bargaining and the role of social norms in the formation of rules.<sup>16</sup> These ideas are of considerable utility if applied, as they should be, to the enterprise rather than to the legal entity. However, all too often scholars fail to make the key distinction, a failure which leads to a muddle in the minds of authors and confusion in the minds of readers. Also, many suffer from the ‘Holy Grail syndrome’, the erroneous assumption that one idea can provide a complete explanation of a complex phenomenon.

Given its influence, one theory is worth looking at in more detail. The nexus of contracts idea was given its initial impetus in Coase’s 1937 article, in which he referred to the firm as ‘the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur’ (Coase, 1937, p. 393, emphasis added). Coase’s idea was then taken further by other writers. In particular, Jensen and Meckling, in their work on agency costs, claimed that: ‘[c]ontractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc’ (Jensen and Meckling, 1976: 311). They used this principle to define the firm as: ‘a legal fiction which serves as a nexus for contracting relationships’.<sup>17</sup> Another definition is that the firm is: ‘a set of bilateral contracts between each stakeholder . . . and the manager, or common agent’ (Laffont and Martimort, 1997: 207 cited in Eisenberg, 1999a: 831). A comprehensive critique of this idea is summed up by its author as follows:

The conception that the corporation is a nexus of contracts can be understood in either a very weak or a very strong sense. In its very weak sense, the conception means only that the corporation is by and large a product of private ordering, including not only reciprocal arrangements, but property rights, bureaucratic rules, and directions by superiors to subordinates. In this very weak sense, the conception has few positive implications and no normative implications. If the rhetoric of corporate-law scholarship was restricted to this very weak sense, the nexus-of-contracts conception would not be objectionable. Typically, however, the nexus-of-contracts conception is used in a very strong sense, to mean that the corporation consists of, and only of, contracts and other reciprocal arrangements. This sense of the term is both descriptively inaccurate and intellectually incoherent.<sup>18</sup>

#### *Utility of the theories*

Despite the weaknesses of the theories, particularly the older ones, time devoted to their study is well spent. At least three benefits can be identified:

1. some thinking contains ideas which are useful in themselves, so long as they, and their inevitable limitations, are properly understood and applied;
2. some thinking, even if erroneous or misleading, has none the less been and remains influential. It therefore needs to be studied in order to understand the background to the errors which result from it; and
3. the theories are useful evidence of attitudes towards enterprises and their place in society.

There are numerous examples of benefit 1, particularly among the modern ideas. Examples of benefit 2 can be found in the fiction theory and the concession theory. The former has been instrumental in tempting the unwary to take an anthropomorphic view and treat the enterprise and the legal entity as individuals. The latter is significant because it embodies the origin of the idea that the state has, and should have, the power to control the enterprise. Sometimes both benefits 1 and 2 are present, as in some more modern theories which, despite offering useful insights, can become tainted with a considerable amount of ideology. One example of ideological contamination can be found in the slide from the neutral and scientific statement A:

Firms are useful mechanisms because they allow the efficient management of Ignorant Owner's assets by Knowledgeable Manager;

to the ideological, far from logically consequential, and controversial statement B:

The maximisation of Owner's profits is, and must be, the sole aim of enterprises and of corporate law.

Another example can be found in the application of simplistic contractual-based conceptions such as that of the nexus of contracts theory to the question of the existence, and by extension the social responsibility, of the enterprise. If an enterprise is 'just' a nexus of contracts, it cannot exist as an entity, therefore as a non-existent object it cannot be socially responsible.

An application of sound theory reveals the trap into which the proponents of the proposition have fallen. They have failed to appreciate the nature of the reality of the enterprise, that is, the real-world difference in internal and external outcomes, and the reification which results in our talking about the enterprise as if it were a physically distinct real-world object. There are indeed problems with the idea of an enterprise being socially responsible, but this way of thinking does not contribute anything to the real issue, the extent to which and the manner in which enterprises can produce external outcomes which are beneficial to society as a whole rather than just to its owners.<sup>19</sup>

An example of benefit 3 can be seen in the contractual and institutional ideas. The former are evidence of the sentiment that the enterprise is essentially

private, whereas the latter are put forward by those who believe that it is essentially public, and it is essential to be aware of these attitudes if workable reforms are to be devised.

### **Corporate law theory and corporate social responsibility**

Let us consider by way of example an application of the ideas set out above to the basic proposition of corporate social responsibility: 'Corporations must be socially responsible'. The proposition is faulty, because it does not make the key distinction. If 'corporations' is read as 'enterprises', the proposition reads: 'Enterprises must be socially responsible'. An important aspect of this sentence is the reification contained in the word 'enterprise'. Someone not familiar with reification might erroneously assume that the enterprise is truly equivalent to a real-world thing or even that it is somehow equivalent to a real person. Indeed, one might argue that the very expression 'corporate social responsibility' derives from such a mindset, and that the extension of social responsibility to enterprises, an idea properly applicable only to people, relies on an anthropomorphic equivalence of the enterprise to a flesh and blood individual. This example shows us that a good grasp of the principles opens the way to an appreciation of the fact that the enterprise is a system, rather than a 'thing' or a 'person', and needs to be studied accordingly.<sup>20</sup> Such an appreciation allows us to formulate some questions regarding the numerous complex issues involved in: 'a corporation's social responsibility'. Such issues include:

1. the way in which the enterprise works;
2. the way in which the: 'causal role of the structure of the corporation' determines the way in which differences in outcomes are achieved (May, 1987: 45 cited in Metzger and Dalton, 1996: 515); and
3. the way in which that structure might be influenced in order to achieve socially desirable outcomes.

If the word 'corporations' is read as 'legal entities', the proposition reads: 'Legal entities must be socially responsible'. This proposition can only mean that the reality of the legal entity (the difference in real-world outcomes deriving from the difference in legal outcomes) should produce socially desirable results. To phrase it as a question: what could the role of the legal entity be in ensuring that socially desirable outcomes flow from the enterprise?

To sum up, a sound grasp of theory has allowed us to identify some basic issues which need to be studied in order to make the concept of 'responsibility' relate meaningfully to what actually happens in the enterprise and the way in which the legal entity gives it legal competence. The groundwork described in this chapter is only the first step on a very long road indeed. But we can have some hope of finding realistic and effective solutions to the vitally

important issues of corporate social responsibility if we start from a sound theoretical base.

## Notes

1. Many thanks to Stephen Tully for his editorial guidance and Andrew Harding for ideas and encouragement. The usual caveat applies. The literature is voluminous. An attempt has been made to strike a balance between the need to facilitate further research and the restrictions of space.
2. The author is grateful to Jane Ball and a fellow traveller on the 18.45 Victoria to Epsom train whose suggestions improved the diagrams during the drafting of Foster and Ball (forthcoming).
3. There are other ways in which the law can deal with real entities, such as the partnership, the unincorporated association, and so on. These methods are not dealt with in this chapter.
4. *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500, 507 (PC). *Ding an sich*, or 'thing in itself' is an expression used by Kant (1781) to mean a thing which actually exists in the world.
5. The expression is slightly adapted from Hart (1954: 53).
6. See, for example, I Corinthians, 11:24, where Jesus says: 'Take, eat, this is my body, which is broken for you: this do in remembrance of me'. See also, *inter alia*, D:3.4.1pr. (the word *corpus* in this text being used, apparently, to mean 'legal personality').
7. This section is based to some extent on Phillips (1994). On theory in the United States, see Ribstein (1991).
8. For a fuller list, see Dias (1985: Ch. 12).
9. Nobel (1999: 1258). On the dispute between the proponents of these two theories in France, see Foster (2000: 596–600).
10. Twining (1996: 6). Oft-cited articles include Brown (1905), Deiser (1908–09), Machen (1910–11), Geldart (1911), Laski (1916), Canfield (1917), Vinogradoff (1924), Dewey (1926), Smith (1928), Radin (1932), Maitland (1936), Nékám (1938) and Wolff (1938). On the historical development of the corporation in the United States, see Williamson (1985: Ch. 11).
11. On the theories in vogue up to 1998, see Orts (1998: 289–98).
12. Coase (1937). On later developments, see Ulen (1993).
13. Presumably, in our terms, a real entity which is coterminous with a legal entity.
14. Kostant (2002: 673). For the general principles, see Blair and Stout (1999).
15. On autopoiesis generally, see Maturana and Varela (1987); on social systems, see Bednarz (1988); on law generally, see Teubner (1987); on the corporation, see Teubner (1988a, 1988b).
16. On employees, see Hansmann (1990); on bargaining, see Utset (1995); on social norms, see Eisenberg (1999b).
17. Jensen and Meckling (1976: 310–11). It is a sad reflection on the state of the field that this fundamentally flawed statement, which demonstrates a complete lack of understanding of the key distinction, is so commonly cited.
18. Eisenberg (1999a: 836). Presumably the author is referring to an enterprise when he uses the word 'corporation'.
19. No attempt is made to go into the vexed question of whether shareholders are truly owners.
20. A person is also a system, but a discussion of this point goes beyond the remit of this chapter.

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## 2 Comparative corporate governance developments and key ongoing challenges from Anglo-American perspectives

*Bryan Horrigan*

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### **Overview**

What are the key comparative challenges worldwide for corporate governance theorists, regulators and practitioners?<sup>1</sup> One challenge concerns the possibility of a universal set of basic operating concepts, dimensions and conceptual frameworks for corporate governance across the public and private sectors, on one hand, and national and international boundaries, on the other. A second and related challenge concerns the development of adequate conceptual frameworks for understanding the network of relationships between all of the different ‘stakeholders’ in corporations. This includes shareholders as primary investors and owners, but also other groups with whom corporations have relationships internally and externally.<sup>2</sup> To the extent that the ‘shareholder primacy’ norm (Blair and Stout, 2001) in much traditional and contemporary corporate theory, regulation and practice places primary emphasis upon shareholder interests, a third and related challenge concerns the multiple ways in which shareholder interests can be understood. Working out the precise relationship between corporate governance, on one hand, and the interplay between shareholder and stakeholder interests, on the other, also leads to a fourth area of contemporary concern, covering corporate citizenship, corporate social responsibility, and ‘the triple bottom line’.<sup>3</sup> The coherence and appropriateness of different models and forms of corporate governance regulation internationally and nationally, particularly in responses across many jurisdictions to the most recent set of corporate collapses associated with names like Enron and WorldCom in the USA and HIH and One.Tel in Australia, is a fifth area of concern. A final contemporary concern focuses on enhancing corporate performance and developing better measures of corporate performance, including the integration of corporate governance standards and key performance indicators as well as the alignment at all organisational levels of corporate governance and performance.

We are yet to track and assess comprehensively the practical workability and effectiveness of the range of corporate governance reforms introduced worldwide in response to recent high-profile corporate collapses.<sup>4</sup> We are yet

to settle the debate conclusively about the links (if any) between corporate governance structures and corporate performance. Both of these require attention to the relationship between good corporate governance and good corporate performance, on the one hand, and between bad corporate governance and bad corporate performance, on the other. Those correlations are not necessarily the same. Both also require a sophisticated model which integrates formal, substantive, functional, behavioural, cultural and other features of corporate governance, especially since many worldwide corporate governance reforms are heavily formal and structural in character, even though the empirical evidence increasingly suggests that attention to these features alone is insufficient. After all, the boards of Enron and WorldCom (in the USA) and HIH and One.Tel (in Australia) could tick off technical compliance with many formal corporate governance checklist items and regulatory requirements.

We are increasingly cognisant of the interdependent relationship between the structural aspects of corporate governance for organisations and the behavioural aspects of boards and their directors. We are yet to frame and settle completely satisfactory alternatives to the prevailing ‘shareholder primacy’ norm in corporate thinking, regulation and behaviour, aptly crystallised in Milton Friedman’s famous comment that ‘few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible’ (Friedman, [1962] 1982: 133). We are yet to develop fully measures and standards of non-financial corporate performance, covering socio-economic and environmental aspects of corporate performance, which are as comprehensive, authoritative and universally accepted as those applying to financial corporate performance.<sup>5</sup> Where non-financial performance and reporting is regulated, questions still arise about the relevance and usefulness of publicly reported data for the various corporate constituencies.<sup>6</sup>

### **Concepts, elements and dimensions of governance**

At the broadest level, ‘governance’ is a concept which applies generally to the purpose, management and functions of nations, governments, communities, organisations and possibly even individuals. ‘Public governance’ relates to the institutions and relationships involving governments and those governed. ‘Public sector governance’ relates to principles, values and frameworks for the governance of public sector bodies. ‘Corporate governance’ focuses more discretely on organisations across the public and private sectors and their governance internally and externally. As a concept, ‘corporate governance’ is most often associated with the private sector and the governance of publicly listed companies, although its use in the public sector is growing. Corporate governance in the public sector contrasts with corporate governance in the

private sector in that it has both similar and different elements and dimensions, and different principles, to be applied in a different context, and within its own framework.<sup>7</sup> In the governance literature, corporate governance is increasingly being perceived as needing more than a mono-dimensional focus on the relationship between a corporation and its shareholders. For example:

Corporate governance is more than simply the relationship between the firm and its capital providers. Corporate governance also indicates how the various constituencies that define the business enterprise serve, and are served by, the corporation. Implicit and explicit relationships between the corporation and its employees, creditors, suppliers, customers, host communities – and relationships among these constituencies themselves – fall within the ambit of a relevant definition of corporate governance. As such, the phrase calls into scrutiny not only the definition of the corporate form, but also its purposes and its accountability to each of the relevant constituencies. (Bradley et al., 2000: 11)

Too many people think of corporate governance narrowly and instrumentally, in terms of it being a means to an end in the sense that it is simply about how organisations are run. Yet ends are just as important as means, and why organisations are run is just as important as how they are run. So, a holistic concept of corporate governance focuses equally on how and why organisations are directed, controlled and managed, and for whose benefit.

In the private sector, corporate governance is often discussed in terms of core areas of board responsibility such as strategy, performance, conformance (for example, compliance) and accountability (mainly to shareholders). One CEO for the Australian Institute of Company Directors usefully characterised these core areas in the following terms:

- (i) *Strategy*: to participate with management in setting the goals, strategies and performance targets for the enterprise;
- (ii) *Performance*: to monitor the performance of the enterprise against its business strategies and targets, with the objective of enhancing its prosperity over the long term;
- (iii) *Resources*: to make available to management the resources to achieve the strategic plan – the money, management, manpower and materials;
- (iv) *Conformance*: to ensure there are adequate processes to conform with legal requirements and corporate governance standards, and that risk exposures are adequately managed; and
- (v) *Accountability to shareholders*: to report progress to the shareholders as their appointed representatives, and seek to align the collective interests of shareholders, boards and management. (Dunlop, 1999, 2000)

This is not the only conceptual map available. Corporate governance in the public and private sectors has a number of common dimensions, although principles and contexts can also differ. These dimensions are outlined in the framework suggested below:

1. mission governance – for example, organisational mission, purpose, roles, functions and constituencies;
2. ownership governance – for example, ‘ownership’ issues and obligations to multiple constituencies;
3. structural governance – for example, two-tiered ‘watchdog’ and governance boards and committees;
4. strategy governance – for example, corporate plans for government-business enterprises (GBEs);
5. performance governance (both organisationally and individually), encompassing process, outcomes and measures;
6. conformance governance, including compliance, due diligence, financial risk management and legal risk management;
7. decision-making governance, including internal and external relationship management, communication and networks;
8. primary accountability governance (to owners and shareholders);
9. secondary accountability governance (to other stakeholders); and
10. value-capital enhancement, including the long-term sustainability of various forms of corporate capital (for example, financial capital, human capital, intellectual capital, social capital and so on), as well as ‘triple bottom line’ emphasis on economic, environmental and social capital.<sup>8</sup>

One weakness of many such definitions or lists of the elements, concepts or dimensions of corporate governance is the absence of synchronicity between the components in the list. It is one thing to identify components of governance and another thing altogether to show how those components relate to one another. Allens Arthur Robinson partner Steven Cole (2002) suggests a working definition of corporate governance which synchronises, integrates, and otherwise aligns the various components. His preferred definition<sup>9</sup> is:

The *systems and procedures* by which corporations are controlled and governed, involving the roles of:

- (i) the Board;
- (ii) individual directors;
- (iii) senior executives;

and their *cultural interface* with:

- (iv) one another;
- (v) management generally;
- (vi) shareholders;
- (vii) other stakeholders;

to deliver *accountable corporate performance* in accordance with the corporation’s *goals and objectives*.

Adopting Cole's structured integration of corporate governance elements, and combining it with the views of other expert governance commentators, we can formulate a more complex statement of corporate and organisational governance which illuminates the linkages between its various components, as follows. Organisations achieve good corporate governance by *aligning, synchronising and integrating* the various *structures, systems, processes, practices and plans* by which the organisation is *directed, controlled and managed* (that is, *governed*), involving the collective and individual *roles and responsibilities* of:

- (i) the Board;
- (ii) individual directors;
- (iii) senior executives and managers; and
- (iv) staff

and their *cultural interface and relationships* with:

- (v) one another;
- (vi) management generally;
- (vii) shareholders;
- (viii) 'inner circle' stakeholders (that is, employees, customers, creditors, financiers); and
- (ix) 'outer circle' stakeholders (that is, regulators, industry peers, governments, and the community);

to deliver:

- (x) *transparent, measurable and accountable corporate performance*; and
- (xi) *sustainable value-capital enhancement*;

for the organisation's *shareholders and stakeholders* by meeting challenges, exploiting opportunities, and managing risks derived from:

- (xii) politico-regulatory factors;
- (xiii) financial factors;
- (xiv) socio-economic factors; and
- (xv) environmental factors;

in accordance with the corporation's *goals, objectives and strategies* in customised ways which translate to all organisational levels and which are effectively *monitored, evaluated and reported* (Cole, 2002; Kiel, 2002; Mills, 2002).

In this way, organisational and individual governance responsibilities integrate politico-regulatory, financial, socio-economic and environmental concerns in a holistic way which flows through to strategic planning, performance and corporate outcomes. In other words, the critical issue of alignment is linked to the elements of corporate governance – in particular, the alignment of the external environment and corporate governance elements in corporate plans and strategies with organisational activities, responsibilities and performance measures. To govern a corporation in a way which promotes sustainable corporate viability and value in response to the risks, challenges and opportunities generated by financial concerns, politico-regulatory dynamics, socio-economic factors and environmental interests is to govern in a way which frames those responsibilities beyond a simple dichotomy between shareholder and stakeholder interests. It responds to internal and external organisational pressures and dynamics which structure and influence corporate behaviour. It takes the analysis and practice of governance beyond arguing how and why companies have responsibilities to shareholders, stakeholders and communities.

This synchronisation of governance elements also has an impact on the conception and alignment of organisational, board, management and staff responsibilities. Corporate governance needs to accommodate and synchronise different institutional focal points. For example, investors have a primary focus upon organisational aspects like leadership and management, the corporate balance sheet, earnings forecasts, risk profiles, shareholder dividends and share values, and overall corporate responsiveness to opportunities and threats from the economic, political and regulatory climates. While organisations and their boards might have a primary focus upon important elements like strategy, internal accountability, external accountability, quality assurance, conformance, performance and resourcing, middle management in organisational sub-units is often more concerned with matters such as organisational pressures, management directives, financial goals, costs and budgets, staffing issues, and factors affecting performance, pay and promotion for themselves and their staff.

### **Corporate governance reforms**

In the post-Enron era, countries like Australia, the USA and the UK have tightened their regulation of corporate governance. The publicly notorious corporate collapses in the USA had somewhat different causes from those in Australia and elsewhere. Consequently, different regulatory approaches and different legal reforms have emerged in different countries, albeit with some overlaps and similarities too. The spate of corporate collapses and the perceived reasons for them in the USA, grounded in perceptions of audit failures and a lack of independence and objectivity by board members,

produced the Sarbanes–Oxley Act. The prescriptive rule-based approach in the US Sarbanes–Oxley Act contrasts with the more flexible principle-based Australian approach in CLERP 9’s reform of corporate disclosure and auditing.<sup>10</sup> The ‘comply or disclose basis’ of the corporate governance principles in the Combined Code of the Financial Reporting Council in the UK (Veasey, 2004: 230) is similar to Australia’s principle-centred ‘comply or explain’ (or ‘if not, why not’) regulatory approach, in which deviations from suggested governance norms are permitted where justified by a company’s particular circumstances. Both the UK and Australia have introduced the idea of non-binding shareholder resolutions on executive remuneration. In Australia alone, the range of public reports, reform proposals, and regulatory guidelines in response to high-profile corporate failures includes:

- (i) the Ramsay Report on reforms to corporate auditing;
- (ii) the HIH Royal Commission;
- (iii) the Australian Stock Exchange (ASX) Corporate Governance Council (CGC) corporate governance principles;
- (iv) CLERP 9’s reform of corporate disclosure and auditing; and
- (v) ongoing test cases on directors’ duties and business judgments in litigation from the HIH and One.Tel collapses.

Regulators, politicians, and the financial media focus heavily on governance-related issues such as:

1. ensuring that research staff and analysts avoid conflicts of interest;
2. keeping different audit functions separate;
3. stimulating greater involvement of institutional shareholders in governance matters;
4. developing broader shareholder powers and remedies;
5. improving the timeliness, amount and range of information available to the market;
6. increasing the number, competencies and performance of independent and non-executive directors;
7. defining the true meaning of ‘independence’ for these purposes;
8. obtaining more advice more often as a precondition for informed decision-making by corporate directors;
9. increasing exposure to personal liability for corporate directors and officers involved in disclosure contraventions and other breaches of corporate governance standards;
10. communicating better with shareholders and stakeholders;



11. meeting the standards of independent ratings agencies and lobby groups;  
and
12. increasing the powers and monitoring of regulators.

As we shall see, some of the corporate governance reforms receiving most regulatory and media attention focus heavily on formal and structural measures at the expense of other elements of good corporate governance.

*Transnational corporate governance regulatory issues*

Corporations with operations beyond national boundaries are affected by differences in corporate governance regulation in each jurisdiction in which they do business. For example, BHP-Billiton has a dual listing in Australia and the UK, which means in practice that the higher of the standards operating in both jurisdictions often becomes the benchmark for the company's operations in both jurisdictions, including tighter linkages between executive remuneration and sustainable corporate performance and shareholder approval of that.<sup>11</sup> Conversely, in the absence of mutual recognition by different countries of each other's corporate governance regulatory requirements, companies might be forced to adopt the regulatory requirements laid down by the most restrictive jurisdiction as the default standard throughout their corporate operations across different countries. For example, US law now requires that all members of audit committees must be independent and that CEOs/CFOs certify the accuracy of the financial accounts to investors, while Australian law simply requires a majority of independent members of audit committees and CEO/CFO certification of the accuracy of financial accounts to the board rather than investors at large.<sup>12</sup>

Moreover, the question of compliance with different corporate governance regulatory standards must be addressed by multinational corporations (MNCs) both horizontally and vertically. On a horizontal level across national borders, different corporate governance regulatory standards might apply in each of the countries in which MNCs do business. On a vertical level within each jurisdiction in which a company does business, however, there can also be a range of different corporate governance regulatory sources and requirements. In Australia, for example, the common and important topic of executive remuneration could be regulated by one or more of these standards – namely, ASX listing rules, ASX CGC guidelines on corporate governance (considered below), Australian accounting standards (including customised compliance with international accounting standards) and major corporate laws (for example, the Corporations Act). Similarly, in the light of the different corporate governance reforms introduced in response to different causes of corporate collapses worldwide, some countries have sought exemptions from the extra-territorial reach and strict requirements of the US

Sarbanes–Oxley Act on matters such as audit independence and certification of corporate accounts.

Many of the post-Enron corporate governance reforms worldwide seek to strengthen the role of independent directors and the preconditions for independence. The true independence of directors is not simply a byproduct of structural aspects such as avoiding formal conflicts of interest, not being involved in a company's operational management, or not having recent or ongoing commercial relationships with a company. Someone could have these technical attributes and still exhibit a lack of independence because of their undue deference to strong executive directors or by falling prey to board 'group-think'. The real qualities of independence sought here include independence of mind<sup>13</sup> and alignment of a director's interests with shareholder interests (Monks and Minow, 2004: 246). Viewed this way, independence is a product of directors' mindset, behaviour, experience and character as much as their technical and more easily measurable arm's-length relationships with the companies on whose boards they sit.

### **Contemporary corporate governance literature**

Corporate governance is now the subject of interdisciplinary study, particularly from legal, management, business, regulatory and political science perspectives. The theory and practice of corporate governance remains a strong topic of specialised scholarship in its own right (for example, Berns and Baron, 1998; *Harvard Business Review on Corporate Governance*, 2000; Fishel, 2003; Garratt, 2003; Whincop, 2003; Mallin, 2004; Monks and Minow, 2004; Farrar, 2005; Austin et al., 2005; and Colley et al., 2003). Scholarship about corporate governance and its regulation increasingly intersects with scholarship about corporate and business regulation generally (for example, Grantham and Rickett, 1998; Braithwaite and Drahos, 2000; Parker, 2002; Kraakman et al., 2004). New scholarship on regulatory theory and the needs of the regulatory state demonstrates the impact of both on the regulation of corporate governance (Parker et al., 2004). Corporate governance in the public sector is also a specialist topic in its own right (for example, Ahn et al., 2002; Horrigan et al., 2003; and Bartos, 2004). Comparative and transnational corporate governance studies are also appearing (Ahn et al., 2002; Keong Low, 2002; Monks and Minow, 2004; and Farrar, 2005).

The cover stories for leading industry and professional journals aimed at corporate directors and officers increasingly target corporate governance and board performance.<sup>14</sup> The same is true of leading business and management journals (for example, Lawler et al., 2002; Roberts, 2002; Sonnenfeld, 2002; and Nadler, 2004). Special thematic issues of university law journals are devoted to the topic of corporate governance.<sup>15</sup> Interdisciplinary corporate governance law and scholarship also branches off into discrete but related topics concerning

corporate responsibility, such as corporate social responsibility and the 'triple bottom line' (for example, Donaldson and Dunfee, 1999; Elkington, 1999; Wheeler, 2002; and *Harvard Business Review on Corporate Responsibility*, 2003), as well as corporate and business ethics (for example, Donaldson and Dunfee, 1999; and *Harvard Business Review on Corporate Ethics*, 2003).

Boardroom analysis is a core topic of study. The design, structure, operation, activity and performance of corporate boards becomes a specialist topic in its own right in contemporary corporate governance literature (for example, Conger et al., 2001; Shultz, 2001; Finkelstein, 2003; Fishel, 2003; Garratt, 2003; Kiel and Nicholson, 2003; and Carter and Lorsch, 2004). Measuring board performance is one aspect of the wider subject of measuring overall corporate and organisational performance (for example, *Harvard Business Review on Measuring Corporate Performance*, 1998; Garratt, 2003; and Kiel et al., 2005). Empirical research in the form of boardroom and CEO surveys, audits and questionnaires is generating new insights into what has been described as 'the black box' of what actually goes on in boardrooms (for example, Conger et al., 2001; Shultz, 2001; Finkelstein, 2003; Carter and Lorsch, 2004; Monks and Minow, 2004). Major public reports and inquiries into corporate collapses and controversial corporate behaviour highlight corporate governance concerns.<sup>16</sup> Similarly, official reports and guidelines on corporate and organisational governance in the public sector increasingly focus upon different board and executive management structures.<sup>17</sup> Studies in corporatisation, privatisation and the transformation of non-departmental public bodies into GBEs highlight the corporate governance issues for entities which straddle the public-private divide (for example, Whincop, 2003). The effectiveness on a cost-benefit analysis of post-Enron regulatory reforms like the US Sarbanes-Oxley Act is increasingly under scrutiny.<sup>18</sup> Global trade and institutions exert an influence on transnational corporate governance, as evidenced most recently by China's accession to the WTO.<sup>19</sup>

Ideological critiques of the philosophical starting points for corporate governance regulation and practices increasingly highlight the influence of corporatism, managerialism and economic rationalism.<sup>20</sup> Critics like John Ralston Saul, for example, point to a transnational threat of 'corporatism' as the rival of representative government, under which individual citizens are secondary rather than primary democratic participants in the sense that real power and control in conducting the business of government is more directed towards mediating between the interests of elite professional, expert and ownership groups than towards genuine attempts to achieve the common good, however elusive that might be (Saul, 1995: 74-5). Is there one universal model of corporate governance? Alternatively, are there really different models of corporate governance regionally – for example Anglo-Saxon, European, North American and Asian models – or is there a developing global

convergence of corporate governance thinking, regulation and practice? There are conflicting views on this issue (for example, Bradley et al., 2000; Guillen, 2000; Luck, 2001; and Salacuse, 2004). The growth of global markets, with the consequent gravitation of capital and shareholder investment to those companies with demonstrably effective governance, is a key factor in the convergence of at least some corporate governance standards across more than one jurisdiction (Monks and Minow, 2004: 537–8). This does not inevitably result in the rule of the lowest common denominator. Dual-listed MNCs might adopt the higher of the two regulatory standards as their transnational operational norm. Institutional investors and their professional advisers might insist on specific shareholder protections from one jurisdiction being included in a company's constitution upon its move of corporate headquarters to another jurisdiction, as in the recent relocation of Rupert Murdoch's News Corp from Australia to Delaware in the USA (Arbouw, 2004: 7–12).

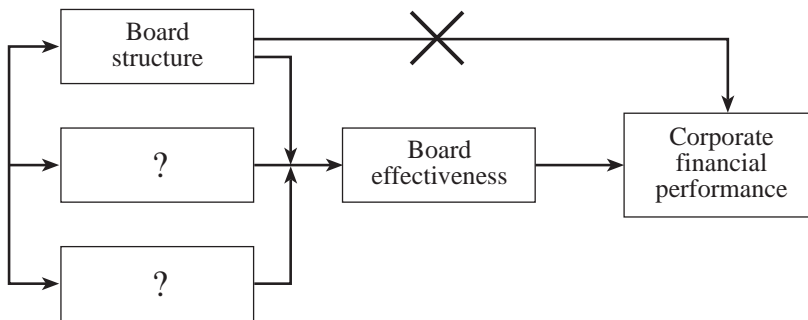
At the same time, some common features of corporate law and governance travel across jurisdictions. Hansmann and Kraakman identify five basic characteristics of a business corporation – namely, 'legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership' (Hansmann and Kraakman, 2004: 1). They identify a number of crucial agency problems for corporations with which corporate governance must deal – namely, the responsibility of a corporation's managers towards its owners, the possibility of opportunistic conduct by controlling shareholders towards non-controlling shareholders, the possibility that the corporation might act opportunistically towards parties who are not shareholders (for example employees, creditors and others), and the responsibility (if any) of managers towards non-shareholders (ibid: 33). While asserting that 'we believe there's no such thing as a universally applicable ideal board structure', Carter and Lorsch (2004: 8, 86–7) also take a stand 'on what is likely to work best most of the time' in terms of board design. These 'best practice' board design ideas from Carter and Lorsch include, for example, the ideas that:

- (i) smaller boards are generally better than larger ones;
- (ii) boards should consist of more independent directors than non-independent directors;
- (iii) either the chairperson and CEO should be separate roles or else there must be a 'lead director'; and
- (iv) all boards should at least have an audit committee, a compensation committee and a corporate governance committee, all comprising independent directors. (ibid.: 87)

Of course, as Carter and Lorsch also point out, corporate collapses like those involving Enron and WorldCom show that the presence of such formal structures only matters if they function properly (ibid.: 87–8).

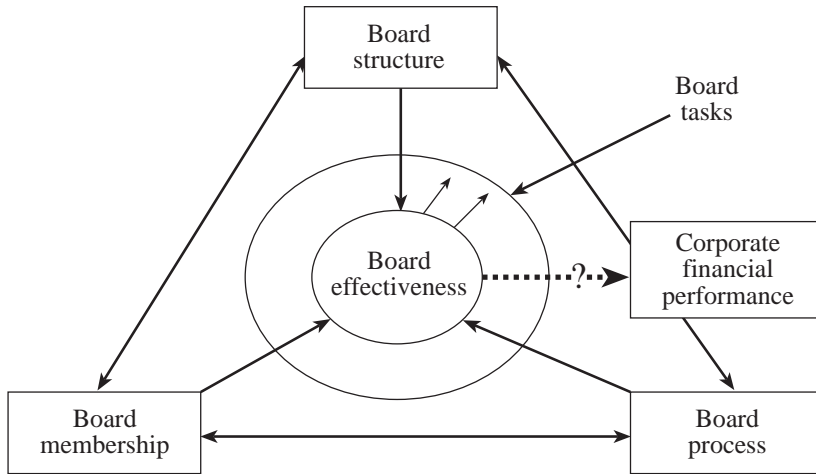
Given his empirical studies of corporate boards across jurisdictions, Professor Richard Leblanc from the Corporate Governance Program at the Schulich School of Business in Canada argues strongly that board effectiveness is a product of board structure (for example, the size and range of committees), board composition (for example, mix of directorial experience and skills) and board process (for example, information-gathering, information-analysis and decision-making activities), and that cognate director effectiveness is a product of director independence, director competence and director behaviour (Leblanc and Gillies, 2004). The dynamic interaction between structural and behavioural factors is crucial. In his view, it is not so much the independence of directors which is critical and which should be mandated in corporate governance regulatory reforms. Rather, we need to understand that effective corporate boards need directors with certain qualities of independence and with certain competencies who choose to behave in particular ways, with all of those elements needing to be present as a precondition for both director and board effectiveness (ibid.). Leblanc's basic model is presented in Figures 2.1 and 2.2.

While Leblanc and I almost certainly agree on the essentials, my own empirical work and interviews on corporate governance and performance across the public and private sectors lead me to conceptualise the 'board effectiveness' factors slightly differently. I also prefer not to wrap up everything about board effectiveness into a product of board structures/frameworks, board composition/competencies and board processes/practices alone. Those critical factors interact with a few others that I think are worthy of equal prominence in any model of board effectiveness across both structural and behavioural dimensions, such as board preparation, board relationships and



Source: Leblanc and Gillies, 2004.

Figure 2.1 Board structure, board effectiveness and corporate financial performance



Source: Leblanc and Gillies, 2004.

Figure 2.2 Interaction of 'board effectiveness' elements

board regulation among others. So, this model can be modified and expanded to include other key features as shown in Figure 2.3.

I suspect that what is implicit within Leblanc's three critical factors are things that I prefer to highlight expressly as separate and equally significant structural and behavioural factors. What is important about both models is that they demonstrate starkly that the kinds of recent corporate governance regulatory reforms which relate mostly to board structures and partly to board composition do not offer a complete package to ensure greater board effectiveness and better corporate performance. Moreover, commonly accepted corporate governance elements like leadership, strategy, conformance and performance have both 'hard' (or formal) and 'soft' (or informal) dimensions and measures, as illustrated in Figure 2.4.

Based on their research and interviews concerning major US corporations, some leading American corporate governance experts crystallise the multifactorial nature of board effectiveness as follows:

The right board practices, however, may be a necessary but not a sufficient condition for having an effective board. They can, for example, be adopted for the wrong reasons. One CEO told us that he adopted a number of board best practices because investors were impressed by them, and he believed that by adopting them his company's stock price would be improved. We suspect that a number of CEOs share his viewpoint. We also feel that it is possible for a board to be effective without adopting all or most of the practices. A firm with a strong CEO who assembles

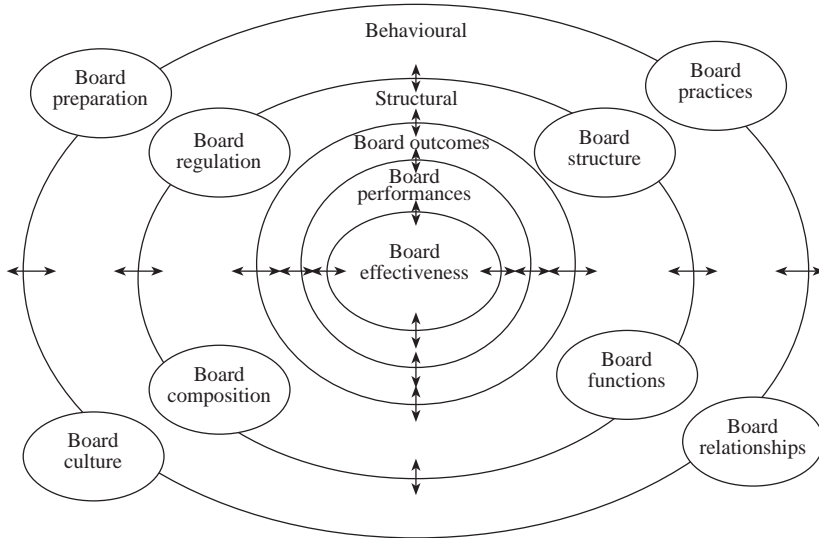


Figure 2.3 Alternative 'board effectiveness' model

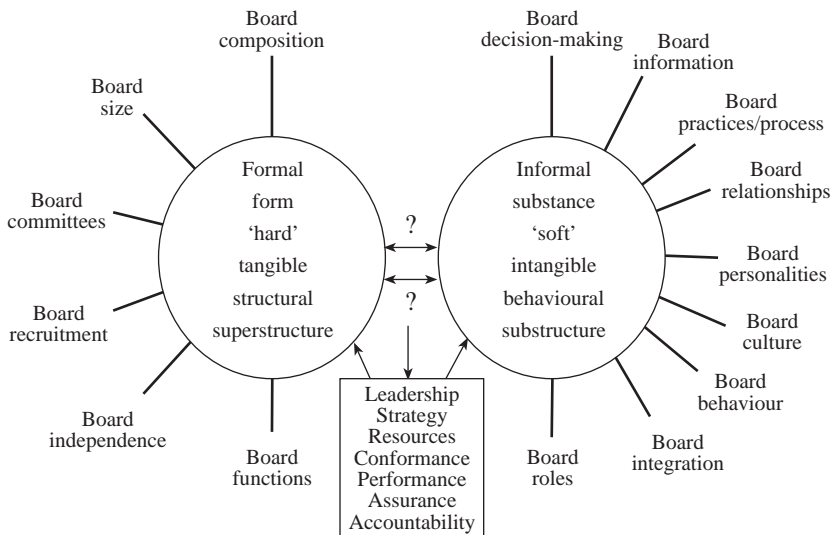


Figure 2.4 Formal and informal corporate governance factors

an equally strong and independent set of individual directors may be able to operate as an effective board without using many of the best practices. The adoption of the right set of practices only increases the probability that the right behaviour will occur; it is not a guarantee. It can also act as an insurance policy to help preserve good governance when leadership changes or a crisis occurs. (Lawler et al., 2002, pp. 311–12)

The existing empirical evidence on any relationship between corporate governance and corporate performance has some inherent weaknesses. While different studies take different stands on the presence and strength of any correlation between corporate governance and corporate performance, assessment often depends upon variable factors like the timelines for examination, the aspects of corporate performance chosen, and the particular groups of companies and jurisdictions selected. Moreover, fresh empirical studies of any relationship between corporate governance and corporate performance are needed in light of the recent changes to corporate governance standards in response to corporate collapses worldwide.

At the outset, however, some basic correlations are worth noting. First, we need to focus as much on the informal and intangible aspects of corporate governance as on its tangible and formal aspects. How the board conducts itself in terms of the trust and interactive dynamics between board members is just as important as having the right number of board committees and the right number of independent directors. Second, the relationship between corporate governance and corporate performance is two-dimensional, not one-dimensional. One dimension concerns any relationship between good corporate governance and good corporate performance; another dimension concerns any relation between bad corporate governance and bad corporate performance. Those two dimensions and potential relations do not cover the same ground. Good corporate governance has been likened in some quarters to ‘good hygiene’. In other words, nobody becomes successful simply by having good personal hygiene, but failing to attend to personal hygiene can certainly hinder your success. Similarly, good corporate governance might be a necessary but not sufficient precondition for good corporate performance.

Of course, in particular circumstances a corporation might have good corporate governance without necessarily adopting all recommended standards. This again emphasises that what counts as good corporate governance is context-dependent. Moreover, successful companies might be successful at everything that they do, so that any perceived connection between their good corporate governance and their good corporate performance is illusory. Conversely, bad corporate governance might set up conditions which make it more likely for bad corporate practices and cultures to emerge. These make the company more prone to bad corporate performance and make its corporate directors and officers less likely to have in place the kinds of practices and



procedures which might afford them a 'due diligence' or 'business judgement' defence in the worst case scenario of a corporate collapse and their prosecution for breaches of corporate duties (Cole, 2002).

So, the evidence and expert views are mixed and the jury is still out on the precise correlations between the matrix of corporate governance factors and corporate performance, especially financial performance. Nevertheless, it is becoming clearer that:

1. there is little (if any) correlation between formal board structures and financial corporate performance alone;
2. both board effectiveness and organisational effectiveness are tied to the interaction between 'hard' and 'soft' governance and performance measures; and
3. the correlations between good corporate governance and conventional corporate governance standards, good corporate governance and good corporate performance, and bad corporate governance and bad corporate performance are neither simple nor absolute.

### **Corporate governance thinking and models**

Unsurprisingly, contemporary corporate governance scholarship continues to probe and often revisit the correlation between corporate ownership and corporate responsibility. On one view, the two core features of the corporate form underlying corporate governance are 'investor ownership' (which confers significant benefits and rights of control to shareholders) and 'delegated management' (which implies that shareholders' interests are managed primarily by others, with shareholders intervening in corporate affairs indirectly or intermittently) (Hansmann and Kraakman, 2004: 33–4). 'Agency relationships' might be added as a third essential component here, not in the narrow legal sense of any strictly legal principal–agent relationship between corporate investors and corporate managers, but in the broader sense of the governance and management of a corporation's internal and external relationships, at least in terms of the cognate relationships between corporate directors and managers and those who affect or are affected by them. This notion of the corporation as a network of internal and external managed relationships as a core component of corporate governance itself has different manifestations.

At a conceptual level, corporate governance models operate on a number of different planes. On one plane, such models might be plotted along a spectrum which has a contractarian shareholder-based focus at one extreme, in which the board primarily acts in the best financial interests of the company and its shareholders as capital investors, and a communitarian stakeholder-based focus at the other, in which calculation of the best interests of the entity and its members might embrace a wider range of interests and factors beyond

shareholders and financial returns (for example, Bradley et al., 2000: 35–41). On another plane, the governance literature plots corporate governance models along a spectrum which has what some commentators call an ‘arm’s length–outsider’ focus at one extreme, in which no shareholders exercise disproportionate control over the entity and outside intervention in management is minimal, and a ‘closely controlled–insider’ focus at the other extreme, in which some shareholders effectively wield controlling power and intervene as owners in the management of the company. The latter focuses more on the influence of particular shareholders than the representation or influence of stakeholders.

Alternatively, in different countries with different corporate regulatory structures, the notion of ‘insider’ and ‘outsider’ control and influence might combine with distinctions between shareholders and stakeholders in board and management representation, to posit a spectrum of corporate governance models with what one Australian Government Treasury CLERP paper calls ‘a shareholder approach or outsider model of corporate control’, at one extreme, and ‘a stakeholder approach or insider model of corporate control’, at the other (Commonwealth Treasury, 1997: 60). According to that CLERP paper, countries like Australia, the UK, the USA, Canada and New Zealand broadly follow the first model, whose focus is ‘profit maximisation for the owners of the corporation’ and where ‘the achievement of corporate goals and profit maximisation is monitored by the owners of the corporation, its shareholders, to whom corporate management is accountable’ (ibid.: 60). Conversely, according to the CLERP paper, civil law countries like France, Italy, Germany and the Netherlands broadly follow the second model, whose ‘governance structures reflect a model of corporate control which seeks to align the various interests of multiple stakeholders – workers, managers, creditors, suppliers, customers and other members of the community’ (ibid.: 60).

Another spectrum focuses on different board structures and roles, with ancillary implications for issues of control and representation by shareholders and stakeholders. A former head of Australia’s corporate and financial services regulator, the Australian Securities and Investments Commission (ASIC), once described this spectrum in terms of a broad distinction between the ‘Anglo-Saxon model’, which ‘involves a single Board (usually consisting of both external and management representatives) which, together with shareholders, comprises the governing structure of the corporation’, and the ‘European model’, under which management and supervisory roles are devolved to separate boards – ‘both a Management Board ([composed] entirely of management representatives) and a Supervisory Board ([composed] entirely of external representatives)’. According to the former ASIC chairman, the perceived advantages of this dual-board model are that ‘it more clearly differentiates the operational and business judgment responsibilities of management from the

higher level policy and strategic role of the Supervisory Board' and also that 'this structural separation provides a more logical and transparent means for liability allocation' (Knott, 2001).

Of course, a multiplicity of other planes are also possible, covering such issues as: the presumed agency problems which result from the separation of ownership and control; the impact on performance of changes in the board-room balance between executive and non-executive directors; relationships between governance structures and changes in the legal and regulatory environments; the impact of good corporate governance practices on corporate performance; the effect of country-specific governance variable and trends; the adaptation of governance structures according to changes in the wider political and non-political environments; and so on (Bradley et al., 2000).

Similarly, the relationships between the different forms of capital and between shareholders, 'inner circle' stakeholders and 'outer circle' stakeholders can form the basis for alternative formulations of corporate responsibility beyond simple shareholder-stakeholder and contractarian-communitarian models. For example, Margaret Blair and Lynn Stout suggest a 'team production approach' as an alternative to 'the prevailing principal-agent model of the public corporation and the shareholder wealth maximisation goal that underlies it' because of a 'shareholder primacy norm' deeply embedded in corporate regulation and thinking (Blair and Stout, 2001: 247, 249, 253). Under their approach, the 'internal governance structure' for corporations relies on a 'mediating hierarchy' with a board of directors at its apex, in which the interests and rights of both shareholders and non-shareholders are mediated through the corporation as a separate legal entity rather than exercised directly by them (ibid.: 250-52). According to this view, corporate success as a collective enterprise rests on the combined and coordinated investment, input and interests of a team of shareholders and non-shareholders such as executives, employees, creditors and local communities in which corporations do business, 'to protect the enterprise-specific investments of all the members of the corporate "team"' (ibid.: 249-50). Accordingly, directors are insulated by the 'mediating hierarchy' from direct control by shareholders and stakeholders, instead being responsible for the 'corporate coalition' of interests as their corporations 'mediate among the competing interests of various groups and individuals that risk firm-specific investments in a joint enterprise' (ibid.: 254, 321-3). Moreover, people involved in corporations do not simply exhibit self-interested behaviour except as restrained by external sanctions, but rather are influenced and socialised internally 'through social framing that encourages officers, directors and shareholders to view their relationships as cooperative ones calling for other-regarding behaviour', thus creating 'internalised trust and trustworthiness ... encouraging cooperation within firms' (Blair and Stout, 2001: 1735, 1735-6, 1799).

Critics of this alternative approach point to its descriptive inability to explain current corporate regulation's primary focus on the shareholder and to its normative inability to produce better distributional outcomes for non-shareholders. Whether viewed in market-based, contract-based, relational or team production terms, the board's mediation of the competing claims of shareholders and non-shareholders to limited corporate resources rests on the merits of those claims and the board's willingness to accommodate them (Millon, 2000: 1038). On a critical view, the team production approach 'does nothing to improve the extra-legal status of non-shareholders in relation to shareholders' and hence 'there is no reason to expect improvements in distributional outcomes' (ibid.: 1037). Accordingly, this alternative approach 'does not advance progressive efforts to construct a broader understanding of management's responsibility to non-shareholders aimed at improving distributional outcomes currently available through market interactions'.<sup>21</sup>

Such criticisms frame shareholder and non-shareholder interests largely in oppositional terms, focused mainly on the competing demands for allocating scarce corporate resources. They are contingent on particular views of responsibility (for example, board responsibilities to others), accountability (for example, sources of corporate accountability beyond ownership), regulation (for example, the legal status of non-shareholder interests) and market dynamics (for example, the extra-legal force of non-shareholder interests). The validity of such criticisms turns not only on the absence of mandatory legal enhancement of non-shareholder interests relative to shareholder interests, but also on the minimal impact of non-shareholder interests on both market dynamics and board decision-making in terms of the importance and power of non-shareholders beyond simply their capacity to bargain. It also rests on a minimalist view of the interdependence of shareholder and stakeholder interests, not least in terms of the alignment and synchronisation of governance dimensions in corporate responses to internal and external risks, opportunities and dynamics as outlined above.

### **Reinterpreting corporate responsibility towards shareholders and stakeholders**

We still lack a universally agreed replacement for the 'shareholder primacy' norm in corporate regulation and practice, or even a consensus about sophisticated forms of incorporating the corporation's relationships with stakeholders within the 'shareholder primacy' norm. Although the duty of directors in most jurisdictions effectively is to act in the best interests of the corporation rather than the shareholders expressly, that translation from one to the other is implicit and automatic in much corporate regulation and practice. Many preconceptions are in play here. In some contractarian theories, corporations are conceived effectively as a compact between the members and the artificial

legal entity constituted by the corporation. Yet this compact does not have all of the features of a normal agreement. Similarly, we talk of shareholders as the 'owners' of the company. Yet the 'ownership' interests of shareholders, and the relationship of those ownership interests to other relationships and interests concerning the corporation, again are not exactly like ownership of a personal item or land.

Indeed, there are some commentaries which revisit the notion of 'ownership' generally and in this particular context (for example, Kelly, 2003). Some commentators point to the existence of ownership obligations as well as ownership rights, at least in terms of obligations which the law imposes on owners towards non-owners of property in a variety of legal contexts, even if the notion of ownership itself contains no inherent obligations in a legal or moral sense (compare Singer, 2000).

As just mentioned, many people read 'the corporation's best interests' as a shorthand reference for 'the best interests of the corporation's shareholders', which in turn they take to be a shorthand reference for 'the best *financial* interests of the *current* shareholders *as a whole* and not other stakeholders'. There are various steps to that conclusion, none of which is free from dispute, notwithstanding the prevalence of the 'shareholder primacy' norm in much corporate regulation, thinking and practice. The connection between corporate best interests and the best interests of the shareholders alone is not automatic. Acting primarily in the interests of shareholders and without regard to or even at the expense of the interests of other stakeholders, including those who might have contributed something directly to the prosperity of the corporation, such as employees, financiers, creditors and people using the corporation's products, must be justified within a coherent conceptual framework of corporate relationships and the responsible exercise of corporate power.

Even on the assumption that the 'shareholder primacy' norm prevails absolutely, there is another step before concluding that the interests of the shareholders means only the interests of the *current* shareholders. There is also another step before concluding that the interests of those shareholders are purely financial, even if they are mainly financial. An employee shareholder whose family lives in the local community affected by a corporation's activities might have a different set of interests from a shareholder who is an individual investor or trader who 'plays the market' and hence trades shares in shorter timeframes, and who in turn has a different interest from an institutional investor interested in the corporation's shares because the corporation appears on a relevant share index. There is even another step before concluding that the interests of those shareholders are all commensurable. Arguing that corporations are interdependent rather than independent social institutions, that corporate boards mediate between networks of internal and external corporate interests (Blair and Stout, 2001), and that companies owe moral and

perhaps even legal obligations to a multitude of stakeholders and not just shareholders, simply returns us to the same basic problem of conceptualising and justifying the responsibility of a corporation and those human agents through whom it acts.

Some jurisprudential scholars conceptualise the corporation as ‘being not a thing or person but the name for a pattern of contractual relationships, in terms of being a network of relationships among people (shareholders, workers, customers, suppliers, executives)’ (Posner, 1993: 186). This ‘corporation as a network of relationships’ model must be considered alongside the ‘shareholder primacy’ model, the ‘boards as mediators of interests’ model, the ‘corporate social responsibility as a precondition for the licence to operate’ model, the ‘good corporate behaviour is good business’ model, and so on. Some of these models can be modified to accommodate one another, and some of them directly compete. Scholars at one of the leading US business schools even go so far as to suggest that the conventional view of corporations is obsolete, and that our models for corporate regulation, behaviour and performance measurement are obsolete too.<sup>22</sup> Many of these models also highlight the interdependence of interests which matter to corporations, even though they might frame the relationship between corporations and those interests in different ways. Social capital theorist Eva Cox, for example, argues that social capital is a precondition for the flourishing of economic capital, rather than the other way around. Just as investors, businesses and markets require a stable legal and political system, as demonstrated by the state of economies in countries with a breakdown in law and order, so too do business interests and relationships rely upon a substratum of social cohesiveness, wellbeing and trust as essential preconditions for optimising financial profit and economic prosperity (Cox, 1995). As Australian business leader and philanthropist Richard Pratt noted recently, the common perception that ‘successful businesses are good for communities’ often overshadows the reality that ‘successful communities are good for business’.<sup>23</sup> He characterised the more academic version of this claim as being ‘that a business draws its licence to operate from the community and therefore has an obligation to that community’.

More recently, Australian corporate director and ASX board member Catherine Walter gave a public speech to chief financial officers in these terms:

Companies will learn that they ignore the social or community licence consequence of limited liability at their peril . . . So, as a group of company executives and directors, we all have a stake in maintaining and advocating good behaviour. We need to constantly remind ourselves that the limited-liability company, however fundamental to an entrepreneurial economy, is not a natural creature. It is a legislative construct that can be legislated away if we are careless of its benefits and responsibilities . . . If we are concerned today about the cost to shareholder

value of compliance, then we ought to remember that more focus on shareholder and stakeholder values may have avoided some of the regulations with which we have to comply.<sup>24</sup>

In this way, corporate citizenship and social responsibility can be redefined in terms of ‘business taking greater account of its social, environmental and financial footprints’ (Zadek, 2001: 7, cited in Zappala, 2003). So, rather than being framed as an additional and non-core aspect of pursuing the best interests of the corporation and those whom it serves, corporate citizenship and social responsibility are instead reframed as an integral part of ‘the role of business in society’ (McIntosh et al., 2003: 16, cited in Zappala, 2003).

Of course, corporate social responsibility (CSR) is neither a one-dimensional notion nor a monolithically uniform one. Company directors might ask themselves a range of different questions. For example:

1. Is this the right thing to do ethically and morally? (that is, altruistic CSR).
2. Will doing it or not doing it affect our corporate reputation? (that is, reputational CSR).
3. Will doing it or not doing it put us in breach of the law? (that is, regulated CSR).
4. Must we do it to stay competitive in meeting expectations of customers and industry peers, even if it costs money to do it? (that is, market-driven CSR).
5. Will doing it be good for business and make us money? (that is, profit-orientated CSR).

Some commentators discuss this multidimensional character of CSR in terms of ‘value-driven CSR’, ‘stakeholder-driven CSR’ and ‘performance-driven CSR’ (Magnan and Ralston, 2002), to which we might also add compliance-driven CSR. Some avoid the trap of one-dimensional CSR analysis by refusing to treat social, environmental and other factors as factors in opposition to financial and economic considerations, focusing instead on the interactions between the different factors in making corporate decisions. For example, social and economic considerations interact in business consideration of the social impact of a proposed economic investment, in what one commentator calls the ‘shear zones’ between the social and economic bottom lines, where issues like business ethics, human rights and stakeholder empowerment can arise (Elkington, 1999: 84, 92). Others argue that non-economic factors like social and environmental considerations can be measured and accommodated within economic analysis itself. In other words, rather than a choice between a narrowly conceived single bottom line of financial and economic concerns, on one hand, and a triple bottom line of economic, social

and environmental concerns, on the other, a true and broader use of economic analysis incorporates all relevant interests which affect decision-making (McAuley, 2001). Still others argue that focusing just on one group of interests (that is, shareholders) and debates about their primacy over others (that is, stakeholders) misses the wider point that all of us are subject to higher-level social contracts which govern our business relationships (for example, Donaldson and Dunfee, 1999). We need to transcend the unproductive debate about shareholder and stakeholder interests trumping one another in a zero-sum way, to recognise that the legal obligation of directors and other corporate officers to the company *as an enterprise in its own right* cannot simply be reduced to the one-dimensional idea of immediately maximising the current financial interests of the company's present shareholders, and must embrace multi-dimensional references to the interests of both shareholders and stakeholders as relational and interdependent interests (Deakin, 2005).

One of Australia's largest banks, Westpac Banking Corporation, was the only company to receive an AAA rating from the Australian-based ratings agency RepuTex in both 2003 and 2004, on a performance scale assessing corporate governance, workplace practices, and social and environmental impact. Around the same time, Westpac announced a record 2.5 billion dollar profit. Westpac's CEO, David Morgan, was reported in the financial press as linking Westpac's non-financial programmes, reporting and listing on sustainability indices to improvements in brand equity, employee retention, customer satisfaction and attraction of new shareholders.<sup>25</sup>

Evidence-based correlations are increasingly being demonstrated between corporate governance and corporate performance, on one hand, and between both and corporate social responsibility, on the other. According to McKinsey's 2002 Global Investor Opinion Survey, foreign investors were prepared to pay a premium of up to 30 per cent for companies with good corporate governance, as a worthwhile guarantee of good oversight and attention to quality (Tsang, 2003: 263). Independent ratings agencies, share indices and investor representative bodies are all increasingly paying attention to a company's non-financial performance as well as its financial performance.

Despite ongoing corporate scepticism about the impact of a company's non-financial health upon its financial bottom line and the unavailability of sufficiently precise and sophisticated non-financial performance standards, almost three-quarters of board directors and executives in a worldwide survey conducted in 2004 by Deloitte Touche Tohmatsu and the Economist Intelligence Unit reported that they felt under growing pressure to consider and assess non-financial corporate performance, and more than 90 per cent indicated non-financial viable signs of their business as significant factors affecting their financial performance, including employee and customer satisfaction and commitment, product and service quality and innovation, governance and



management processes, quality relationships with external stakeholders, quality business processes, and strong corporate brands and reputations.<sup>26</sup> Admittedly, all of this could be viewed narrowly as a concern about generating and analysing sufficient non-financial performance information simply to know 'how well their companies are satisfying customers, delivering quality products and services, operating with efficient processes, and developing new products and services'<sup>27</sup> or alternatively viewed more widely in terms of 'the interdependency of wider stakeholder needs and long-term shareholder benefits' (Lagan, 2004: 19).

Of course, companies embracing corporate social responsibility might have mixed motivations, not all of which are or even should be wholly altruistic. Those motivations include enhancing employee quality and loyalty, protecting a company's reputation and 'brand', and meeting the demands of stakeholders, regulators, rating agencies and even corporate representative bodies for better non-financial performance and disclosure. On a wider level, some corporate critics argue that, far from simply being a marketing ploy, corporate social responsibility 'presents corporations as responsible and accountable to society and thus purports to lend legitimacy to their new role as society's rulers' (Bakan, 2004: 27).

Saying that those who pursue the best interests of shareholders must do so *responsibly* does not necessarily mean making shareholder interests subordinate to other stakeholder interests. Rather, it points to the permissible ways in which pursuit of the primary interests of the shareholders can be achieved, and perhaps identifies boundaries of permissible and impermissible behaviour which are not grounded simply in what is legal or illegal – as exemplified in the contemporary importance of peer and industry 'better practice' standards, business ethics, reputational risk and so on. Even under the prevailing 'shareholder primacy' norm, the relationship between shareholder and stakeholder interests is not a pure zero-sum relationship, at least of a kind in which focusing on the best interests of shareholders crowds out any consideration of stakeholders.

All good companies and their boards focus on shareholders among other stakeholders. The real question concerns the proper balance between the different sets of interests. However, simply equating shareholder and other stakeholder interests, or allowing directors to choose freely between them, would be problematic in both theory and practice.<sup>28</sup> Acknowledging that the personal liability of directors is the point of highest leverage for introducing legal reform in this area, corporate lawyer Robert Hinkley argues for a legislative change to directors' duties so that directors can pursue shareholder interests 'but not at the expense of the environment, dignity of employees, and the welfare of the communities in which the company operates'.<sup>29</sup> Conversely, corporate lawyer and former Australian competition regulator Bob Baxt

argues that '[w]e need no further expansion of the duties of directors under the Corporations Act to give priority to interest groups that society believes need protection', and that '[t]o require directors to sacrifice their primary obligations would be to further stifle the entrepreneurial spirit that is seriously in danger of being extinguished as a result of over-regulation' (Baxt, 2004: 55).

### **Australian corporate governance developments**

#### *James Hardie and corporate responsibility*

Many of the worldwide corporate governance issues and developments canvassed here are also reflected in recent developments in Australia. Take the example of Netherlands-based James Hardie Industries.<sup>30</sup> The James Hardie group was once a major manufacturer of asbestos building products. Its subsidiaries developed asbestos disease liabilities. It established a trust fund and partly paid shares to compensate victims. Its shift of corporate headquarters from Sydney to Amsterdam needed court approval and was allowed by the New South Wales (NSW) Supreme Court in 2001 on the basis that this fund was adequately equipped to meet all legitimate claims. Later events demonstrated that the trust was underfunded by more than one billion dollars, and a NSW government inquiry was set up to examine the matter. In the course of that inquiry, James Hardie made a contingent offer to provide an unspecified amount to provide additional funds to meet such claims. The Commission of Inquiry later found that the company had established the trust fund with 'the cheapest provision thought "marketable"' (Jackson, 2005: [1.25]).

'There's absolutely no doubt that the foundation was significantly underfunded and the board takes responsibility for that', admitted James Hardie chairman Meredith Hellicar at an information-only meeting for shareholders in Sydney on 15 September 2004, two days before the annual shareholder meeting at the corporate headquarters in the Netherlands and less than one week before the due date for the NSW Inquiry Report by Commissioner David Jackson QC. One shareholder at that meeting was reported as responding that, even if there was a moral obligation to asbestos victims with viable but currently unproved claims, asking the shareholders to approve additional funds to address the admitted shortfall in funding asbestos liability claims was akin to asking shareholders to approve a '\$1 billion-plus charitable donation'. One leading corporate governance adviser (Corporate Governance International) cautioned its institutional clients against accepting the company's annual accounts without any allowance for the contingent liability of unfunded asbestos claims. Other shareholder representative groups sought answers from directors about the perceived damage to shareholder value and corporate reputation. Interestingly, Meredith Hellicar argued James Hardie's case on both a moral and a two-pronged business level, citing 'moral precepts'

as well as damage to the share price and harm to corporate reputation if the issue of unfunded asbestos liabilities was not dealt with once and for all. Responding to shareholder concerns about approval for funding any shortfall, she said:

You're right, we can't just go along to shareholders and say, we think this would be a good thing to do. We do believe, however, the realities are that even if you don't share our moral precepts, the facts of the matter are the share price is impacted by this issue, the company's reputation is impacted by this issue, so even if a shareholder were not willing to accept the proposal on moral grounds . . . it will help the company go forward and grow and that will be reflected in the share price.<sup>31</sup>

The James Hardie episode starkly crystallises the tensions inherent between ownership, limited liability, stakeholder interests, and non-piercing of the corporate veil.<sup>32</sup> It demonstrates that corporate governance and responsibility cannot be viewed just in terms of strict legal liability. For some commentators, it exposes deficiencies in corporate regulation such as the inadequate protection of large-scale victims of the activities of corporations with long-term contingent liabilities at the date of liquidating and distributing corporate assets. In response to delays in negotiating a settlement package agreeable to the company, unions, and victims, the NSW Attorney-General told the Australian intergovernmental ministerial council responsible for national corporate law:

[T]o the degree that it seems to be possible for both legal representatives and company directors and managers of corporations to invoke shareholders' interests to justify behaviour that is, on every reasonable ground, socially irresponsible, then I think we need to have another look at the law that governs the responsibilities of directors.<sup>33</sup>

In the end, the final report on James Hardie criticised high-ranking corporate officers for possible breaches of the law, but otherwise found no legal basis on which the Netherlands-based parent company could be liable immediately for the shortfall in the compensation fund in covering future asbestos liabilities. Nevertheless, in what is probably the biggest voluntary compensation package for victims in Australian corporate history, the company reached agreement in December 2004 with unions and representatives of victims on a long-term compensation package worth 1.5 billion dollars.<sup>34</sup> Leading corporate academics argue that the James Hardie saga not only raises questions about 'the role of the board of directors and the CEO in creating the right corporate culture and balancing the interests of stakeholders, growing activism by those affected by corporate action, and possible law reform' but also shows that the fact that directors must act in the best interests of shareholders does not mean that they are precluded from considering the interests of stakeholders too (Ramsay, 2005a: 63).

*Corporate governance and the Australian HIH report*

One of the major players in the Australian insurance industry, HIH, collapsed in 2001. The report by the HIH Royal Commission is a rare and detailed judicial analysis of a major contemporary corporate collapse and the extent to which corporate governance failures contributed to that collapse. The HIH Royal Commissioner, Justice Owen, clearly suggested a correlation between corporate governance and corporate performance:

Good governance processes are likely in my view to create an environment that is conducive to success. It does not follow that those who have good governance processes will perform well or be immune from failure . . . No system of corporate governance can prevent mistakes or shield companies and their stakeholders from the consequences of error . . . However, good governance practices help to focus those in charge of a company on the very purpose of their corporate activity and the direction of their business and enable them to identify emerging problems early. (HIH Report, 2003: Section 6.1.2.)

The HIH Commissioner cited a number of corporate governance failures contributing to HIH's bad corporate performance, including:

- (i) the lack of clearly defined and recorded policies and procedures;
- (ii) the absence of adequate board analysis of future corporate strategy;
- (iii) intimidation or domination of the board by the CEO;
- (iv) inadequately defined limits on the CEO's authority;
- (v) over-reliance by the board on advice and information from senior management;
- (vi) a failure of middle management to accept responsibility;
- (vii) inadequate internal 'whistle-blowing' and 'bad news' transmission mechanisms;
- (viii) an unclear corporate understanding of legal obligations involving corporate groups;
- (ix) an inadequate understanding and handling of conflicts of interests; and
- (x) an inadequate internal corporate governance culture.

These factors display a mix of 'hard' and 'soft' aspects of corporate governance (see Figure 2.4).

*ASX CGC 'best practice' corporate governance principles*

While the creative accounting and auditing failures of significant corporate collapses in the USA resulted in the prescriptive corporate governance reforms in the Sarbanes–Oxley Act, Australia has adopted a more principle-centred approach, in line with its different legal and corporate cultures and a perceived difference in the nature and causes of corporate collapses in Australia. Under

this principle-centred form of co-regulation, a ‘comply or explain’ or ‘if not, why not’ regime applies. Various business, regulatory, investor and other perspectives were represented in the stakeholder representation informing the development of the ASX CGC’s corporate governance principles. Companies can depart from these corporate governance principles, but they must explain and justify their departure from them. Of course, that legal reality must be considered against the background of the pragmatic reality of high expectations and pressure from the business media, institutional investors, shareholder representative bodies, and independent rating agencies, all of whom are likely to scrutinise carefully the stated justification for any departure from these principles as the de facto norm. There are ten major corporate governance principles as follows, all of which have subsidiary recommendations attached to them:

1. ‘Lay solid foundations for management and oversight’;<sup>35</sup>
2. ‘Structure the board to add value’;<sup>36</sup>
3. ‘Promote ethical and responsible decision-making’;<sup>37</sup>
4. ‘Safeguard integrity in financial reporting’;<sup>38</sup>
5. ‘Make timely and balanced disclosure’;<sup>39</sup>
6. ‘Respect the rights of shareholders’;<sup>40</sup>
7. ‘Recognise and manage risk’;<sup>41</sup>
8. ‘Encourage enhanced performance’;<sup>42</sup>
9. ‘Remunerate fairly and responsibly’;<sup>43</sup> and
10. ‘Recognise the legitimate interests of stakeholders’.<sup>44</sup>

These ten principles can embrace both ‘hard’ and ‘soft’ elements of corporate governance (see Figure 2.4), although ‘hard’ elements currently dominate the recommendations. They also make it standard practice for good corporate governance to require at least some reference to stakeholder interests (see Principle 10, which has room for further development). As with most guidelines on corporate governance, however, a decision-making framework which adequately encompasses shareholder and other stakeholder interests remains elusive.

At the time of writing, Australian reform of directors’ duties, corporate social responsibility and ‘triple bottom line’ reporting is under review.<sup>45</sup> This follows ‘enlightened shareholder value’ proposals in the UK, designed to make directors accommodate designated stakeholder interests in their decision-making.

## **Notes**

1. Some of the material here uses and amplifies ideas first developed in Horrihan (2002, 2003) and Horrihan et al. (2003).

2. For example, these groups include what I call 'inner circle stakeholders' (such as employees, customers, creditors and financiers) and what I call 'outer circle stakeholders' (such as regulators, and even local, national and global communities).
3. In contrast to the traditional, single, financial 'bottom line' for corporations, 'triple bottom line' thinking suggests that companies should make decisions and assess their performance in economic, social and environmental terms. Advocates of such views do not necessarily or always see corporate decisions and activities in zero-sum terms, in which one set of interests (say, the interests of shareholders) must win and another group of interests (say, those of stakeholders) must lose, at least where the two sets of interests compete. Rather, they argue that corporations and those through whom they act are engaged in a much more complex enterprise in which corporate performance, profitability and sustainability are critically affected by the corporation's responsiveness to multiple features of the human and regulatory environments. For more on this aspect, see the discussion and references in Horrigan (2002).
4. The implementation, workability and cost-benefit assessments of the range of corporate governance reforms introduced in the USA in response to corporate collapses and scandals surrounding Enron and WorldCom (that is, the Sarbanes-Oxley Act) and in Australia after the corporate collapses of HIH and One.Tel (that is, CLERP 9) must be subjected to immediate and long-term empirical research, along with other elements of the relationships between corporate governance and corporate performance. The factors affecting the empirical data here include the chosen timescale, the economic climate at the time of analysis, the choice of relevant jurisdictions for comparison, the choice of companies for analysis, the choice of corporate governance features for analysis, the public availability of reliable corporate data information, the difference between pre-2003/04 and post-2003/04 empirical results due to any changes in corporate governance regulation in the post-Enron era, and – of course – the difficulty of establishing the causal relations between any of these factors and corporate performance.
5. See, for example, 'Companies score poorly on responsibility', *Australian Financial Review*, 9 November 2004, 4; 'Non-financial reporting: corporate storytelling', *The Economist*, 6–12 November 2004, 13; 'Non-financial reporting: is it any use?', *The Economist*, 6–12 November 2004, 66–67; and 'In the dark: what boards and executives don't know about the health of their businesses', Economist Intelligence Unit and Deloitte Touche Tohmatsu Survey, October 2004.
6. For a discussion of this point in the context of mandatory requirements for Australian company directors to report on compliance with relevant environmental regulation in their annual directors' reports, see Bubna-Litic (2004).
7. Accordingly, in some contexts it is appropriate to talk of 'corporate governance' in terms of its origins and meanings in the private sector, while on other occasions it is appropriate to talk more broadly of 'organisational governance' of bodies across the public and private sectors.
8. Of course, elements relating to corporate social responsibility are not confined to the latter dimension alone but cut across other governance dimensions too. Other candidates for express mention in such a list include 'people', 'leadership' and 'ethics'. They are implicit within one or more of these identified dimensions of governance, but others might regard them as dimensions of governance in their own right.
9. Cole (2002). In the interest of transparency and full disclosure, the author is a consultant to the law firm which includes Mr Cole as a partner.
10. 'CLERP' stands for 'Corporate Law Economic Reform Program'. The latest reform package is CLERP 9, concentrating on post-Enron issues of corporate auditing and disclosure.
11. See further 'Executive pay plans under scrutiny', *The Australian Financial Review*, 17 September 2004, 1 & 80; 'BHP promises pay transparency', *The Australian Financial Review*, 14 September 2004, 59 & 64.
12. On these points about transnational differences, see: 'Lucy hopeful of US exemptions', *The Australian Financial Review*, 17 September 2004, 6.
13. See, for example, 'Are independence and performance mutually exclusive?', AICD Review–News, Issues, Events, & Education (2004), *Company Director*, 20 (10), 24.

14. For example: 'Corporate governance: theory and practice', *Company Director*, 2003, **19** (4), 10–14; 'Building a better board', *Company Director*, 2004, **20** (5), 14–23; 'The Age of Super Global Governance', *Company Director*, 2004, **20** (10), 6–12; 'Special "Board Essentials" issue of "Keeping Good Companies"', *Journal of Chartered Secretaries Australia Ltd*, 2003, **55** (5).
15. For example: 'Contemporary issues in corporate governance', thematic issue (2002), *University of NSW Law Journal*, **25**.
16. For example, Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation, 2004, NSW Government (that is, the James Hardie Inquiry: report accessible via [www.cabinet.nsw.gov.au/publications](http://www.cabinet.nsw.gov.au/publications)); The Failure of HIH Insurance, 2003, Commonwealth of Australia (that is, the HIH Royal Commission; report accessible via [www.hihroyalcom.gov.au/finalreport/index.htm](http://www.hihroyalcom.gov.au/finalreport/index.htm)); and Restoring Trust, Report to the Hon. Jed S. Rakoff, the United States District Court for the Southern District of New York on Corporate Governance for the Future of MCI, Inc. (that is, the WorldCom Report), 2003 (accessible via [www.findlaw.com](http://www.findlaw.com)).
17. For example, Review of the Corporate Governance of Statutory Authorities and Office Holders (that is, the Uhrig Report), 2003, Commonwealth of Australia; Public Sector Governance, 2003, Australian National Audit Office (ANAO) (updating Applying Principles and Practice of Corporate Governance in Budget Funded Agencies, Discussion Paper, 1997; and Corporate Governance in Commonwealth Authorities and Companies, Discussion Paper, 1999); and Barker, 2004 (accessible via [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)).
18. For example: Hartman, 2004; and 'US softens stance on Sarbanes', *The Australian Financial Review*, 20 December 2004, 10.
19. See, for example, Special Issue on Corporate Governance in Post WTO-China, Special Edition of the *Australian Journal of Corporate Law* (2004), **17** (1), 1–156.
20. For example, Saul (1997) and Kelly (2003). This has implications for business-related education and scholarship too; see, for example, James (2004) and Thornton (2004).
21. Millon (2000: 1005). However, as the CLERP paper also notes, Australia blends aspects of stakeholder involvement with its model too, in terms of creditor initiation of corporate insolvency or employee representation on the board of superannuation fund trustees. The same applies to employee representation on the boards of corporate employers, and to the appointment of stakeholder representatives or even senior public servants by ministers to the boards of public sector agencies.
22. 'Back to the drawing board: is the traditional theory of the firm obsolete?', Knowledge@Wharton, online newsletter (accessible via <http://knowledge.wharton.upenn.edu>).
23. 'Doing the right thing is good for business', *The Sun-Herald*, 25 January 2004, 51.
24. 'Directors can shape regulation or get hemmed in', *The Australian Financial Review*, 28 September 2004, 63.
25. On these points, see 'Companies score poorly on responsibility', *The Australian Financial Review*, 9 November 2004, 4.
26. 'In the dark. What boards and executives don't know about the health of their businesses', A Survey by Deloitte in Cooperation with the Economist Intelligence Unit, 2004 (accessible via [www.deloitte.com](http://www.deloitte.com)).
27. 'Corporate boards and senior executives see shortcomings in monitoring and reporting', Media Release, 12 October 2004, Deloitte Touche Tohmatsu.
28. 'Options canvassed for Hardie law changes', *The Australian Financial Review*, 12 November 2004, 59; and Ramsey, 2005c: 22.
29. Quoted in 'Options canvassed for Hardie law changes', *The Australian Financial Review*, 12 November 2004, 59.
30. In the interest of transparency and full disclosure, the writer discloses that he is a consultant for a law firm that has acted for James Hardie Industries. These comments are based solely upon publicly reported information in the news media.
31. 'Hellicar vows to restore Hardie's honour', *The Australian Financial Review*, 16 September 2004, 3.

## 50 *Research handbook on corporate legal responsibility*

32. On this narrative of events, see 'Hardie faces asbestos revolt', *The Australian*, 8 September 2004, 25; 'Hardie chiefs face fireworks at meeting', *The Australian*, 15 September 2004, 2; 'Hardie faces 'no' vote from investors', *The Australian Financial Review*, 15 September 2004, 3; 'Hellicar vows to restore Hardie's honour', *The Australian Financial Review*, 16 September 2004, 3.
33. 'Options canvassed for Hardie law changes', *The Australian Financial Review*, 12 November 2004, 59.
34. 'Dust settles with a \$1.5b Hardie deal', *The Australian Financial Review*, 22 December 2004, 1; 'Relief, and some caution, as agreement secured', *The Sydney Morning Herald*, 22 December 2004, 7.
35. For example, formalise and disclose management and board functions and roles.
36. For example, have a majority of independent directors, ensure that the chair of the board is an independent director, and establish a nomination committee.
37. For example, establish a code of conduct and disclose the corporate policy on trading in company securities.
38. For example, require CEO/CFO sign-offs to the board on corporate financial reports, and establish corporate audit committees comprising only non-executive directors and with a majority of independent directors.
39. For example, outline written policies and procedures implementing the ASX Listing Rule requirements.
40. For example, ensure that the external auditor is in attendance and available to answer shareholders' questions at annual general meetings.
41. For example, establish policies on risk oversight and management, and ensure written certification from the CEO/CFO to the board about the accuracy of corporate accounts.
42. For example, disclose the performance evaluation criteria and process for the board, board committees, individual directors and key executives.
43. For example, establish a board remuneration committee, and disclose to investors the company's remuneration policies, the costs/benefits of those policies, and the link between corporate performance and remuneration paid to key directors and executives.
44. For example, establish and disclose a code of conduct including legal and other obligations to stakeholders.
45. The Australian Government's Corporations and Markets Advisory Committee's inquiry and the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into director's duties and corporate social responsibility.

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### 3 The fiduciary duties of directors: a proposal for improving corporate governance in Latin America<sup>1</sup>

*Cándido Paz-Ares*

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#### **Corporate governance, fraud and negligence: a working hypothesis**

The objective of this chapter is to understand the relationship between rules of law and market forces and, from there, to establish the bases of a legal policy concerning director liability capable of providing operators with guidelines for designing their governance structures, lawyers with criteria for interpreting the legislation in force and legislators with elements of reflection for a legislative reform which, *ceteris paribus*, will tend to maximize the value of business enterprises and, consequently, facilitate the development of capital markets. Critical to such an endeavour is pinpointing the fulcrum of equilibrium in the director liability system that will allow this efficiency objective to be achieved. This point of equilibrium is not a universal one since it depends on the conditions of individual markets, the institutions operating in individual environments, the circumstances involved in individual companies and even the preferences of the parties thereto.

The fundamental bases for the qualitative estimation of the phenomena concerned lie in an analytical separation of the technological aspect (managerial capacity to generate the highest returns) from the deontological aspect (management's willingness to distribute gains in the most equitable manner) and in the corresponding distinction between the duties of care and loyalty. The duty of care – the duty of diligence of the 'orderly businessman' – requires directors to invest a specific amount of time and effort and to develop a sufficient level of expertise devoted to management or supervision of the company with a view towards maximising value production. The duty of loyalty – the duty to act as a 'loyal representative' – calls for directors to put shareholder interests before their own so that the company derives the benefit of the value so maximised (Article 127 of the Spanish Company Act: CA; Article 171 of the Peruvian General Company Act; Article 59 of the Argentinian Commercial Company Act: CCA; Articles 153 and 155 of the Brazilian CA; and Article 157 of the Mexican General Corporations Act: GCA). This distinction, in turn, gives rise to another, which pits acts of mismanagement (owing to a lack of expertise, attention or dedication) against acts of misappropriation (or acts of

diverting value from the corporate sphere to the individual director's sphere or that of his/her next of kin). And to another, which sets negligence against wilful misconduct, *dolus*: intent. In this respect, breach of duty of loyalty generally involves wilful misconduct and, vice versa. In this fashion, we arrive at the *summa divisio* of the breaches a director may commit: negligence and fraud.<sup>2</sup>

The hypothesis proposed in this chapter can be formulated as follows: the liability system must be structured in such a way that it is as stringent with fraud (wilful misconduct) as it is lenient with negligence (negligent conduct). In short, we advocate ways of arbitrating an abstention policy where negligence is concerned and an intervention policy where disloyalty is involved.

The point of view underlying our hypothesis militates against the tendencies that have traditionally presided over European doctrine affiliated to Latin doctrine and, most certainly, to Spanish and Latin American doctrine. The director liability map drawn by our tradition is opposed to the layout traced in our hypothesis. It is characterised by the enormous stringency with which breaches of duty of care are treated and the scant attention paid to breaches of duty of loyalty. A noteworthy illustration of this phenomenon is the scarce development of the duty of loyalty in continental company acts and in actual case-law experience. Spain provides a classic example in the latest reform from which the 1989 Spanish CA arose. On this occasion, all efforts focused on strengthening the liability system for breach of duty of diligence (suppression of the exemption for ordinary negligence, establishment of joint and several liability, inversion of the burden of proof and so on) (Martínez Machuca, 1997: 1157). However, neither the legislator nor the guiding doctrine was concerned about making similar changes to the liability system for breaches of duty of loyalty. The publication of the Olivencia Report drew attention to this omission.<sup>3</sup> The consistency of this policy appears to be supported by the most widely accepted law and finance academic research, which has empirically demonstrated the strong correlation between the development of capital markets and the protection of the rights of minority shareholders (La Porta et al., 1998 and 2000). It is therefore not surprising that it has begun to flourish precisely with modifications in corporate and securities law aimed at strengthening shareholders' rights.<sup>4</sup>

The remainder of this chapter is divided into three principal sections. The first seeks to demonstrate the economic rationale of our hypothesis of mitigating liability for negligence and fortifying liability for fraud. The second section is devoted to the treatment of fraud liability. Our proposal for severity or stringency stands on the threefold plane of the characterisation of disloyal conduct, facilitation of litigation and increase of sanctions. The final section addresses liability for negligence by exploring means that would allow the excessive stringency of the legal system to be attenuated, both in the field of interpreting constituted legislation and that of statutory design.

## **The economic anatomy of directors' liability**

### *Firm's value and director's liability*

In order to clarify the economic rationale behind our hypothesis, it is worth examining the relationship between a firm's value and its directors' liability. The firm's value depends on its capacity to generate profits which, in turn, depends on its ability to cut costs. In this regard, cutting transaction costs, that is, the costs of defining, monitoring and enforcing the contract system into which the firm is broken down, contributes to the increase in the firm's value (Matthews, 1986: 903).

The issue of director liability should be considered as one more item of a firm's contractual or transactional technology. Its function is to reduce transaction costs derived from maintaining ownership separate from management. The director liability system curbs these transaction costs by aligning director incentives with shareholder interests. The threat of having to indemnify the damages caused by misconduct acts as a deterrent so that directors manage a firm in accordance with its owners' interests.

The error sometimes committed by attorneys and regulators stems from the assumption that the correlation between liability stringency and firm value is linear. When a particular threshold is exceeded, the increase in liability stringency can produce an effect opposite to that sought. Establishing any governance mechanism is not cost free and involves an ongoing marginal cost (for the directors) and a diminishing marginal benefit (for the shareholders).

The optimum degree of liability stringency lies midway along the full range of possibilities – exemption of liability and objective liability; precisely at the point where the cost for directors to commit themselves to a certain degree of liability is equal to the benefit for shareholders of having the directors so committed. This is the point of equilibrium at which, *ceteris paribus*, the firm's value is maximised.

We believe that the stringency/leniency strategy we have formulated lies within the equilibrium zone. This is based on a comparative evaluation of fraud and negligence on three planes: (i) incentives for breach; (ii) substitutability of governance mechanisms; and (iii) legal assessment of the directors' conduct.

*Breach incentives and the different conduct dangers* The first factor to take into account is the extent of natural alignment existing between management incentives and shareholder interests. The magnitude of this variable depends on the return obtained by directors from breaching their duties. *Ceteris paribus*, there will be a greater abundance of the type of breach that generates profit for the defaulters. Accordingly, the focus of any director liability system must be aimed at breach of loyalty duty, as this conduct produces the greatest

advantages for its perpetrators – in contrast to negligent conduct, where defaulters do not usually derive much benefit (Posner, 1998: 452). In order to determine the danger of the different types of conduct, it is critical to distinguish between management decisions, where directors and shareholders share the common interest in seeing the business prosper, and self-dealing transactions, where interests are not so aligned.

*Governance mechanisms and different levels of enforcement substitutability*

The second factor to take into account is the degree of substitutability of the liability rules as governance mechanisms. In this respect, a leniency policy will be more justifiable in cases where the firm has other governance mechanisms in place. A substantial difference also stands between the breach of duty of loyalty and the contravention of duty of care.

Corporations – particularly public corporations – possess powerful market disciplinary mechanisms that reduce the need to resort to the legal system to constrain the negligent conduct of directors. In this context, substitutability exists between legal and market safeguards. The parties concerned will be less inclined to resort to liability rules where the market affords other cost-free safeguards. This phenomenon characterises public corporations, since directors:

1. are subject to substantial reputational effects as they incessantly approach markets in search of resources;
2. make specific investments in the firm that they cannot recover if they are terminated;<sup>5</sup> and
3. operate under the permanent scrutiny of efficient markets (stock market, control mechanism market, top executives market) (Easterbrook and Fischel, 1991: 94–7).

For private corporations, incentives for diligent conduct essentially lie in the less-pronounced separation existing between ownership and management. That many directors are also company owners provides them with a powerful, natural incentive to perform their duties ‘reasonably’.

Corporations do not possess alternative mechanisms for equally effective liability rules for disciplining disloyal conduct. There are three fundamental reasons for this circumstance. First, the very nature of such conduct makes it less discernible. It usually involves self-interested transactions where, precisely as a result of the substantial advantages directors draw from them, they tend to be disguised. Negligent conduct, because it is generally not voluntary, is far more salient (see Scott, 1986: 301–2). Second, breaches of loyalty duties tend to multiply at the end of directors’ relationships with a company, when market discipline is debilitated. Finally, ownership by the directors of a

substantial tranche of the firm's value does not help in any way to prevent fraud. On the contrary, it encourages it, because if directors are insured against the risk of reversal, they may even feel sufficiently protected to attempt to extract excessive personal advantages from the company, which ought to be shared with the minority shareholders. As will be considered further below, experience has taught us that markets with a high percentage of concentrated owner shareholding face a greater risk of minority shareholders' being expropriated.

*Uncertainty, risk of error and over-compliance* The third and most decisive factor for setting an optimum stringency level in directors' liability is the extent of legal uncertainty in which such decisions are taken. Where only a slight degree of uncertainty is involved, there will be justification for finding ways to impose a stringent liability policy. On the other hand, if the uncertainty is considerable, a lenient policy is more appropriate. Uncertainty occurs when directors cannot anticipate the legal consequences of their actions (Calfee and Craswell, 1984: 965ff.). There are several grounds for this scenario:

1. the ambiguous or generic nature of the legal mandate (judicial errors in evaluating the conduct involved);
2. difficulties in satisfying the burden of proof (judicial errors in verifying a specific level of correct conduct); and
3. the cognitive deficiencies of the agent proper (director's incapacity to permanently monitor his/her level of care or in determining the level of care involved).

The level of uncertainty involved determines the risk of error. This risk, in turn, gives rise to the problem of over-compliance, which can be substantial in economic terms. Those who anticipate the possibility of judicial error will make every effort to adopt precautionary measures over and above those required by the duty of diligence. A leniency policy will therefore be advisable when the risk of error is high and the costs of over-compliance are considerable, and vice versa.

From the point of view of error risk, there are considerable differences between liability for negligence and disloyalty. In principle, cases of wilful misconduct scarcely involve any risk of error for directors because: (i) breach of duty of loyalty constitutes the type of contravention where directors are unlikely to commit an error of judgement – operations disqualify themselves precisely on the grounds of drawing excessive personal advantage, and (ii) there is also only a remote possibility of judicial error because, in contrast to negligence that involves a complex technical and economic assessment, the



judgment on loyalty is a moral issue for which judges are well-equipped (Demsetz, 1986: 356).

Negligent conduct, in contrast, poses serious problems of error. The risk stems from the scant experience judges have in this field and the non-existence of a consolidated *lex artis*. As a result, it is highly likely that poor financial results will tend to be equated with breaches of diligence (Chapman, 1996: 1679ff.). The problems courts face are also aggravated by 'selection bias'. As the majority of cases follow poor financial results, courts tend to assume that they are the outcome of breaches of duty of care (Fischel and Bradley, 1986: 266). The increase in error risk gives rise to company costs on two scores: it augments the cost of managerial capital and inflates the cost of risk management.

If directors are subjected to a risk beyond their control, they will increase their remuneration demands. In many circumstances, the inability to structure an appropriate remuneration scheme will also complicate recruiting talented directors. Under the prism of risk management, the problem is exacerbated. Directors are generally more risk averse than shareholders given that they have specific human capital invested in the company. This circumstance is less applicable, if at all, to shareholders and far less so with shareholders of public companies, who can freely allocate risks by diversifying their portfolios. In such a situation, it is highly inefficient to offload directors with a risk that shareholders can better assume.

Turning to over-compliance costs, the differences between negligence and disloyalty are also substantial. A very stringent disloyalty liability system scarcely causes any pitfalls, the worst of which is the renunciation of a few insider transactions that may be auspicious to the company. The costs of over-compliance resulting from a strict negligence liability system, on the other hand, are substantial. Namely, error risk and risk aversion give rise to a highly inefficient form of precaution that has been termed 'paper walls'. The incentive created by stringent liability rules effectively leads to defence barriers for virtually every decision: decisions are not taken unless they are preceded by exhaustive (and costly) expert reports and opinions, for example, auditors' certificates; investment bank opinions; engineer reports; legal reports; and so on. There is also the danger of exacerbating the associated agency costs because experts, in turn, seek to mitigate their accountability by rendering conservative opinions.

### **Liability for disloyalty and the bases for a high deterrence policy**

In the continental legal systems, and by derivation, in Latin American legal systems, corporate law has been absent and even tolerant towards self-dealing transactions and other dubious practices from a duty of loyalty perspective. Scant attention has been paid to them and, when addressed, it has been with a

large dose of ingenuousness. The root of the problem lies in having fashioned director liability rules in a unitary fashion and taking negligence as the model.<sup>6</sup>

This method of procedure has led to two gross errors: an error of defect in the treatment of disloyalty and one of excess in the treatment of negligence. The error of excess must be corrected by a policy of leniency, while the error of defect must be combated by a policy of stringency. The foremost challenge consists of articulating in Latin American legal systems a policy that not only transplants good standards and practices arising in other institutional contexts, but that also seeks to adapt itself to the corresponding institutional framework. Ultimately, this is a matter of fashioning a policy capable of increasing the deterrent effectiveness of liability for breach of duty of loyalty. In order to articulate this stringency policy, we must analyse Latin American legal experience and determine the reasons responsible for the virtual futility of fraud prosecution. There are three fundamental causes: (i) inadequate characterisation of disloyal conduct; (ii) scarce litigation in the matter of duty of loyalty; and (iii) insufficient sanctions established. These shortcomings have jointly contributed to the extremely low deterrence level of expropriation practices, and we therefore advocate intervening in each of the three dimensions.

*Inadequate characterisation of the object and subject of disloyal conduct*

In order to address the inadequacies detected in the dimension relative to the legal coverage for duty of loyalty, it is useful to highlight the three planes in which they flourish and the reasons behind them, namely: (i) the abstract nature of the definition of disloyal conduct; (ii) the artificiality of authorisation procedures; and (iii) the narrow identification of the recipients of the liability system.

*Specification of the duties of loyalty* Company acts in the majority of Latin American countries have traditionally been restricted to establishing a highly generic duty of loyalty. The epitome of this practice is Article 171 of the Peruvian GCA, which merely requires directors to act as loyal representatives.<sup>7</sup> This legislative laconicism also reflects the general tone of continental European law. It is true that the legal coverage provided by this general loyalty clause could have allowed the doctrine and case law to gradually generate clear guidelines on the subject. Experience has shown us, however, that this result has hardly been achieved, to a large extent, as a consequence of the scant opportunities judges have had to pass rulings and thereby acquire sophisticated expertise on these issues.

The first step to strengthen the effectiveness of the duty of loyalty consists of detailing the principal liabilities derived from the general principle. Devising specific rules of conduct: (i) increases the observability of different classes of misconduct and facilitates enforcement; (ii) provides standards to

guide director conduct; (iii) supplies coverage for operators to withstand improper pressures; and (iv) helps create an appropriate corporate culture.

This specification work should be undertaken following the case law developed by the oldest standing legal experiences in these conflicts and American law in particular.<sup>8</sup> The catalogue should, at a minimum, prohibit directors from: (i) carrying out related-party transactions; (ii) taking advantage of the position as director for private purposes; (iii) pursuing corporate opportunities; (iv) competing with the company or its subsidiaries; and (v) intervening and voting on matters where a director has a personal self-interest. To these rules must be added special regulations governing director remuneration, designed to ensure the reasonableness of the amount, transparency of their terms and impartiality of the body establishing them.

*Mandatoriness of the duty of loyalty and exemption clauses* The next item of the stringency policy we propose is to make expropriation technology ineffectual. To this effect, several principles apply.

The first is the principle of mandatoriness of the system derived from the duty of loyalty, such that legal regulation cannot be repealed or amended in the company by-laws. The argument that freedom of contract is not damaging in this field, or that in any case, it is up to the owners to draw up the contract as they deem appropriate because the markets will efficiently discount from the share value the anticipated flows of 'private benefits' distracted by insiders, is unconvincing (Easterbrook and Fischel, 1982: 734–5).

The above principle of mandatoriness is not incompatible with an *ad hoc* principle of exemptivity, by virtue of which transactions involving a potential conflict of interest can be authorised on a case-by-case basis. While this possibility complicates enforcing the duty of loyalty, the draconian counter-solution may prove more costly since it prevents many transactions from getting under way. We must not overlook the fact that related contracting can generate savings in transaction costs. Any regulation of the exemption clauses must be given careful thought. We must consider three fundamental rules: (i) a rule of procedure capable of ensuring the independent nature of the body granting the exemption in respect of the director concerned; (ii) a material rule of innocuousness capable of guaranteeing that the transaction is fair and carried out at arm's length; and (iii) a rule of transparency on the terms discussed below.

Approval by the general meeting should exclude votes related directly or indirectly to the parties affected. We must avoid the crass charades that companies have all too often presented. Bearing in mind the problems of collective action, it will probably be advisable to reinforce the quorums for passing such measures and to be scrupulous about regulating the public requests for proxy votes.

*Subjective extension of liability* The last and most decisive item for implementing a stringency policy for cases of fraud arises as the outcome of extending the application of the regulations governing the duty of loyalty to all parties with a similar role in the company. In this case, the extension is more justifiable than the original regulation referring to the directors as the greater opaqueness of the activity carried out by these parties, who frequently operate in the shadow or backstage of the formal decision-making bodies, gives rise to an even less disciplinary effectiveness of the governing instruments that the market forces provide (Scott, 1983: 938). At a minimum, the extension ought to cover the following parties: (i) members of the supervisory board or similar bodies, syndicates and auditors; (ii) the individuals representing legal entity directors; (iii) the company's senior officers (even if not board members); (iv) the de facto directors, that is, persons who in the day-to-day management of the company perform the standard functions of a director without entitlement or with invalidated or lapsed entitlement; (v) the shadow directors, whom we could define as persons under whose orders the company's directors are accustomed to acting (Schultheiss, 2000: 66; Perdices, 2002: 345); and above all (vi) the controlling shareholders (even though on most occasions they could be subsumed under the 'shadow director' figure).

Extending the disloyalty legislation to cover controlling shareholders is undoubtedly a critical nuance of our proposal as the potential for expropriation they possess can be very high. This figure is common in the continental capital markets and particularly in the Latin American markets. The recent empirical evidence regarding the volume of expropriations is revealing. Suffice it here to report on the non-linear correlation between the firm's value and the rate of ownership concentration (for instance, in Spain share value rises in the concentration range up to 30 per cent, drops in the 30–65 per cent range and then rises again in the top portion: Shleifer & Vishny, 1997: 737–783; Miguel et al., 2001: 9–10). In order to achieve appropriate legal certainty, the legislation should specifically define the figure. The possibilities are varied. Nonetheless, it would be wise to formulate the corresponding legal provision in such a way that it would include all parties who directly or indirectly, alone or jointly with third parties, hold the majority of the corporate stock carrying voting rights or who are otherwise in a position to sway majorities at the company's general meeting.<sup>9</sup>

*Insufficient body of litigation on the subject of duty of loyalty*

If we examine the case-law experience in Latin America, Spain and some other European countries, we find little litigation over the duty of loyalty. The dearth in litigation is generally caused by: (i) the high level of capacity required to bring the director liability action (*acción social de responsabilidad*); (ii) the

opaqueness of the conflicting situations; and (iii) the difficulties of proof confronting shareholders.

*Capacity of individual shareholders to bring the director liability action* The extreme difficulty confronting shareholders in making director liability effective stems from the infuriating formalities involved (to initiate a derivative suit, a shareholder must first obtain a resolution from the general shareholders' meeting barring the company from bringing the action) and from the high share participation such laws impose on shareholders to bring a derivative suit.<sup>10</sup> The prototype minority shareholder who is a victim of the directors' breach of duty of loyalty virtually never possesses even a 5 per cent holding. In our opinion, if there is a genuine desire to rein in the prevailing impunity and sanction this disloyal conduct, the aforementioned restrictions must be revoked. To do so, individual shareholders must be eligible to bring action regardless of the determination of the shareholders' meeting and independently of their shareholding.<sup>11</sup> Naturally, certain precautions may need to be taken to discourage frivolous litigation.

Our proposal is consistent with the recent continental European trend. The most articulate initiative is contemplated by a report by the German Government Panel on Corporate Governance (July 2001), which includes indications concerning the procedure to admit legal action. Even this proposal may be insufficient. Individual shareholders have scant incentives to initiate legal proceedings because they only benefit from a minute fraction of the resulting gain. The most attractive of the various incentives (excluding the American contingency system) consists of granting to the claiming shareholders a small percentage of the damages payable to the company by way of additional compensation over and above the costs of bringing action. Something similar, although less effective, has been envisaged in the recent Argentinian reform, which permits individual shareholders to apply to be paid the part of the quota corresponding to them from the award obtained (Article 75, Public Offers of Securities Act). Finally, it would be remiss not to mention the possibility of subjecting the director liability action to arbitration, as effected, for example, by Article 125 of the Chilean CA.

*Duty of transparency* The second aspect of our proposal consists of setting up a duty of full disclosure on transactions involving conflicts of interest (Black, 2001b: 18–19). Duties of transparency should be articulated in a staggered fashion. We would propose that the following duties be imposed: (i) a duty on the part of the director to inform the board about the transaction he/she intends to carry out with the company; (ii) a duty on the part of the board to inform the external auditor, the audit committee and, where appropriate, the regulator of 'material' proposed transactions;<sup>12</sup> and (iii) a duty on the part of

the board to consign the corresponding information, in appropriate detail, to the annual report so that shareholders have ample information about ‘risky traffic’.<sup>13</sup> The communication must be followed up by verification by the external auditors. The first step would be to audit all authorised operations that appear in the annual report; the second, to report to the shareholders thereon; and the third, to investigate whether any operations have been carried out that were not communicated or authorised (Black, 2001a: 600).

*Burden of proof of disloyalty* The last mechanism facilitating litigation concerns the burden of proof. Inverting the burden of proof is laudable in the field of disloyalty as another facet of the stringency policy we advocate, for the purpose of offsetting the shareholders’ predicament with respect to asymmetrical information: direct monitoring of the director by the shareholder may be prohibitively costly and often require expert knowledge (Cooter and Freedman, 1991: 1055–6 and 1069–71). As a result, it is, in any event, advisable to formulate this rule expressly on the terms provided by Article 77 *in fine* of the Argentinian Public Offers of Securities Act in the wake of the 2001 reform: ‘*en caso de duda acerca del cumplimiento del deber de lealtad, la carga de prueba corresponde al director*’.<sup>14</sup>

#### *Insufficient volume of sanctions*

The third dimension of the ineffectiveness of fraud prosecution relates to the volume of sanctions. The policy of stringency we advocate is consistent with the economic theory of sanctions, which generally rests on the inverse ratio between the likelihood of detection and the magnitude of the penalty. The preventive potential of a mere settlement of damages inflicted on the company is likely to be insufficient. It is therefore necessary to raise the cost of the sanction to offset the likelihood of detection and the difficulty of prosecuting violations of the duty of loyalty. In the case of mismanagement, where there is a higher probability of detection, this is unnecessary, whereas in the case of misappropriation, a policy of greater penalisation is warranted. There are essentially three possibilities for increasing the magnitude of sanctions in private law: (i) disgorging the enrichment; (ii) punitive damages; and (iii) current general remedies.

*Disgorgement: restitution of undue enrichment* The first of these possibilities can be understood as a requisite of commutative justice. It simply consists of compelling the director responsible to refund the profit he/she has gained as a result of breaching his/her duty of loyalty. This approach is in fact a way of achieving the desired aim, to increase the cost of disloyalty (Easterbrook and Fischel, 1993: 441–3). It is therefore surprising that our countries’ corporate law expressly contemplated this possibility, although some exceptions

undoubtedly exist (for instance, Article 42.7, Chilean CA). In spite of the clamorous silence of corporation laws on this matter, private law systems provide a broad enough base to extend the sanctioning apparatus of the undue enrichment doctrine to the hypotheses presented here. Such extension is perfectly viable in Spanish law, which applies an analogy to all or almost all of the violations of the duty of loyalty (conflicts of interest, corporate opportunities, insider trading, and so on) of the rules contained in the legislation on partnerships (see Article 1683, Spanish Civil Code, and Article 136, Spanish Commercial Code), which usually provide restitution of undue enrichment in the event of violation by a partner of his duty of non-competition – a duty that is derived from the general duty of loyalty (Abeltshauser, 1988: 424–6; Paz-Ares, 1991: 1420–21; Llebot, 1996: 70). As was to be expected, this solution is also advocated in the legislative proposals for emerging countries.

*Punitive damages and penal clauses* One effective method is the legal articulation of a system of ‘private fines’. We propose introducing an *ad hoc* legal provision which, for cases of disloyalty, requires the offender to pay the company an additional sum for the amount resulting after multiplying the amount obtained for damages and undue enrichment by a set coefficient, for example, of between 1.5 and 5. The coefficient to be applied on a case-by-case basis would be selected by the judge as a function of the gravity of the conduct. This proposal will undoubtedly encounter resistance among Spanish and Latin American attorneys and scholars for whom punitive damages represent the incarnation of foreign doctrine. Punitive damages in the contractual field, rejected in Anglo Saxon law, are however admissible in Continental law (see Articles 1152–5, Spanish Civil Code). There is no question as to whether companies are entitled to incorporate penal clauses into their articles of association in order to guarantee fulfilment of duties of loyalty (Articles 1152–5, Spanish Civil Code).

*General remedies* In addition to the sanctions characteristic of the liability system referred to in preceding paragraphs, there are always the current remedies: actions involving application for annulment, dismissal and removal.

### **Liability for negligence: a more indulgent view**

As highlighted above, the director liability scheme in our legal systems has given rise to two errors: a defect in the treatment of disloyalty and an overemphasis on negligence. We have endeavoured to combat the error of defect with a policy of stringency. We shall now try to correct the error of excess by defending a leniency policy. The dimensions in which these excesses arise are similar to those where we have previously encountered shortcomings: (i) legal control of negligence; (ii) incentives for taking legal action; and (iii) sanctions

that should be levied on the directors who commit mismanagement offences. We now turn to formulae for mitigating the problems.

*Excesses in the field of matters subject to legal scrutiny*

The stringency of the most substantive rules of director liability for negligence probably stems from strictly legal prejudices or from certain traits of the traditional legal culture that are beyond the scope of this chapter.<sup>15</sup> The considerations that follow endeavour to take into account aspects that do not always appear to have been previously taken into account: the particular circumstances in which the business decision-making process is carried out and the non-legal mechanisms that contribute to its proper development.

*Discretionality of business decisions: an area of immunity* The most direct way of achieving our aim would be to scale back the demandable diligence standard by re-establishing the ‘Roman privilege’ by virtue of which directors would only be liable for gross negligence. This is the solution adopted for partnerships by the Spanish Commercial Code (Article 144).

The preferable approach is isolating the area of director activity in which liability may prove more costly. This area is undoubtedly the field of business decisions. The technical discretionality of directors must be protected. The proposal is the equivalent of incorporating a business judgment rule into our legal systems. The reasons justifying the removal of this field from legal scrutiny are well known: (i) there is no consolidated *lex artis* capable of serving as a reference for judging the decisions; (ii) judges are ill-prepared for adopting this type of decision, and it does not appear to be wise to substitute business decisions for legal decisions; and (iii) there is an additional risk related to selection bias, since lawsuits tend to proliferate at times when results have been poor and cause and effect may be unwarrantedly assumed (Fischel, 1985: 1437ff.; Eisenberg, 1990: 945ff.).

On many occasions judges find themselves having to take this path. A recent decision by the Provincial Court in Cordova, Spain is particularly noteworthy. The judgment advocates acknowledging that directors possess ‘a certain privileged status where liability imputable for their organic performance before the company is concerned, so that the integrity of their personal wealth is not endangered’. Should this opinion be contested, the court adds:

[W]e would be converting director performance into high risk work . . . Loss can be attributed to a wide range of factors, the majority of which should not be directly imputed to directors’ management as – particularly when they are partners – they are the first to be interested in economic success. It should be borne in mind that on almost all occasions the decisions a company requires imply assuming risks that are precisely the factor that justifies profit. (*SAP Cordova*, 27-1-1997; *ARC*, 1997-1: 94).<sup>16</sup>



The same has happened in other legal experiences, such as in Italy and Switzerland – or even Germany, which is probably the country that has traditionally most resisted the business judgment rule.<sup>17</sup>

Removing business management from legal scrutiny must be contingent upon compliance with a number of provisos, namely that: (i) directors obtain reasonable information on the decision; (ii) they follow the established form-related procedures; and (iii) no conflict of interest exists in any collateral consequence of the decision.

*Exception: the ‘duty of independence’* If directors adopt a decision under a conflict of interest, we are in the realm of duty of loyalty. Nonetheless, it is advisable to exclude from the immunity declaration cases where directors are called to supervise transactions that may involve conflicts of interest between the direct managers and the company. Typical cases include: (i) fixing retributions; (ii) defensive measures in battles over control; (iii) approval of transactions involving conflicts of interest; (iv) greenmail and buying back of own shares; and so on. For these cases, a *tertium genus* has been proposed which would stand midway between the duty of diligence and the duty of loyalty: the duty of independence.

*The different positions of the director* The proposed leniency policy calls for moderating the subjective scope of the director liability for violation of the duty of care. In this area there are several issues to note.

The first relates to the increasing differentiation of functions within the collegial administration body, in which internal directors (with executive functions) and outside directors (with control functions) coexist in a process that derives from the consolidation of the so-called supervision model and the correlative decline of the traditional models – managerial, representative and participative. This phenomenon requires adjusting the duty of care of directors in accordance with their role in the board.

The second remark refers to the joint and several nature of director liability established in Spain and all legal regimes of the Latin American region (Article 133.3, Spanish CA; Article 158, Mexican GCA; Article 274, Argentinian CCA; and Article 158.2, Brazilian CA). This rule is a direct consequence of the collegiality principle that characterises the organisation of the administration bodies, and in this sense is formally irreproachable. However, it is a rule that cannot be mechanically applied, but rather must be adjusted in view of the principle of labour division – which acts as liability ‘firebreak’ – in those areas in which it is justified from an organisational perspective (Paz-Ares, 1997: 166).

Finally, we should note the reform of Article 274 of the CCA effected by Argentinian Law 22.903, by virtue of which, and notwithstanding the rule of

joint and several liability, ‘the attribution of liability will be made pursuant to the individual performance in those cases in which functions would have been assigned on a personal basis in accordance with the statute, the regulation or the resolution of the stockholders’ meeting’. This rule reduces uncertainty, facilitates the decision-making process and fosters the establishment of more efficient organisations.

#### *Excesses of litigation*

The proposed leniency policy is aimed at minimising litigation through several measures, which are summarised below.

*Restricting the capacity to bring lawsuits* For the same reasons as we have been expounding above, it would not seem appropriate to admit the so-called individual derivative suit and even less, to subsidise the litigation on the terms we have proposed in respect of actions for liability for breach of the duty of loyalty. In this case it is advisable to preserve the traditional systems of bringing a liability action and, in particular, to make the capacity to bring a director’s liability lawsuit for possession contingent on possession of a significant stake in the company, for example, 5 per cent.

*Shifting the burden of proof to the plaintiff* The criterion that has prevailed in the Spanish practice and in certain Latin American countries does not accord with the leniency policy requirements and with the economic rationality that supports it. That is, it imposes on directors the burden of disproving the accusations of negligence (Machado Plazas, 1997: 326). An approach of this nature purports to be justified by the accessibility of the proof<sup>18</sup> and to be legally based on the regime of joint and several liability of directors, a regime that can only be avoided by those who prove they did not participate in the approval of the resolution (Article 133.2, Spanish CA; Article 274, Argentinian CCA; and Article 155, Brazilian CA). This criterion should be revisited since we are aggravating the problem of over-compliance and favouring the futility of anticipated precautionary measures. Each party should be required to prove the premises of fact of the rule that is favourable to it. Our proposal is perfectly consistent with the rules of joint and several liability of the board of directors such that directors may only avoid the liability if they prove that they have not contributed to, and even opposed, the applicable decision.

#### *Excesses of sanction and freedom of contract*

The last plane on which an indulgence policy can become effective is related to sanctions. Those upholding an assessment which ‘simply’ repairs the damage consider the question from the point of view of the compensatory

function of civil liability and not from its preventive function. If we examine the issue from this angle, we immediately realise that quantifying the sanction as a function of the damage caused may prove to be counterproductive for the company. Directors and officers may be risk averse, which may prove costly to the company as it exacerbates the problem of conservative policies and the squandering on cautions directed at minimising the liability risk.

We first suggest a quantitative limitation on director liability for negligence, depending on a multiple of the overall amount of the director's annual remuneration. The aim is to mitigate the high risk aversion that a director would otherwise have to bear. The limitation is particularly appropriate when the indeterminacy of the law is considerable and there is a low likelihood of corruption. This is precisely what occurs with the duty of care: the governing legislation is one of the most indeterminate and generic constituents of the legal system and the directors generally have no motive to act negligently.

The objections that could be levelled at this proposal – (i) that it fails to fulfil the compensatory function; (ii) that it proves to be unfair for the shareholders; and (iii) that it is inconsistent with the principles of our legal tradition – are all more apparent than real. To take heed of this, we must make three clarifications. First, director liability is contractual and, therefore not subject to the imperative characteristic of tort law whose fundamental function is to compensate victims. Second, the liability limitation we propose, far from being unfair to shareholders, can precisely be justified on the grounds of equity or fairness, because the potential liability in cases in which it applies would otherwise be excessive in relation to the nature of the defence, culpability and the economic benefits expected from serving the corporation. Third, our proposal is harmonious with the fundamental rules of our tradition.<sup>19</sup>

## **Conclusions**

It is to be expected that the legal reforms with respect to directors' duties and corporate governance currently under way within Latin America draw upon pre-existing models from the North American and European traditions. As argued above, liability for the breach of loyalty should be more stringent, and that of the duty of care, more lenient. Such a perspective is consistent with maximising efficiency, the realities of commercial and judicial decision-making and enhancing the relationship between shareholders and directors.

## **Notes**

1. The author thanks Stephen J. Hess for his invaluable contribution. This chapter is derived from a paper presented at the Third Meeting of the Latin American Corporate Governance Roundtable (8 April 2001), organised by the OECD, the IFC and the World Bank. An extended and more elaborated presentation of the argument has recently been published in a Spanish law review (see Paz-Ares, 2003).
2. The central nature of this distinction is adroitly underlined by Scott (1983: 927–8; 1986: 299–300, 307–8). For a different point of view, see Fischel and Bradley (1986: 290–91).

## 70 *Research handbook on corporate legal responsibility*

3. See Comisión Especial para el Estudio de un Código Ético de los Consejos de Administración chaired by Professor M. Olivencia, *El Gobierno De Las Sociedades Cotizadas*, Madrid, 1998, II.8.
4. See, for example, Brazil (Act. 303/2001), Argentina (Decreto 677/2001) and Chile (LMV and Act 19.705/2000).
5. For example, where director liability actions prosper, the directors are automatically terminated (see Article 134.2 II Spanish CA).
6. Only recently has any attention begun to be paid to the duty of loyalty; see the Chilean, Brazilian, Argentinian and Mexican reforms of 2001.
7. The CAs in other countries (see, for instance, Article 59, Argentinian CCA) are couched in similar or even more imprecise terms (see, for example, Article 157, Mexican GCA).
8. The restatement of the American Law Institute's Principles of Corporate Governance (ALI, 1996) inspired Spain when the chapter of the Olivencia Report on fiduciary duties was proposed.
9. The definition should be accompanied by an assumption which deems that a person possesses this capacity of influence whenever he/she holds 25 per cent or more of the stock carrying voting rights and no other person exists who directly or indirectly, alone or jointly with third parties possesses a larger fraction: see ALI (1996: 1.10).
10. Five per cent according to Spanish (Article 134 of the CA), Brazilian (Article 159.5 of the CA) and Argentinian legislation (Article 276 of the CCA); 30 per cent according to Peruvian (Article 184 of the General Company Act) and Mexican legislation (Article 163 of the GCA), even though Mexico has reduced the demand to 15 per cent in the recent 2001 reform: see Article 14 bis V d) Securities Market Act.
11. This is the traditional situation contemplated in American legislation and, with limitations, in British law: see Gower et al. (1992: 482ff.).
12. The initiative involving the auditor being informed is reflected by the most recent reforms introduced in the Latin American region: see Article 73 of the Argentinian Public Offers of Securities Act and Article 14bis 3 V of the Mexican Securities Market Act.
13. For example, Article 35 of Act 24/1988 (Spain) on the securities market.
14. The Argentinian regulation replicates s. 93 (2) of the German *Aktiengesetz*.
15. In a word, they could be associated with formalism, rationalism and centralism.
16. See also STS 11 October 1991; SAP Madrid 24 June 1993; RGD 589 (1993): 10532; SAP Toledo 12 December 1994; AC 1995-1: 780.
17. For Italy, see Bonelli (1991: 361ff.); for Switzerland, see Grass (2000: 3ff.).
18. See, for example, Article 217.6, *Ley de Enjuiciamiento Civill* (LEC).
19. The rule that specifies the limitation on the liability to the damages foreseeable at the time of drawing up the contract is included in Spanish law in Articles 1107 and 1103 of the Civil Code.

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## 4 Directors' duties within the United Kingdom

*Rebecca Parry*

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### **Introduction**

This chapter considers the English law on directors' duties. This is an area of law that has traditionally been regulated according to principles established by judicial decision, strengthened in some cases by means of statutory provisions. A complex body of such case law has been established. However in July 2002, after an extensive Company Law Review process, the government announced an intention to codify the law in this area, in the interests of clarity and accessibility (*Modernising Company Law*: 26ff.). The draft Companies Bill (*Modernising Company Law*: 343ff.; *Draft Companies Bill*, s. 17 and Sch. 2, para. 2.) indicates that this codification, although replacing the common law, will not substantially alter the case-law principles. It should be added these laws should not be viewed in isolation – they are supplemented to a significant extent by non-legal codes of conduct, in particular regarding listed companies. We shall begin with an examination of theoretical considerations, before examining the historical evolution of the law in this area. Finally the prospects for future reform in this area will be summarized.

### **Theoretical considerations**

The main theoretical controversy in the context of directors' duties centres around the appropriate objective of the company's activities. Some theorists contend that the directors should manage the company in the interests of its shareholders: this may be termed 'the shareholder argument'. Others contend that the directors should take the interests of stakeholders, such as employees and customers of the company, into account in making decisions: this may be termed 'the pluralist' or 'stakeholder argument' (Dine, 2000: Ch. 1; Millon, 2001). A common starting point for theorists is to examine the nature of the company itself from a structural perspective: examining whether the company is the product of private agreements or whether it is an organic social enterprise. This structural analysis is then used to determine the proper objectives for the company.

Two main criticisms may be made of the approaches that have been taken to date. First, the theoretical model of the company does not necessarily provide a suitable basis for identifying the normative principles that should govern the operation of the company. Second, those on each side of the

shareholder/stakeholder debate use the different theoretical models in differing ways to justify their arguments, thereby confusing the proper operational objectives of the company. It has therefore been contended that debates should be focused on the issue of how those involved in, and affected by, the company should relate to one another, and how the state should relate to such persons.

The traditional conception of the company is that it is a vehicle that serves the interests of shareholders. The company has been viewed as a 'nexus of contracts' under which shareholders, creditors, employees and all other stakeholders bargain at the outset to agree the terms to govern their relationships. In some instances these private bargains are supplemented by statutory provisions. This model, which has its roots in 'realist' conceptions of the company as a body autonomous from the state, has been used to argue in favour of minimal regulatory interference and against a requirement to take account of stakeholder interests. Stakeholders such as employees are able to bargain to achieve protection against risks, since the company's obligations to them are clearly defined, whereas shareholders are unable to do so since, as the ultimate bearer of the risk of failure, they cannot anticipate all potential risks.

Shareholder theorists point out that shareholders own the company and therefore directors should operate the company in the interests of the shareholders (Berle and Means, 1932). Maximising shareholder dividends is beneficial for society since it increases social wealth. Furthermore, if directors do not merely concern themselves with generating a profit for shareholders they are, in effect, imposing a tax upon them and deciding how to use the money generated.<sup>1</sup> Critics point out that, even if the nexus of contracts theory is used to explain the basis of companies, it does not necessarily specify how the company should be operated and the objectives that it should pursue.

Those who favour the pluralist approach have employed a variety of complex arguments. A company is not merely the private property of shareholders but is an organic enterprise which lives beyond their interests. A number of theoretical models support the view that the company is a pluralist enterprise. For example, the concession theory regards the ability to create a company as arising from a concession by the state and feminist theorists contend that caring for others should be factored into corporate decision-making (O'Neill, 2001). The realist theory supports the argument that if the company is a distinct social entity it should bear the full range of benefits and burdens that personhood implies. Good corporate behaviour would have regard to its impact upon others (Dodd, 1932: 1154). Focusing only on shareholder interests can lead to social costs such as compulsory redundancies, factory closures, low wages or environmental pollution. Some theorists go further to argue that corporations should be required to act as good citizens (Nader et al., 1976).



More recently, theorists have separated the structural debate about the nature of the company from the debate about operational matters. Millon (2001: 58) has argued:

[The] analysis of difficult questions of social policy [has] probably been hindered by assumptions about the distinctiveness of activity in the corporate form, whether the corporation is thought to be an entity or instead is an aggregation of people distinct from the rest of society.

He advocates a focus on the rights and duties of individuals as against each other, regardless of their place within the corporate framework (*ibid.*: 57). Questions of individual responsibility and obligation, wealth distribution and state power can be properly addressed without being clouded by debates about the nature of the company.

UK company law reflects elements of the shareholder/pluralist debate. The traditional view has been that directors owe duties to the company, whose interests are those of present and future shareholders.<sup>2</sup> In recent decades, UK company law has embraced stakeholder interests to a limited extent. Under the Companies Act 1985, section 309, the performance of their functions requires directors to have regard to the interests of employees in general as well as the interests of its members. Furthermore, where the company is insolvent the interests of the company are equated to the interests of its creditors (*Brady & Anor v Brady & Anor*, 1987; *West Mercia Safetywear v Dodd*, 1988).

It is unlikely that contemporary legal reform will produce significant changes in this area. During the Company Law Review this issue was presented as a choice between an 'enlightened shareholder value' approach (a modification of the shareholder approach noted above) and a pluralist approach. The former is regarded as being inclusive on the basis that long-term prosperity may be achieved by fostering cooperative relationships with employees, creditors and other stakeholders, even though this may entail short-term costs. The enlightened shareholder approach represents a move away from what Margaret Blair has termed 'market myopia' whereby directors tend to be too responsive to short-term pressures from financial markets and neglect the company's long-term interests (Blair, 1995: Ch. 4). The pluralist approach goes further to include interests which are not considered subordinate to shareholder interests and do not merely achieve greater value for shareholders (Company Law Review, 2002a: para. 5.1.13).

The review identified several problems with the pluralist approach including the difficulty of enforcement and recommended a more limited approach. The White Paper summarised their recommendations as follows:

The basic goal for directors should be the success of the company in the collective best interests of shareholders, but directors should also recognise, as the circumstances require, the company's need to foster relationships with its employees,

customers and suppliers, its need to maintain its business reputation, and its need to consider the company's impact on the community and the working environment.

The *Draft Companies Bill* replicates this approach by requiring directors to manage the company in good faith in the interests of its members but to also take account of other factors that a person of care and skill would consider relevant including the stakeholder interests quoted above (*Modernising Company Law*: 343ff.; *Draft Companies Bill*, s. 17 and Sch. 2, para. 2.). However, the position alters under contemporary jurisprudence where the company is or is nearly insolvent. The draft bill provides that directors must take such steps as they believe necessary to reduce the risk that the company will be unable to pay its debts as they fall due and to promote the success of the company for the benefit of its members taking into account all material factors practicable for the director to identify (*Modernising Company Law*: 343ff.; *Draft Companies Bill*, s. 17 and Sch. 2, para. 8.). The director is required to achieve a reasonable balance in reducing the risk of insolvency. Where the company goes into liquidation directors are required to exercise due care and skill to minimise the potential loss to the company's creditors.<sup>3</sup>

### **Historical evolution**

The current rules on directors' duties were established many decades ago through judicial precedent and reinforced by statute. More recently these laws have been supplemented by further codes, such as the Combined Code on Corporate Governance, Stock Exchange Listing Rules and the City Code on Takeovers and Mergers, mostly applicable to companies listed on the Stock Exchange.

The main body of case law concerns the fiduciary duties of directors under which the position of directors is analogised to that of trustees. Opinions differ as to how this approach to directors' duties originated. The most persuasive explanation<sup>4</sup> is that of Sealy (1967) who suggests that the limited legal vocabulary of the early period when cases concerning corporations were first decided compelled resort to trust principles as the concept most familiar to judges.

These equitable principles enabled the courts to provide redress where directors put their own interests ahead of the company; exceeded their authority; failed to properly exercise their discretion; or failed to act honestly in the interests of the company. However these principles were ill-equipped to assess the extent to which directors were required to attend to their duties or to exercise informed judgement in matters of policy. The courts therefore developed a separate set of common law duties having features in common with the law of negligence. These rules placed a duty on the director to act with skill, care and diligence.

### **The contemporary legal position**

Directors' most onerous duties arise from their status as a fiduciary. Directors must act in good faith in the interests of the company, must not fetter their discretion and must exercise powers for the purpose for which they were intended. Directors are prohibited from entering into transactions where their personal interest may conflict with that of the company or from otherwise benefiting from their position. They are also required to exercise proper care, skill and diligence in carrying out their duties. The nature of each of these duties will be discussed below and reference will be made, where appropriate, to the draft Companies Bill.

#### *Fiduciary duties*

This set of duties arises out of the degree of trust reposed in directors and seeks to ensure integrity in their actions.

*Duty to act in good faith in the interests of the company* This duty is primarily a subjective one. Lord Greene MR in *Re Smith and Fawcett Ltd* (1942: 306) said that directors 'must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company'. However the courts also impose an objective threshold. As Bowen LJ said in *Hutton v West Cork Rly Co* (1883: 671): 'Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational'. Accordingly, if an act or decision is made which no reasonable director or board of directors could have properly come to, the court will intervene.

If directors disregard the interests of the company, even unconsciously, they will breach their fiduciary duty. Such a breach will be proved where it can be shown that directors acted in the interests of themselves or a third party (*Re W and M Roith Ltd*, 1967).

*Duty not to fetter discretion* Directors must not allow their decision-making powers to be restricted by, for example, agreements with persons such as shareholders, other directors or parent companies (*Kregor v Hollins*, 1913). However, an important exception to this principle arises where the company enters into a commercial agreement to execute a plan and directors undertake to vote in a particular manner to put that plan into effect (*Fulham Football Club Ltd & Ors v Cabra Estates plc*, 1992). The directors will not commit a breach of duty provided that they have not fettered their discretion. This basic rule and its exception feature in the draft Companies Bill (*Modernising Company Law*: 343ff.; *Draft Companies Bill*, s. 17 and Sch. 2, para. 3.).

*Duty to exercise powers for a proper purpose* The directors must exercise their powers for the purpose for which they were conferred, and if they do not then they will have exceeded their powers (*Howard Smith Ltd v Ampol Petroleum Ltd*, 1974). Directors cannot, for example, issue new shares in order to forestall a takeover (*Hogg v Cramphorn Ltd & Ors*, 1967; *Criterion Properties plc v Stratford Properties LLC*, 2003) or to secure sufficient votes to pass a resolution (*Punt v Symons & Co Ltd*, 1903). Directors who use a power for a purpose other than that for which it was conferred will commit a breach of duty even if they act in what they believe to be the company's best interest. Powers are construed in the context of the company's constitution: actions that might normally be regarded as illegitimate may be valid in the context of a particular company (*Re Smith and Fawcett Ltd*, 1942).

*The no conflict rule* Directors are subject to strict rules regarding conflicts of interest. The basic rule is disclosure (Companies Act 1985, s. 317). Although the no conflict rule derives from the director's fiduciary status it is technically incorrect to regard it as a director's duty. The position was explained by Vinelott J in *Movitex Ltd v Bulfield & Ors* (1986: 99, 432):

The true principle is that if a director places himself in a position in which his duty to the company conflicts with his personal interest or duty to another, the court will intervene to set aside the transaction without inquiring whether there was any breach of the director's duty to the company.

It is therefore more correct to speak of a prohibition from transacting in a position of conflict of interest rather than the director being subject to a duty not to transact. Indeed a director may be in a position of conflict without necessarily being in breach of duty, an issue that is of importance in considering the question of remedies.

In the Companies Bill, conflicts of this nature are divided into three categories: transactions involving a conflict of interest; the personal use of the company's property, information or opportunities; and benefits from third parties (Koh, 2003). This classification will be adopted for the discussion which follows. However, it is also necessary to discuss the issue of competing directorships which has generated important case law but is not dealt with under the draft Companies Bill.

**TRANSACTIONS INVOLVING A CONFLICT OF INTEREST** A director is forbidden to enter into arrangements in which there is a possibility that personal interests may conflict with fiduciary duties to the company. Arguably the rule needs to be strictly enforced since there is considerable potential for directors to exploit their position. The judicial attitude was expressed by Lord Cranworth in *Aberdeen Railway Co v Blaikie Bros* (1854) as follows:

[I]t is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect.

Not only must directors act in good faith, they must also be seen to act in good faith: the prohibition applies even if the terms of a proposed contract with the director are perfectly fair. The expression 'possibly may conflict' means 'that the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real sensible possibility of conflict' (*Boardman & Anor v Phipps*, 1967: 124). The rule therefore includes not only contracts which the company enters into with the director personally but also those where the company contracts with a party to whom the director is closely connected.

A company will only be bound by a contract in which one of its directors is interested if there is an enabling provision in the articles of association or if the company in general meeting approves the contract (*Aberdeen Railway Co v Blaikie Bros*, 1854). Non-disclosure does not make the contract void or a nullity but it will be voidable on equitable grounds unless sanctioned by the company (*Hely-Hutchinson v Brayhead Ltd & Anor*, 1968; *Guinness v Saunders plc & Anor*, 1990).

PERSONAL USE OF THE COMPANY'S PROPERTY, INFORMATION OR OPPORTUNITY  
Another aspect of the no conflicts rule is that a director must not, without informed consent, make use of company property, opportunities or information (*Cook v Deeks*, 1916). The main problems arise where directors possess information. If a director utilises opportunities or special knowledge and, as a result, secures a profit then this profit must be accounted for. This principle is strictly applied as illustrated by *Regal Hastings v Gulliver* (1967): directors were ordered to account for their profits even though they had acted in good faith and the company would have been unable to benefit from the opportunity if the directors had not invested. In *Bhullar v Bhullar* (2003) a director was liable to account to the company, having purchased property adjacent to the company's premises and having not informed the company of this opportunity, even though negotiations were under way for the sale of the business.

More difficult issues arise where a director resigns before taking up the opportunity. The no profit rule may apply even after the directorship ceases. In *Canadian Aero Service v O'Malley* (1973) directors who had been negotiating on behalf of the company resigned to set up their own company to take the contract. It was held that their fiduciary duty survived their resignation and could be enforced against their new company as well as them individually. Significantly, this was a diversion of a maturing business opportunity which

the company had been actively pursuing and it was the position of the directors with the new company rather than a fresh initiative which led to the conclusion of the contract.

In *IDC v Cooley* (1972) the defendant was held to have misused a company opportunity and made to account for the profits gained even though there was only an estimated 10 per cent chance that the company could have got the contract itself. The rule is strict to encourage directors to inform shareholders.

Directors will not be held liable if the profit does not derive from their former fiduciary status. In *Island Export Finance Ltd v Umunna* (1986) a director of a company which had a contract to supply post boxes to the Cameroon postal service was permitted to take up a similar contract following his resignation. The prospect of the contract had not been a material factor behind his resignation, there was no evidence that the company was pursuing further business with the Cameroon authorities at that time and it could not be said that the director had taken a maturing business opportunity.

Under the Companies Bill, directors will only be able to make use of any property, information or opportunity that came to them in the performance of their functions in one of three situations: (a) if the company has given informed consent; (b) where the company is a private company, the board of directors have given their informed consent and there is nothing within the articles to invalidate such authorisation; or (c) where the company is a public company, a constitutional provision enables the board of directors to provide authorisation and such authorisation has in fact been given. Notably, the boards of private companies can provide informed consent unless the constitution prevents them doing so whereas the boards of public ones can only do so if the constitution permits them (*Modernising Company Law*: 343ff.; *Draft Companies Bill*, s. 17 and Sch. 2, para. 6).

**BENEFITS FROM THIRD PARTIES** A director, as a fiduciary, is not permitted to accept bribes. If accepted, a bribe is regarded as the property of the company (*Attorney General for Hong Kong v Reid*, 1994). In addition the company may rescind any contract obtained through bribery (*Taylor v Walker*, 1958). These principles are reflected in the Companies Bill which provides that ‘a director or former director of a company must not accept any benefit which is conferred because of the powers he has as director or by way of reward for any exercise of his powers as such’. Such benefits may only be accepted if it comes from the company, if the company has given informed consent or if the benefit is incidental to the director’s position.

**COMPETING DIRECTORSHIP** The issue of whether a director should be permitted to hold a position in a rival company has been one of the more anomalous issues in this area of law. Until recently the case-law held that if there was

nothing in the company's regulations to indicate that a director's services must be rendered to that company alone, the director was at liberty to become a director of even a rival company (*London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* (1891) approved in *Bell v Lever Brothers Ltd*, 1932: 195). In the absence of evidence of a breach of duty, such as leaking information to that rival company, directors could not be restrained from holding this position. This approach has recently come under fire and will probably be confined to cases where the competing directorship is merely nominal (*In Plus Group Ltd v Pyke*, 2002; *British Midland Tool Ltd v Midland International Tooling Ltd*, 2003; Goddard, 2004). Since this issue has been omitted from the draft Companies Bill future developments are in the hands of the courts.

*Duty to exercise care and skill* This is not one of the fiduciary duties but is concerned with satisfactory performance standards rather than honesty or scrupulousness in dealings with the company. Directors are expected to discharge their duties with care, skill and diligence. However, generally the courts avoid interfering in matters of business judgement.<sup>5</sup> The pioneering case is *Re City Equitable Fire Insurance Co Ltd* (1925) where Romer J laid down three propositions which have since become the classic statements of the duties of care and skill.

THE STANDARD EXPECTED Romer J first dealt with the standard of performance expected of directors. Directors are objectively required to take such care as ordinary people may take on their own behalf but, subjectively, they need not exhibit a greater degree of skill than that expected of a person of equivalent knowledge and experience. This test has been recently replaced by reference to statutory provisions which contain a greater degree of objectivity. However it is arguable that Romer J's test was misinterpreted and its subjective elements overplayed.

The modern standard of care and skill required of directors has been adapted from the test applicable to directors of insolvent companies under the Insolvency Act 1986 (UK), section 214, which addresses wrongful trading (*Norman v Theodore Goddard*, 1991; *Re D'Jan of London Ltd*, 1993). This standard appears also in the draft Companies Bill (*Modernising Company Law*: 343ff.; *Draft Companies Bill*, s. 17 and Sch. 2, para. 4). Section 214 applies a two-part test under which the director is assessed according to both subjective and objective elements. Objectively, directors are required to have the general knowledge, skill and experience expected of a reasonably diligent person carrying out the same functions in relation to the company. Subjectively, directors are assessed according to what would be expected of a reasonably diligent person possessing the director's own general knowledge,

skill and experience. Since directors are assessed according to the higher of the two standards, a poorly qualified director will be unable to rely upon lack of expertise for failing to meet the objective standard. In contrast, a higher level of performance will be expected of well-qualified directors. Section 214 puts emphasis on the functions carried out by a director: less is accordingly expected of a non-executive director than an executive one.

Directors in a contractual relationship with their company may also owe duties of fidelity, care and skill under that contract which may be more stringent than the equivalent obligations at common law.

**CONTENT OF DUTIES** Directors, both collectively and individually, must acquire and maintain a sufficient level of understanding to enable them to discharge their duties (*Re Barings Bank plc (No. 5)*, 1999 endorsed 2000: 535). Knowledge of specialised matters may not be required (*Re Continental Assurance plc*, 2001), although if directors have expertise the company will be expected to benefit from it (*Brazilian Rubber Plantations and Estates Ltd*, 1911). Even if directors have not been allocated any particular duties they are unable to absolve themselves of responsibility by claiming reliance upon others (*Drincqbier v Wood*, 1889; *Re Peppermint Park Ltd*, 1998).

**DELEGATION** As a matter of practicality directors will usually be permitted to delegate duties to others (*Dovey v Cory*, 1901). Indeed, powers of delegation will normally be provided under the articles (*Companies (Tables A to F) Regulations 1985*, SI 1985/805, reg. 72). However directors will be liable if they do not delegate to an appropriate person (*Re City Equitable Fire Insurance Co Ltd*, 1925) or fail to monitor the person to whom they have delegated (*Re Barings Bank plc (No. 5)*, 1999 endorsed 2000). In *Re Barings Bank plc (No. 5)* (*ibid.*) the court rejected the defendant's contentions that he was entitled to trust the managers to whom he had delegated unless he was given any cause for concern. The court held that a director must be proactive, rather than reactive. It was not possible to just 'sit back and admire the view'. Under the draft Companies Bill, directors are prohibited from delegating any of their powers except where authorised by the company's constitution (*Modernising Company Law*: 343ff.; *Draft Companies Bill*, s. 17 and Sch. 2, para. 3(a)). Beyond this, little guidance is given as to the permissible extent of delegation and it would appear that the common law principles are left unaffected.

### *Bringing the directors to account*

The enforcement of directors' duties occurs in a number of ways. Under company law the company has the power to sue to enforce duties. This decision lies in the hands of the shareholders who will either vote to ratify the



breach, if capable thereof, or take action against the director. Directors can use their own shares to vote, since they vote in their capacity as shareholders (*North-West Transportation Co Ltd v Beatty*, 1887). Although ratification will release the director from liability and make binding any contract that is voidable by reason of the breach, not every breach is ratifiable. The principle of majority rule applies such that if the wrongdoers control a majority of the votes they can ensure that no action is taken by the company. However this outcome may be inequitable and thus the courts have developed the derivative action where there has been an unratifiable breach of duty and the wrongdoers control the general meeting (*Burland v Earle*, 1902; *Edwards v Halliwell*, 1950).

The necessity for ratification by the general meeting in the context of the no conflict rule is burdensome since any contract in which the director has an interest must be ratified. In the interests of administrative convenience companies will normally have a provision in their articles obviating the need for the general meeting to vote on every conflict of interest. Table A of the Companies Act is a model set of articles which includes for example regulation 85 which provides that directors can be party to a transaction or agreement with the company provided they have disclosed their interest to the board.<sup>6</sup> Under regulations 94 and 95 they cannot vote on any matter in which they have an interest or be in the quorum. So that regulation 85 does not unduly erode the protection given to shareholders under the no conflict prohibition, it is inoperative under the Companies Act 1985, Part X in relation to specified transactions, such as those of a high value (Companies Act 1985, s. 320). In such cases, the approval of the general meeting is required and disclosure to the board will not suffice. A simplified regime is proposed under the draft Companies Bill.

Even where a transaction involving a conflict of interest is ratified, a director may need to take further steps to avoid criminal liability. Under the Companies Act 1985, section 317 directors are required to disclose their interests to the board. Criminal sanctions apply for a breach of this rule but the validity of any contract is unaffected by this section (although, as noted above, the contract may be voidable under common law unless ratified). A director can make a general disclosure regarding a person or company to avoid repeated disclosures.

The courts have developed a flexible range of remedies to enable breaches of fiduciary duties to be resolved in an equitable manner. A contract entered into in breach of fiduciary duty, for example for an improper purpose, can be rescinded provided it has not been ratified. This course of action will be inappropriate if rescission would harm the interests of third parties. If directors hold property as a result of a breach of fiduciary duty they will be considered to hold it on behalf of the company as constructive trustee. For example, if directors have benefited from a sale of company property they will be ordered to

account for any profits. If holding company property they will be ordered to restore it to the company. If this is not possible, the director may be ordered to pay compensation to the company for any loss that it has suffered. A further possibility, if the breach has not yet occurred, will be to issue an injunction. The remedies under the no conflict rule depend on whether the director has simply failed to declare his/her position of conflict or whether he/she has additionally committed a breach of duty. The conflict of interest renders the contract voidable, although the court will not permit avoidance if third parties would be harmed (*Transvaal Lands Co v New Belgium Dev Co*, 1914). If they have also committed a breach of duty the remedies noted above will also be available.

To remedy a breach of the duty of care and skill, the company may bring an action against the director as outlined above. In addition, the director may be sued under an appropriate provision of the director's service contract. Breaches of this nature may be ratified, thereby reducing the prospects for a minority shareholder bringing a derivative action since negligence does not provide a basis for doing so unless it personally benefited the director (*Pavlides v Jensen*, 1956; *Daniels v Daniels*, 1978). Under proposed reforms the scope of that remedy will be widened to also include negligence (Company Law Review, 2002b).

If the company becomes insolvent the liquidator may bring an action to enforce the director's duties for the benefit of creditors (Insolvency Act 1986 (UK), ss 212, 213 and 214). This means of regulation was undermined in the past by funding difficulties confronting the liquidator (*Re Floor Fourteen Ltd*, 2001; Parry, 1998). The law has since been reformed to enable the liquidator to pay the costs of such actions from the assets of the insolvent company.<sup>7</sup> Directors may also be brought to account under the director disqualification regime. This regime enables the courts, in various circumstances, including where a person has been found unfit to be a company director, to make an order preventing that person from carrying out specified activities in relation to companies, including management and direction (Company Directors Disqualification Act 1986 (UK)). This form of regulation has been particularly significant in shaping the development of directors' duties, thereby remedying the problems associated with shareholder enforcement and litigation by the liquidator.

### **Influential policy issues and possible future legal development**

As outlined above, the law in this area should soon be put on a statutory footing. However its substantive content should not differ significantly from existing case law principles. Detailed guidance as to the likely reforms can be found in government publications (Goddard, 2003).

## Notes

1. See, for example, M. Friedman (1970), 'The social responsibility of business is to increase its profits', *The New York Times Magazine*, 13 September, regarding the directors as employees of the shareholders, rather than trustees of their interests.
2. Directors do not owe duties to individual shareholders (*Percival v Wright*, 1902), except if there is a special relationship which gives rise to fiduciary obligations: *Allen v Hyatt* (1914); *Platt v Platt* (1999). See further Arsalidou (2002) and the City Code on Takeovers and Mergers GP 9.
3. *Modernising Company Law*, pp. 343ff.; *Draft Companies Bill*, s. 17 and Sch. 2, para. 9. This replicates the 'every step' defence to claims of wrongful trading under the Insolvency Act 1986 (UK), s. 214(3).
4. An alternative explanation, discredited by Sealy (1967), is that companies were unincorporated and established by deed of settlement under which directors were appointed as trustees.
5. *Re Elgindata Ltd* (1991). This is one reason why the Company Law Review considered that directors did not require the additional safeguard of a 'business judgment rule' as applied in the United States: Company Law Review, 2002a, 42. See also Law Commission (1999) and Scot Law Com No. 173, Cm 4436, Ch. 5.
6. Although the Companies Act 1985 (UK), s. 310 prohibits any provision exempting company officers from liability for, *inter alia*, breaches of duty, it has been held that Article 85, in restricting liability under the no conflict rule operates as a prohibition rather than as a duty: *Movitex v Bulfield* (1988).
7. Insolvency Rules 1986, r 4.218(a) (SI 1986/1985), as amended by Insolvency (Amendment) (No. 2) Rules 2002 (SI 2002/2712).

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## 5 Regulating the approach of companies towards employees: the new statutory duties and reporting obligations of directors within the United Kingdom

*Simon Goulding and Lilian Miles*

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### **Introduction**

The question as to whether in law the directors of companies ought to give greater consideration to non-shareholder interests continues to receive attention. Those persons who are employed by a company in the private sector will be concerned with their terms and conditions of employment, job security and, if there is one to which they have been contributing, their company pension. The shareholders of the same company who on a proprietary view, are the owners of the company, will have rather different priorities, namely dividend payments and the capital growth in the value of their shares. The directors who control the company may of course, be some of the most significant employees themselves but, as they are appointed by the shareholders and can ultimately be removed by them, will focus on the shareholder interests and this in any event is what the law, which endorses the proprietary view, will require.

It has been argued many times that the vehicle of incorporation must be employed for the good of society generally and not simply as a means to line the pockets of shareholders (Dodd, 1932; Wedderburn, 1985a, 1985b, 1993; Norwitz, 1991). This is often referred to as the ‘pluralist approach’. On the other hand, it is argued that restricting company management to the single objective of profit maximisation is the most efficient way of using companies to contribute to the wealth of the economy (*Hutton v West Cork Railway Company* (1883) 23 Ch D 654; De Bow and Lee, 1993; Alcock, 1995). UK company law has traditionally paid little attention to the contention that directors should owe duties to persons other than company shareholders, preferring instead to focus on and support the shareholder wealth maximisation approach.<sup>1</sup> The Company Law Review (CLR) in its work to reform company law in the UK consulted on precisely this issue; in whose interests ought the company to be run? It considered both the shareholder value maximisation and pluralist approaches and largely approved the former. It also for the first time drafted a set of directors’ duties and obligations, which incorporates this

approach. These recommendations were to a large extent, endorsed by the government in its White Paper which followed shortly after the CLR completed its review process (Modern Company Law, Final Report, 2001 and *Modernising Company Law*, White Paper, 2002). It is against the background of these wider stakeholder arguments referred to above that the implications these proposals have for the employee community will be considered in this chapter.

### **The current position**

The general rule is that when directors are exercising their powers of management they are to act 'in the interests of the company as a whole' (*Re Smith & Fawcett* [1942] Ch 304: 306). The exact meaning of this phrase has been the subject of considerable debate. From a purely legal point of view, it means the interests of the company as a commercial entity and this is in most cases, judged by reference to the interests both of present and future shareholders.<sup>2</sup> UK company law is still, despite tendencies to the contrary, resistant to the idea that directors should act in the interests of non-shareholders such as employees, suppliers, creditors (except in limited circumstances), consumers and the community.<sup>3</sup> All of these last interest groups may be taken into account by the directors in the exercise of their discretion but only in so far as the company itself is benefited.

The position of employees *vis-à-vis* the companies which employ them and on which their livelihoods depend is not regarded in the UK as a matter to be regulated by company law. The traditionally held view is that this was a matter for employment or labour law. UK company law accords only minimal recognition to the rights and interests of company employees. An express and arguably novel supplement to the scope and content of directors' obligations was introduced in the Companies Act 1980, s. 46 which is now contained in s. 309 of the Companies Act 1985. The section sets out the basic obligation of directors in the most general of terms:

- (1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.
- (2) Accordingly the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.<sup>4</sup>

A few points may be made with regard to the effect of s. 309. First, although directors are required to have regard to the interests of employees, the section does not impose a positive duty on them which is owed directly to the employees. This is made clear by subsection (2) which emphasises that the duty identified by the section is 'to the company alone'. Further it states that

directors are only required to consider or have regard to the interests of employees in the context of their duty to the company which is for the interests of its members. Directors may, for example, rearrange the business of the company to save jobs so long as the interests of the members generally are also served. They might be in some difficulty however if they carried on the business of the company at a loss (such as authorising a cut in profits) in order to save jobs. In other words, they may engage in acts which benefit employees, but only so long as this is in balance with the rights of shareholders. 'Including' a duty to have regard to the interests of the employees raises difficulties where the interests of the employees are in direct conflict with the interests of members in a particular case.

Second, no guidance is provided in the section to directors as to how they should interpret their responsibility under this provision. Nor is there any direction as to how they must strike a balance between employees' interests against those of the shareholders or the relative weight which can be given to the interests of employees.

Third, employees have no direct means of enforcing the duty, either individually or collectively. The enforcement of this duty, like any other fiduciary duty, is at the discretion of the company. If those in control of the company at the relevant time do not authorise the company to bring an action against the directors when they fail to have regard to the interests of the employees, employees have no remedy under s. 309, even when their interests are adversely affected as a result of actions taken by directors.<sup>5</sup> One way forward might be for employees to own shares in the company and to bring an action against the directors in their capacity as shareholders (although for their benefit as employees). However, this is only possible if either employees owned the majority of shares in the company, or they brought a derivative action (*Foss v Harbottle* (1843) 2 Hare 461) to enforce the duty for their benefit as employees. Both are remote possibilities.<sup>6</sup> Hence even if directors did breach their duties under s. 309, any remedy granted will, as in all other cases of breach of duty, go to the company and not directly to the employees.

Fourth, giving priority to employee benefits, such as higher wages or better working conditions, may be an expensive exercise for the company. This may in turn, lower profits and consequently, reduce dividends and the share price of the company. The priority of businesses in the UK is that of maximising shareholder wealth. This has been achieved through the payment of attractive levels of dividends to shareholders to retain their investment, even though this may not be justified by company performance. This is a 'short-termist, low investment and low productivity approach to business'.<sup>7</sup>

The courts have not, as a matter of principle, sought to improve the position of employees by incorporating into the duty to act in the interests of the company, a duty to also act in the interests of employees. There is no common



law duty on directors to take into consideration the interests of employees,<sup>8</sup> although in some cases the courts have been sympathetic to their plight. In *Re Welfab Engineers Ltd* ([1990] BCLC 833: 838) for example, the directors sold the assets of the company to one purchaser in the hope that its business would survive as a going concern. The liquidators of the company brought a claim against the directors alleging that the directors had acted improperly since they appeared to have acted in a way which prioritised the preservation of the business and the jobs of employees rather than achieving the maximum price through selling individual assets or advertising the proposed sale more widely. Without citing s. 309, Hoffman J held that they had not breached their duties. His Lordship recognised the pressure the directors were under as a result of the 'widespread unemployment and industrial devastation in the Midlands at the time'. Preserving employees' jobs in these circumstances was held to be an element of the directors' reasons for acting and did not taint their decision to sell the whole business with unlawfulness.

In *Fulham Football Club v Cabra Estates* ([1994] 1 BCLC 363) the Court of Appeal expressed the view that a company was more than just the sum total of its shareholders; it was a community of interests. The directors of Fulham Football Club Ltd had pledged to support the planning application of another party for the development of certain land and then had reneged on this decision. They argued that since they were bound by their fiduciary duties to act in the best interests of their company, their future exercise of discretion could not be fettered, otherwise this would infringe their duty to the company. The Court of Appeal held that the fact that directors were under a duty to act bona fide in the interests of the company did not mean that they could never commit themselves to act in a particular way in the future especially if there were significant benefits flowing to the company from the transaction. The judge at first instance had held that as all the members of the company had agreed to the commitment, the directors would be bound to carry out their wishes (*ibid.*: 376). Interestingly in the Court of Appeal, Neill LJ disagreed (*ibid.*: 393). His Lordship held that even if the directors had acted unlawfully in this case, unanimous shareholder approval or support would not have helped them, since, having regard to the recent recognition of creditors' interests and the obligations in s. 309, the company consisted of more than just the shareholders. This reasoning recognises that employees form a legitimate constituency for consideration and that shareholder primacy in the exercise of directorial discretion cannot always be taken for granted.

In *Re Saul D Harrison & Sons plc* ([1995] 1 BCLC 14), it was alleged in a petition brought by a member under s. 459 of the Companies Act 1985 that the company was being maintained purely for the benefit of the directors without regard to the interests of the members and that this amounted to a breach of

the directors' duties. In striking out the petition at first instance, Vinelott J pointed out:

Under s. 309 of the *Companies Act 1985* the directors of a company are required to have regard to the interests of its employees as well as the interests of its members. This company has over 100 employees, and because it has been able to find new premises in the same neighbourhood, the company has been able to ensure that their employment has not been jeopardized. The company's duties to its employees was clearly a matter which the directors were entitled to take into account if they were of the opinion that there was a reasonable prospect that the company's business could be salvaged. (*Re a Company ex parte Burr* [1992] BCLC 724: 734)

This view was reiterated on appeal by Hoffman LJ (*Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14: 25). Although these decisions demonstrate a shift away from the pure profit maximisation approach towards one which encompasses the interests of other stakeholders, they are, unfortunately, few and far between. What they demonstrate quite clearly is that s. 309 is likely to be of value to directors of the company in defending themselves against hostile claims for breach of duty brought by liquidators or shareholders and used to justify *ex post facto* certain actions which the directors have taken. That said, it is impotent as a means of enabling employees to directly influence the actions of directors.

Where there is a cessation of the company's business there is a further statutory amendment to the common law position which is both broader and narrower than that under s. 309. Section 719 of the *Companies Act 1985* provides that directors do have power to make provision for the benefit of employees in this case even where the constitution of the company does not confer this power and even though it is *not* in the best interests of the company.<sup>9</sup> But this power can only be exercised if there is a sanctioning resolution from the majority of shareholders.<sup>10</sup> This leaves no room for doubt as to where the priorities of English company law lie.<sup>11</sup>

A final point with regard to the recognition of employees' interests is that contemporary company law does not require or recognise consultation with employees as particularly important. One modest step forward in this respect was made by the *Companies Act 1980* which required directors of companies with over 250 employees to include in their annual report a statement describing the actions that have been taken during the financial year to introduce, maintain or develop arrangements aimed at:

- (a) providing employees systematically with information on matters of concern to them as employees;
- (b) consulting employees or their representatives on a regular basis so that the views of employees can be taken into account in making decisions which are likely to affect their interests;

- (c) encouraging the involvement of employees in the company's performance through an employees' share scheme or by some other means;
- (d) achieving a common awareness on the part of all employees of the financial and economic factors affecting the performance of the company.<sup>12</sup>

This is however, a largely formalistic requirement which can be satisfied by a few perfunctory statements contained in the reports. Ultimately, under s. 234 it is a criminal offence for the directors to fail to comply with the requirements of Schedule 7. But it is only through this oblique way that they are obligated to give any thought to any employee involvement or consultation. The provision certainly does not confer on employees any positive rights to be consulted. To be sure, enlightened and progressive companies will want to present to the outside world a positive commitment to employee involvement and will want to avoid the negative connotations associated with poor employee relations. The act presupposes that directors as a matter of good practice will want to keep employees informed but this is hardly a substitute for an active right to participate.<sup>13</sup>

The generally unsympathetic attitude of UK company law thus leaves employees in a vulnerable position. This is of concern, given that employees are a fundamental constituent within a company. They contribute to the success of the company, enable it to fulfil its contractual obligations to its customers and render services to those who use them. Giving due regard to their interests will not only foster feelings of loyalty towards the company, but will also add job satisfaction. This will have a direct impact on productivity, profitability and share price. Therefore the pluralist approach, at least in respect to the consideration of employees, is far from being inconsistent with the interests of shareholders. Employees currently have no right to be represented on company boards. Nor do they have an independent right to be consulted on future policy, strategy or plans. Not surprisingly, the Combined Code on Corporate Governance contained in the UK Listing Rules sees the role of the directors almost purely in terms of managing the company for the benefit of the company's shareholders. Arguably, the value of s. 309 can only be realised if concrete measures for employee involvement were set up within the company. At present, dealings between management and the workforce are generally conducted at local level between the company and a trade union recognised for the purpose of collective bargaining. However, collective bargaining agreements are not enforceable in court unless the parties agreed in writing that the agreement should be legally binding.<sup>14</sup>

### **Employees and the company law review**

The government launched a major review of company law in 1998. This was finally completed in 2001. The proposed terms of reference of the exercise

was, among others, to consider how core company law can be modernised in order to provide a simple, efficient and cost effective framework for carrying out business activity which:

- (i) permits the maximum amount of freedom and flexibility to those organising and directing the enterprise
- (ii) at the same time protects, through regulation where necessary, the interests of those involved with the enterprise, including shareholders, creditors and employees; and
- (iii) is drafted in clear, concise and unambiguous language which can be readily understood by those involved in business enterprise. (Modern Company Law for a Competitive Economy, 1998: para. 5.2)

The review was managed by a small steering group with detailed work on particular issues being delegated to working groups. Several consultation documents were released during the review process in order to gauge the views of businesses, academia, the public and company stakeholders.<sup>15</sup> Among the many issues the CLR tackled was directors' duties. There was much debate during the consultation process as to whether company law should adopt a 'pluralist approach', that is, that a company should serve a wider range of interests not subordinate to that of shareholders, but which are valid in their own right. Ultimately the 'enlightened shareholder value' approach was adopted: the primary role of directors should be to promote the success of the company for the benefit of its shareholders as a whole, but that they should also recognise, as circumstances require, the company's need to foster relationships with other stakeholders, its need to maintain its business reputation and its need to consider the impact of operations upon the community and the environment (Davies, 2002: Ch. 9; Parkinson, 2002: Ch. 2). This approach was endorsed in the Government White Paper which followed in July 2002.

The CLR considered s. 309 of the Companies Act 1985. Although it is possible to interpret s. 309 as obliging directors to adopt a 'pluralist approach', the CLR thought it unlikely that Parliament had intended to introduce such a radical change to the common law duty of directors (Modern Company Law: The Strategic Framework, 1999: paras 5.1.17–23). The CLR believed that to so interpret s. 309 would upset the preferred 'enlightened shareholder value' approach, thereby allowing directors to give preference to employee interests at the expense of those of the shareholders.<sup>16</sup> The CLR also pointed out that s. 309 is 'obscure and ambiguous' (Modern Company Law: Final Report, 2001: Vol. 1, 352 at note 318). Over the objections of NGOs and trade unions, the admittedly weak provision will, under the new framework, be repealed (Williamson, 2003: 518). Instead, employees will be grouped together with a range of other non-shareholder interests which the directors may take into account while discharging their duty to their companies.

The primary role of directors under the new framework will be to promote the success of the company in the collective best interests of the shareholders. But, the review believed they would only be able to do this if they also looked at both short- and long-term issues, and when *all* the factors affecting the company's relationships and performance were taken into account. High shareholder returns should be viewed as the result of running a successful enterprise, rather than as an end to be pursued in its own right. The CLR recommended that the duty of loyalty be drafted in the following manner:

A director of a company must, in any given case –

- (a) act in the way he decides, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole . . . and
- (b) in deciding what would be most likely to promote that success, take account in good faith of all the *material factors* that it is practicable in the circumstances for him to identify. (Companies Bill, Schedule 2, para. 2 at p. 412 of Vol II of Final Report)

In this paragraph, the 'material factors' means –

- (a) the likely consequences (short and long term) of the actions open to the director, so far as a person of skill and care would consider them relevant; and
- (b) all such other factors as a person of skill and care would consider relevant, including such of the matters in note (2) as he would consider so.

These matters are –

- (a) the company's need to foster its business relationships, including those with its employees and suppliers and the customers for its products or services;
- (b) its need to have regard to the impact of its operations on the communities affected and on the environment;
- (c) its need to maintain a reputation for high standards of business conduct;
- (d) its need to achieve outcomes that are fair as between its members. (Companies Bill, Schedule 2, para. 2 at p. 413 of Vol II of Final Report)

### **The implications for employees of the proposed duty of loyalty**

The position of employees under the current s. 309 and the inadequacy of company law for upholding their interests were considered above. Will the new formulation of the duty of loyalty change the way directors perceive the relationship between their companies and employees or compel them to do more to attend to the needs of employees? Will it inspire change in corporate practice so as to benefit employees directly? The new formulation of the duty clearly envisages that directors take into account interests other than those of shareholders when managing their companies. Some have endorsed this approach as the right way forward:

[B]y talking about the company's needs to foster employment relationships, it makes the link between stakeholder relationships and shareholder value explicit, thus emphasising that investing in stakeholder relationships and in the environment are not optional extras, but an essential part of what directors should do. (Williamson, 2003: 520)

It is important, however, to note that under the new formulation, employee interests will still *not* have an independent value. Directors may decide to award higher wages to employees, but this will not be viewed as a step which can be taken to promote employee welfare in its own right, rather it can only be carried out if it formed part of an overall strategy to promote the 'success of the company in the collective best interests of the shareholders'. The duty is thus phrased in a way only to 'encompass' non-shareholder interests; they are to be considered in order that directors may discharge their overriding duty to their company. Consideration of matters affecting employees will thus still be subordinate to that of the primary goal of directors to promote the success of the company. In this sense, the obligation under new formulation of the duty of loyalty is no different from that under the present s. 309 of the Companies Act 1985.

Furthermore, the new formulation only requires directors to consider non-shareholder interests to the extent 'practicable in the circumstances for him to identify'. This cannot be interpreted as a serious or meaningful obligation upon which employees or any other non-shareholder constituents can rely. The circumstances where it was *not* practicable for directors to take into account non-shareholder interests may include time constraints and the lack of, or non-availability of information. This is in fact a step backward for employees' interests in three ways from the current law under s. 309 which states that the matters to which the directors *are* to have regard are the interests of employees. First, primacy is given to shareholder interests under the proposed statutory formulation, whereas the s. 309 instruction does not expressly subjugate the interests of employees. Second, employee interests are only one of a list of material factors which the directors can take into account if it is practical to do so.

Third, the new formulation continues to endorse a focus on the overall promotion of shareholder interests, with stakeholder interests occupying a place in the wings. Until the law imposes a direct obligation on directors to consider employees' interests, it is not likely that we shall witness any real change in practice. Given the drafting of the new formulation, it is likely that any obligation to consider employees' interests will be seen as a 'soft' rather than 'hard' option. If the new formulation is to change corporate practice, a stronger message that a change of behaviour is expected should have been conveyed to directors. This new formulation does not and cannot encourage the director community to appreciate the advantages of placing employee priorities further up their agenda.

### **The operating and financial review**

Hand in hand with the new formulation of the duty of loyalty are proposals on reporting and disclosure. The CLR proposed that companies of a certain size must report on certain matters, if these were judged material to an understanding of their business. It acknowledged that stakeholders such as employees, customers and the community had a legitimate interest in the activities of the company, especially those companies wielding significant economic power (Modern Company Law, Final Report, 2001: 3.28–30). To this end, it recommended that all companies of significant economic size (the majority of public companies and large private companies) should produce, as part of their annual report and accounts, an operating and financial review (OFR) which would provide key information about the company.<sup>17</sup> This review would be a qualitative, as well as financial, evaluation of performance, trends and intentions, prepared by the directors from their perspective as managers of the business and its purpose will be to show, in the directors' own terms, what matters about the business as regards performance and direction (Modern Company Law, Final Report, 2001: 8.33). The intention is that directors, through the OFR, will provide an explanation to shareholders and others as to how they have looked after their social responsibilities, employees, the environment and the community.<sup>18</sup>

The government welcomed the CLR's recommendations in its White Paper (Modernising Company Law, White Paper, 2002: Vol. 1, Part 2, 4.28–41). The White Paper, broadly following the recommendations of the CLR, concluded that in order to achieve the review objective, an OFR must contain at least the following core elements:

- (a) a statement of the company's business in the financial year to which the operating and financial review relates;
- (b) a fair review of performance during that financial year and of the position of the company at the end of that year;
- (c) a fair projection of the prospects for the company's business and of events which will, or are likely to, substantially affect that business. (Companies Bill, Clause 74 at p. 36, Vol II of White Paper)

In addition, when forming an opinion as to whether the OFR achieved the review objective, directors have a duty to consider whether the inclusion of information about other matters is necessary. These matters include (i) the company's policies in relation to employment by the company, (ii) the company's policies on environmental issues relevant to the business, (iii) the company's policies on social and community issues relevant to the business (Companies Bill, Clause 75 at p. 36, Vol II of 2002 White Paper). For non-shareholders such as company employees, it is information in these categories which will be of particular significance and interest. But why are matters

concerning employees relegated to second place as factors to be reported in the OFR only if directors judged them relevant to an assessment of the company's business? Is the implication that it cannot be very important to address the relationship between the company and its employees? If so, then it is conceivable that even where directors do in fact report on employee matters, the quality of information given may be vague, ambiguous or incomplete. In view of this, what potential does the OFR have to initiate changes in director behaviour? Is the OFR in respect of the treatment of employees a significant step forward from the requirements presently contained in Schedule 7 as discussed above? Perhaps not surprisingly, it has been remarked that the CLR had 'proposed the weakest possible statutory provision' with regard to the consideration of non-shareholder interests (Mayson et al., 2003: 526).

A further point which can be made is that while the CLR originally envisaged that the OFR will be published for the benefit of a wide range of stakeholders,<sup>19</sup> the government took a different view. It agreed that the OFR would be a major benefit for company stakeholders. However, it believed that the objective of the OFR was to provide 'such information as will permit the members of the company . . . to make an informed assessment of the company's operations, its financial position and its future business strategies and prospects' (Companies Bill, Clause 73 at p. 35, Vol II of 2002 White Paper). Limiting the OFR audience to shareholders will make it very unlikely for employee issues to take their rightful place in the corporate governance agenda. Shareholders are not generally interested in non-financial information (such as that concerning employees). They will be more interested in facts and figures relating to profit and dividend. If the OFR is meant primarily for shareholders, the opportunity for debate on, and discussion of, matters concerning employees and other non-shareholders may be reduced. Directors themselves may lose the incentive to provide important or significant information on employee and other stakeholder issues. The reality is that there are very few issues which are of importance to employees and other stakeholders which are also likely to become matters of concern for shareholders. The ability of employees and other stakeholder groups to raise concerns about the content of the OFR may therefore be affected (Williamson, 2003: 522).

Also, the reporting and disclosure of relevant matters in the OFR cannot of itself generate meaningful change in corporate practice. If adopting the 'enlightened shareholder value' approach really means looking at both short- and long-term issues, and taking into account *all* the factors affecting the company's relationships and performance, directors must learn to view the relationships between their companies and employees and other non-shareholder constituencies from a fresh perspective, recognise the contribution that employees make to the success and prosperity of the company and be sensitive to opportunities to promote employee welfare. Unless and until mechanisms are



established to help facilitate change in director behaviour and company policy, the provision of information itself provides only half the picture (*ibid.*: 523).

Finally, apart from simply stating that there must be disclosure of information by the company where these are judged material to an assessment of the business, the review did not envisage strengthening the position of employees further. Viewed positively, the OFR may be informative. It may enable shareholders and others to make a proper judgement about the company, assess the strategies it has adopted and consider the potential for successfully achieving these strategies. But are employees and other non-shareholders able to challenge the OFR if it contained sparse or vague information or no information at all? What if they felt that their interests and concerns had not been given proper attention? This could easily happen: what is important to one group of stakeholders may differ significantly from what matters to another, for example, environmental pressure groups as contrasted with company employees. However, since it is for the directors to make a subjective judgement as to what matters are material and must therefore be included within the OFR, the opportunity for non-shareholders to subsequently challenge the way the reporting process was conducted is implicitly ruled out.

Several other questions may be asked. What form should the OFR take? How should it be presented so that it is clear and understandable? Does inclusion of any information in the OFR amount to a commitment to implement any strategies or promises on the part of directors? What process should be used in order to decide whether or not information is material? Both the review and the White Paper had anticipated these concerns. To help stimulate discussion on how the OFR should be implemented, the White Paper provided a commentary on a preliminary draft of the OFR, addressing important issues such as form, content and audit (see Annex D). To help directors prepare their OFRs, it is envisaged that a Standards Board will draw up detailed rules for their compilation (*Modernising Company Law, White Paper, 2002: Vol. 1, Part 2, 4.33–34; Modern Company Law, Final Report, 2001: 3.41, 8.49–52*). The White Paper also stated that companies which failed to provide the right quantity as well as quality of information would risk adverse comparison and questions from their shareholders and others (*Modernising Company Law, White Paper, 2002: Vol. 1, Part 2, 4.33*). Further, it envisaged that ultimately, and in the worst-case scenario, directors may have to defend their reporting decision-making before the courts.<sup>20</sup> Finally, the requirement that the OFR be audited by the company's auditors (*Companies Bill, Clause 81 at pp. 38–9, Vol II of 2002 White Paper*) should go some way (in theory) towards ensuring that directors had given exhaustive consideration to the nature of information included within it.<sup>21</sup>

As a first step towards implementing the OFR proposals, an independent group (the OFR Working Group) was established in December 2002 to help provide guidance to directors as to how to assess whether an item is material

to their company and should therefore be included in the OFR.<sup>22</sup> Its consultation document, released on 27 June 2003, looked at the concept of materiality, the principles which directors might apply in reaching a judgement on materiality<sup>23</sup> and the process which they go through in deciding what should be included in the OFR.<sup>24</sup> The document makes it clear that it is for directors to decide what items are material. The working group's remit is only to help directors meet their obligations in relation to the OFR.<sup>25</sup> Specifically, the group identified six criteria against which the process for making judgements on materiality can be assessed. The process should be transparent, provide for appropriate consultation within the business and externally with key shareholders, allow account to be taken of appropriate comparisons both within and outside the company, comprehensive, consistent and subject to review.<sup>26</sup> In addition, certain pertinent questions should be asked when applying the process in practice. These include whether the board has all the relevant knowledge and skills to make judgements as to what is material, how information for the OFR should be constructed, how the board can ensure the reliability of the information before it, what processes of challenge should be used to ensure that information which is material is in fact included in the OFR, how information should be presented and finally, the nature of feedback and review procedures to be in place between one cycle and another.<sup>27</sup> The consultation period ended in September 2003 and the group had originally intended to publish its final report in December 2003. However, since its consultation document was launched, the government announced plans to implement the proposal for a statutory OFR using existing powers under the Companies Act 1985 and anticipated publishing draft regulations on the OFR in due course.<sup>28</sup> As a result, the group will be liaising closely with the Department of Trade and Industry to coordinate the publication of its final report with that of the draft OFR regulations.<sup>29</sup>

## **Conclusion**

It is said that shareholders bear the greatest risk in relation to a company given the financial loss they face should their company not perform well. But the reality is that company employees stand to lose more. If their company fails, they lose their jobs and possibly their final salary company pensions as recent experience has shown.<sup>30</sup> This will mean a loss of income, confidence and livelihood. Shareholders on the other hand, can and do diversify their risks. They can sell their shares and leave if their company is underperforming. The shareholders' 'stake' in the company is, to this extent, highly liquid. Company law must address this inequality. The ineffectiveness of s. 309 of the Companies Act 1985 in protecting employee welfare has been considered. Under the newly formulated duty of loyalty the position of employees is no better and arguably worse. The shareholder primacy approach will continue to

dominate and the relationship between directors and employees is still not regarded as a concern of company law. Employees continue to be regarded as mere suppliers of labour, alongside other suppliers of goods and services. This is unfair as it does not recognise the contribution that employees make to their companies (Wedderburn, 2002: 110). Employees are fundamental in enabling the company to operate.

Under the proposed reporting provisions, companies of a certain size must report on certain matters where deemed relevant to an assessment of the business. In forming an opinion as to whether the OFR achieved the review objective, directors have a duty to consider whether the inclusion of other matters, such as information about the company's employment policies is necessary. However, there is no obligation to include such information within the OFR if not deemed relevant to an assessment of the business. This expectation is a subjective judgment. Without the law expressly stating that non-shareholder interests *must* (as opposed to *may*) be given consideration, it is difficult to foresee a change in corporate culture so that the interests of other stakeholders such as those of employees can be taken seriously. That said, directors have a duty to consider whether including information on employees is necessary. For as long as the law does not properly acknowledge the role that employees play in the company, directors simply will not and cannot accord to them the recognition they deserve. Stakeholders such as employees are important constituents within the company in their own right. They directly contribute to the good of the company. The law must expressly address the relationship between the company and its employees as part of the directorial function (Dean, 2001: 71). It is disappointing that the future framework of company law will prolong the vulnerability of employees and expose them to much higher levels of risk as compared with shareholders. It is also regrettable that UK company law has not seized the opportunity to be more receptive to a constituent of the company upon which so much of its successful conduct depends.

Since the writing of this chapter, the government has published a White Paper 'Company Law Reform' (March 2005). The White Paper sets out the government's proposals for the reform of company law and builds on the work of the CLR. The proposals for reform will be introduced through the Company Law Reform Bill (draft clauses can be viewed at <http://www.dti.gov.uk/cld/chapter7.pdf>). The proposals on the duties of directors can now be found in Part B of the Bill. Chapter 1 of Part B outlines the general duties of directors. The duty to promote the success of the company for the benefit of its members (duty of loyalty) is now found in Clause B3 (p. 89).

'The Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005' to implement the OFR came into force on 22

March 2005. They can be viewed at <http://www.opsi.gov.uk/si/si/2005/20051011.htm>. The issues which must be included in the OFR are listed under SCHEDULE 7ZA of the Regulations.

## Notes

1. This is not to say that companies ignore the interests of stakeholders, merely that company law does. Indeed many successful companies pay due regard to the interests of stakeholders as part of their work: see further Taylor (2000, Ch. 5); Dean (2001); Mayson et al. (2003: 13–17, 521–2, 524–6).
2. See further Evershed MR in *Greenhalgh v Arderne Cinemas* [1951] Ch 286: 291; Dillon J in *Panavision Limited v Lee Lighting Limited* (1991) BCC 620: 634 and *Hutton v West Cork Railway Co* (1883) 23 Ch D 654: 672.
3. In recent years however, the idea of companies discharging ‘social responsibilities’ to their communities has become very fashionable. See the government website on CSR <http://www.societyandbusiness.gov.uk>. Within the Department of Trade and Industry (DTI), there is now a Minister for Corporate Social Responsibility. The DTI has also issued reports on CSR: *Business and Society: Developing CSR in the UK* (URN 01/720) (2001) and *Business and Society: CSR Report 2002* (URN 02/909) (2002).
4. It is perhaps worth pointing out that at the same time the then Conservative government was fighting off all attempts to implement the draft 5th EC Directive which would have provided considerable representation for employees on the boards of public companies. For a critique of s. 309, see Villiers (2000: Ch. 30).
5. Note however, that employment law does obligate directors to consult with employees in certain circumstances: for example, transfer of undertakings, collective redundancies and on some health and safety issues.
6. A derivative action is only possible if the directors’ actions amount to ‘a fraud on the minority’ (for example, illegal or conducted in bad faith) and cannot be ratified by the shareholders: *Prudential Assurance v Newman Industries Ltd* [1982] Ch 204.
7. The share of profits allocated to dividends roughly doubled in the 1980s and are continuing to rise, even during the recession years in the 1990s when profits were stagnant or falling. Also, research shows that the UK trails behind other major economies such as France, Germany and the USA in terms of resources allocated to investment, research and development: see Williamson (2003: 512).
8. See *Parke v Daily News Limited* [1962] Ch 927, although now reversed in part by s. 719 of the Companies Act 1985 (UK) on the particular matter in issue. It is also very difficult for an employee to bring proceedings against directors for failing to comply with statutory obligations which normally impose only criminal sanctions for default, for example, in the area of safety and compulsory insurance legislation: see *Richardson v Pitt Stanley* [1995] 1 All ER 460; Wedderburn (2002: 99–111).
9. Companies Act 1985, s. 719(2). This provision can be made from distributable profit.
10. Companies Act 1985, s. 719(3). A special resolution may be required if the constitution so provides. The constitution can also provide that the directors alone can make this resolution.
11. Where a company is in the course of being wound up, the liquidator can make provision for the benefit of employees but only after the company’s liabilities have been fully satisfied and the costs of the liquidation provided for. Again the provision can only be made if there is a resolution sanctioning the payments from the shareholders: Insolvency Act 1986, s. 187.
12. Now contained in the Companies Act 1985, Schedule 7, Part V.
13. There is also a requirement imposed on employers to consult with prospective and active members of occupational pension schemes i.e. the employees before making significant changes in respect of future pension arrangements. Pensions Act 2004 ss. 259–61. However, the validity of a decision made without such consultation is not affected.
14. See further *Ford Motor Co Ltd v AUEFW* [1969] 2 QB 303; s. 179 Trade Union and Labour Relations (Consolidation) Act 1992.

15. See [www.dti.gov.uk/cld/reviews/condocs.htm](http://www.dti.gov.uk/cld/reviews/condocs.htm) for the list of consultation documents released during the review process.
16. The CLR gave the pluralist approach some consideration: *The Strategic Framework* (1999: paras 5.1.8–38). See also *Modern Company Law: Developing the Framework* (2000: paras 3.20–31).
17. *Modern Company Law, Final Report* (2001: 3.44). Many large companies have been publishing OFRs on a voluntary basis for many years and guidance in relation to OFRs has been in existence since 1993.
18. See, for example, R. Davis, 'The perfect time for a thorough rethink of company law', *The Times*, 25 July 2002: 26; N. Lerner, 'Appropriate measures: improvements in corporate governance should keep the UK in the vanguard', *Financial Times*, 25 July 2002: 2; L. Kemeny, 'Government to think small on company law', *The Sunday Times*, 14 July 2002: 3.
19. 'Company accounts and reports are published for the benefit of a wide range of users with actual and potential relationships with the company, shareholders and creditors, business partners, employees and others. It is important to take account of the information needs of all such users and to create a climate for informed and responsible dialogue between companies and those with a legitimate interest in their performance and prospects': *Modern Company Law, Developing the Framework* (2000: para. 5.20).
20. *Modernising Company Law, White Paper* (2002: Vol. 1, Part 2, 4.33). See also *Modern Company Law, Final Report* (2001: 8.64–67) which elaborates on the power of the Reporting Review Panel to commence proceedings in court in respect of defective OFRs.
21. For the position of stakeholders, see Miles (2003).
22. *The Operating and Financial Review Working Group on Materiality: A Consultation Document* is available at <http://www.dti.gov.uk/cld/ofrwgcon.pdf>.
23. As to what directors are 'aiming to do?', see *ibid.* (13, para. 15).
24. As to how directors shall do it, see *ibid.* (13, para. 15).
25. See further *ibid.* (12, para. 8).
26. See further *ibid.* (23–4, para. 43).
27. See further *ibid.* (23–4, para. 42–4).
28. Since this chapter was written, draft regulations have been published together with a consultation document. These can be viewed at [www.dti.gov.uk/cld/financialreview.htm](http://www.dti.gov.uk/cld/financialreview.htm). The consultation period closed on 6 August 2004.
29. Since this chapter was written the working group has released a 'Practical Guidance for Directors' which can be viewed at [www.dti.gov.uk/cld/pdfs/ofr\\_guide.pdf](http://www.dti.gov.uk/cld/pdfs/ofr_guide.pdf).
30. Examples of corporate insolvencies continue to reveal deficiencies in occupational pension funds, e.g. most recently and notably at MG Rover, although the government has sought to remedy this problem outside company law by introducing the Pension Protection Fund for future insolvent schemes and the limited Financial Assistance Scheme for insolvent schemes arising before April 2005: Pensions Act 2004.

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## 6 Protecting supplier interests through English company law

*Christopher Ruane*

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### **Company law and supplier protection**

Imagine a scenario in which S supplies a product or service to P. This transaction will possess many contractual characteristics, whether or not any legal contract in fact exists. Let us assume for simplicity that efficient market theory holds true. If both S and P contract voluntarily, we may characterise their transaction as efficient. To regulate the transaction, it must be contended that the transaction contains imperfections, despite its efficiency. This contention may employ the policy argument that mere efficiency is an inadequate normative benchmark for such transactions (Cheffins, 1997: 142–57). Alternatively, it may involve a more specific critique of the bargain struck. Perhaps, for example, threatened transaction costs led to gaps in the terms of the transaction, which only a regulator using a hypothetical bargaining model could fill efficiently (*ibid.*: 264–307).

One response would be self-regulation. For example, a supplier who achieves efficient pricing through low-wage production may voluntarily agree to a code of practice regulating his employment practices. The relational nature of much business transacting may in itself allow for a degree of supplier protection. An alternative is legal regulation. As a response to the incomplete contracting identified above, this could apply on either side of the transaction. Suppliers and purchasers may each suffer from contractual gaps. Thus, purchaser protection may provide a valid justification for regulation. The scope of the present chapter, however, is limited to supplier protection. Law may be able to remedy such incompleteness of the contract. For example, legislation may mandate that certain standard terms are fulfilled by the purchaser independently of any given transaction. If the purchaser is a company, law may impose an obligation upon it to meet certain informational requirements which are designed to serve suppliers' interests.

Should the supplier still stand in need of protection, law can provide for a structuring of the parties to the transaction which overcomes certain contractual gaps. This may involve structuring the purchaser, for example through providing for the legality of suppliers' cooperatives or using government procurement as a policy tool. Or it may entail structuring the supplier, for example through the enablement of a given shareholding structure such as the

use of ‘golden shares’. If, after all of this, the supplier still suffers from incomplete contracting, there may be specific company law protections which are of use. For example, company law may mould directors’ duties to assure suppliers’ protection. This chapter will examine the foregoing approaches to supplier protection in turn. First, we shall situate the question of supplier protection within broader theoretical themes of company law.

#### *Company law as a response to agency problems*

What is commonly understood to be the classic model of company law in most common law jurisdictions is that of shareholder primacy. The truth is slightly more nuanced. Even jurisdictions such as the United States and the United Kingdom utilise various provisions aimed at protecting the interests of non-shareholder constituencies. Overall, however, shareholder primacy continues to weave its intoxicating web within British legal thought.

Hansmann and Kraakman employ a model of economic agency to delineate the principal–agent relationships which company law governs. They outline three economic ‘agency problems’ which concern the appropriate scope and exercise of power, either of directors or of majority shareholders. Thus, in economic terms, the shareholder *qua* principal relies on the director *qua* agent for the relevant part of his economic wellbeing (Hansmann and Kraakman, 2004).

Hansmann and Kraakman’s conceptual approach treats most company law as a series of legal strategies which may be classified into three which concern the principal’s control and two which involve structuring the agent’s decision. This is illustrated in Table 6.1.<sup>1</sup>

This may be problematical for a supplier-orientated view of company law. In common with much economic analysis of law, Hansmann and Kraakman’s approach here works in the fashion of reductionism by defining the appropriate scope of company law by reference to shareholders’ interests. That does not mean that there is not scope for the consideration of interests of constituencies other than shareholders, even within this sort of principal–agent analysis.

*Table 6.1 Legal strategies for the regulation of ‘principal–agent’ relationships*

Enhancing the principal’s control			Structuring the agent’s decisions	
Affiliation rights	Appointment rights	Decision rights	Setting agent incentives	Constraining agent decisions



For example, in structuring the agent's decision, a duty may be imposed on the director to consider particular constituencies' interests in making selected decisions. In practice, however, it will be seen that such a multi-constituency viewpoint seems to fit only awkwardly with the overall conceptualisation of company law as a response to agency problems. Approaches which draw on economic analysis tend to imply that non-shareholders ought to protect themselves through efficient private contracting. This is not necessarily inaccurate in principle, a point made by Hansmann elsewhere in his discussion of ownership forms including supplier cooperatives (Hansmann, 1996) and considered further below.

### *Suppliers as stakeholders*

A broadly alternative approach to justify the concern of company law with suppliers' interests would be the use of a 'stakeholder' model. Stakeholder theory was set out in 1963 as an antithesis to the shareholder-centric model. Its classic exposition was found in the work of Freeman (1983), who argued that stakeholders are those groups which have a stake in or claim to the firm, specifically including suppliers, customers, employees, shareholders and the local community. In the United Kingdom, the term was popularised far beyond the arena of company law by Will Hutton in his influential book *The State We're In* (Hutton, 1995). Accordingly, stakeholder theory in the company law sense is now sometimes taken as being a broad-ranging theory of interest protection which encompasses all of those who have some stake in the company's economic surplus, or possibly simply in its activity. Recast in terms of efficiency, this means that companies should seek to maximise the total creation of wealth. This translates into the objective of maximising the sum of the rents flowing to each stakeholder group (Kelly and Parkinson, 1998: 190).

The writer considers that this definition is unhelpful since it inevitably leads to unresolved questions of appropriate precedence of interests in the event of clash. It can lead to a specious, efficiency-based approach to stakeholder theory which seeks to equate it with a shareholder-centred approach by positing that satisfying stakeholder needs is the most efficient way to ensure that long-term shareholder interests are served. This difficulty is foreseen by Parkinson in his discussion of stakeholder theories embraced by management literature: 'they are often a means of reinforcing shareholder supremacy, since they invoke the idea that in the medium or long term the interests of shareholders and stakeholders coincide, on the premise that the interests of all groups ultimately depend on profitability' (Parkinson, 1996: 141).

For these reasons, in line with Parkinson's approach, this definition will be rejected by the present writer. There are other ways in which a poorly defined approach to the question of what groups are stakeholders and which of their

interests deserve to be considered can actually be counterproductive for the validity of the stakeholder model.

Moreover, even if it is argued that stakeholder interests can be broken out from the overarching long-term objective of profit maximisation, the stakeholder model risks being overbroad and so lacking in utility when it comes to formal policy direction. There is a danger, as Parkinson notes in relation to what he terms the more radical stakeholder theories, of ending up with theories which are ‘too conceptually ill-disciplined to form a basis for enquiry into practical reform’ (ibid.: 142). In an attempt to avoid these pitfalls, Kay and Silberston’s definition suggests that stakeholding offers as its key consequence an opportunity to maximise the economic performance of the firm (Kay and Silberston, 1995; see also Ireland, 1996). Stakeholders themselves do not receive rights, but rather the board of directors is obligated to protect their interests. Such a definition may raise questions at the margin as to why particular interest groups are not taken into account by the theory. Overall, however, it reduces to a more workable formulation an approach whose nebulous wideness might otherwise make it impractical.

### **Historical development**

Before 1844, suppliers typically contracted privately for protection in their dealing with business firms. For example, they were able to pursue debts personally against partners in a copartnership, the forerunner of the company (Scott, 1910). The advent of limited liability for companies in England with the Joint Stock Companies Act 1844 (UK) thus represented a regression in terms of supplier protection. What Hansmann and Kraakman (2000) term ‘defensive asset partitioning’ put investors’ personal estates outside the reach of a company’s creditors in an unprecedented way. Suppliers have developed methods to circumvent the hypothetical bargaining model embodied in company law. For example, suppliers of finance commonly agree that directors or their spouses will act as personal guarantors for certain of a company’s debts (Freedman, 1994: 561).<sup>2</sup> But such mechanisms cannot comprehensively circumvent the impact of the hypothetical bargaining model inherent in the limited liability firm.

The *laissez-faire* approach of the Victorian bench meant that suppliers were still supposed to contract for their own protection in their dealing with companies. They could expect scant judicial innovation to help them, despite the asset partitioning which followed the 1844 Act. What legislative activity there was tended to be focused on the protection of employees rather than of suppliers organised as firms. This trend continued into the twentieth century, with an ever increasing body of labour law and mandated employee protection. Company law, by contrast, barely chipped away at the primacy of the shareholder. Thus, the history of supplier protection until the late twentieth century

was one in which the only development of note was the regressive one of the limited liability firm usurping widespread private contractual protection.

### **The contemporary legal position**

#### *Purchasers' self-regulation*

Purchasers may choose to fill particular gaps in their contracts with suppliers through self-regulation. Such a scheme may be devised voluntarily, or effectively at the behest of government. In some cases, it may well be obvious why a purchaser would voluntarily opt to incur marginal costs in this way. For example, a company which trades on an image of moral goodness may efficiently treat its suppliers in a way which avoids conflict with its image and a negative impact on sales.

Where there is not this sort of economically efficient justification, it seems less likely that firms in a competitive marketplace would opt in to the additional economic burden of self-regulation. They had already chosen to leave certain gaps in the contract at its formative stages. This antipathy to voluntary self-regulation is especially common in the context of interest to us, where the supplier is not a worker but a firm and so less likely to rally consumers' purchasing habits (Shaughnessy, 2000: 163).

Such self-regulation as exists typically takes the form of a company committing itself to abide by a code of conduct. In some cases, products may also be labelled to confirm their conformance to some sort of standard. The voluntary self-regulatory codes which have been seen to date have been of limited impact. As Liubicic argues,

Codes and labelling schemes provide reason for cautious optimism as to the rights of the relatively small number of workers employed by image-conscious [multinational corporations], or the subcontractors, contractors and suppliers associated with them, in the formal export sectors of developing economies. Outside this small slice of the world economy, however, current measures that lack the coherence and credibility necessary for the meaningful protection of decent working conditions are likely to fail. (Liubicic, 1998: 157–8)

This conclusion reflects the problem identified above, that companies in competitive marketplaces lack incentives to opt into self-regulation where this reduces their economic efficiency.

#### *Relational transacting*

The supplier–customer relationship is often an ongoing one of some standing. This may have an impact on the likelihood of a supplier resorting to formal legal protection. Positively framed, this may allow the supplier to protect himself through reliance on his bargaining power even in the absence of legal

rights. Viewed negatively, it can emasculate suppliers' formal legal rights. Seeking to enforce them could well damage the relationship irrevocably.

This analysis mirrors Drury's work on relational contracting (Drury, 1986). This is based on Macneil's distinction between one-off transactions and obligations undertaken in the course of a continuing relationship (Macneil, 1978). Drury quotes Beale's work, partly based on Beale and Dugdale's empirical study of engineering manufacturers' contracts in the Bristol area (Beale, 1980; Beale and Dugdale, 1975):

[W]hile the law regards each contract as a separate thing normally irrelevant to any other contract, in practice an individual contract may be just one small part of a much larger commercial relationship between manufacturers who are doing business with each other on a regular basis. (Beale, 1980: 5)

Drury applies this in the context of the company contract (Wedderburn, 1957, 1958), arguing that under a relational analysis a shareholder's right to enforce a particular term of the company contract should be considered in the light of the rights of the company's other shareholders (Drury, 1986: 224). His work is of interest in this chapter for refocusing company lawyers' attention on the theory of relational contract and the earlier empirical work which supported it. It seems plausible to contend that suppliers may use the relational nature of their contracting as a form of self-protection.

*Legal regulation: incompleteness of the contract on account of informational requirements*

Supplier interests may be served by the imposition on companies of publicity and disclosure obligations. The idea behind this approach is very simple, namely that the more that potential suppliers know before dealing with a company the more they will be able to reduce the negative consequences of any informational asymmetry which otherwise exists.

Some principles of company law are so well established that we may no longer even think of them as informational requirements. Hansmann and Kraakman argue that limited liability 'permits the firm to enlist creditors as monitors' (Hansmann and Kraakman, 2000: 425). If this is so, creditors might be expected to make voluntary disclosure a term of lending. But doing this on an individual basis could be economically inefficient. So, although to some degree the filing requirements seem to protect shareholders, they are also a mechanism which abet suppliers and other stakeholders combating informational asymmetry in an economically efficient way.

Since the 1980s, there has been a fairly *ad hoc* development of specific statutory informational rights. Disclosure requirements of interest to suppliers under Schedule 7 of the Companies Act include 'particulars of any important

events affecting the company or any of its subsidiary undertakings which have occurred since the end of the financial year', 'an indication of likely future developments in the business of the company and of its subsidiary undertakings' and 'an indication of the activities (if any) of the company and its subsidiary undertakings in the field of research and development'. Companies of a certain size must also detail creditor payment policy.

### **Structuring the parties to the transaction**

British company law provides for substantial flexibility of corporate constitution. This enables a corporate structure to be chosen which may provide or substantially deny certain sorts of protection to suppliers. As will be seen, this can be done in defining a company's objectives. A more structural approach which could be employed by either side in the supply contract is exemplified by the rules on corporate groups.

#### *Rules on corporate groups*

The extent to which company law facilitates the division of a firm into legally distinct sub-units is of significance in determining the ability of that firm to isolate or partition its assets.

It is common for firms to be designed with a group structure which enables them to operate as a single economic unit functionally, but which formally consists of many standalone subsidiary companies each enjoying distinct legal personality. In this way, the split between suppliers and their customers may be artificially emphasised, since the supplier may be an independent legal entity but in fact operate as part of a corporate group which includes its customer. Company law can respond to this phenomenon through its rules about corporate groups.

The British response is firmly grounded in an approach to legal form reflecting the strict corporate personality approach associated with *Salomon v Salomon* (1897). This was vividly illustrated in *Adams v Cape Industries plc* (1990). The Court of Appeal held that a tortious judgment against a wholly owned American subsidiary could not be enforced against its English parent company. In doing so, the court rejected counsels' argument that the companies were part of a 'single economic unit' (*DHN Food Distributors Ltd. v Tower Hamlets London Borough Council*, 1976. Compare *Woolfson v Strathclyde Regional Council*, 1978), that the subsidiaries were a 'façade' and that the parent–subsidiary relationship was one of agency. This strident decision was handed down with hints of moral equivocation subdued by legal form, belying the fact that the corporate structure allowed the parent to benefit from the subsidiary's operation in the United States without risking tortious liability. As the court said, 'Whether or not this is desirable, the right to use a corporate structure in this manner is inherent in our corporate law' (*Adams v Cape Industries plc*, 1990: 544).

*Structuring the purchaser*

*Suppliers' cooperatives* We can ask ourselves why it is that a supplier may stand in need of any legal protection. It has been noted above that such protection is an example of 'gap filling', where law counteracts a perceived failure in efficient bargaining which commonly reflects a bargaining weakness on the supplier's part. As Hansmann (1996) has demonstrated, there is no reason why a constituency such as suppliers could not protect itself through strong contractual provisions, to the extent of constituting a firm. An example would be a suppliers' cooperative. In UK law, such an approach is contemplated through standard companies legislation as well as more specialist vehicles (for example, the Industrial and Provident Societies Act 1965 (UK)). Why do so few suppliers seem to adopt it? Hansmann suggests:

[W]here a firm *does* have a class of patrons with highly homogenous interests, ownership is often an attractive alternative to market contracting for those patrons. Market contracting, like politics, has its costs, and ownership can reduce those costs by removing the conflict of interest between firm and patron that lies at their root. (Hansmann, 1996: 289)

Furthermore, suppliers' cooperatives have four essential characteristics:

1. there exists a highly homogeneous input;
2. the input must be provided by numerous different suppliers. No one supplier will be of sufficient size on its own to supply the full needs of a purchaser of efficient scale;
3. there must be a compelling efficiency reason to maintain the suppliers' separateness as producers rather than merging them under unified control; and
4. a firm's purchases of the input by market contracting alone would involve some degree of market failure.

The main inputs which Hansmann identifies as meeting these criteria are financial capital, labour and agricultural crops. During the 1990s in the United Kingdom, a wave of demutualisation suggested that financial capital suppliers are now less rather than more likely to structure themselves in such a way. Hansmann's analysis suggests that suppliers' co-ops will be a fairly unusual mode of business association.

*Government procurement* Government has legislative power to provide for certain protections to be afforded to chosen firms. An alternative use of government power in protecting suppliers is through its position as a contracting party. Thus, for example, it may stipulate in its purchasing tenders that the

successful bidder must perform in a particular fashion, for example only purchasing goods locally. Such considerations were a significant factor in many national governments' purchasing decisions at least until the 1990s. As Arrowsmith recorded in 1995:

[M]any states have used their purchasing powers to support domestic industry. Many have followed general 'buy national' policies, designed to promote employment or a favourable balance of payments, and have also often adopted policies directed at more specific objectives, such as promoting new industries or regional development. (Arrowsmith, 1995: 236)

Increasingly, European lawmakers have focused on national bias in public procurement and a series of directives prescribes the considerations which are permissible in public procurement.<sup>3</sup> However, these rules exclude entities which, while connected with government, are unlikely to apply national preferences in procurement, because they are subject to commercial pressures to purchase in an efficient manner (Arrowsmith, 2004: 72).

### *Structuring the supplier*

*Golden shares* Some suppliers are in a position whereby their continued existence in business is a matter of national importance. This may seem to be obvious for companies in what might be termed a vital strategic industry, such as the operator of a national grid network or companies providing certain services essential to smooth government. The same argument may also be applied for more political reasons, however.

This can act as a pretext for the government to nationalise a company, a vice-like mode of supplier protection. But even in the context of a denationalised company, a government may seek to ensure ongoing control in certain matters by virtue of reserved powers or weighted voting rights. Thus, typically the share capital of a denationalised company will contain a special rights redeemable preference share held by the government or its nominee. Certain matters are specified as being a variation of these special rights and so require the consent of the holder of the special (or 'golden') share. Alternatively, the relevant provisions may be entrenched in the corporate constitution, for example through the use of a class rights device (Graham and Prosser, 1988: 414).

This technique was popular with Britain and many continental European governments from the 1980s onwards. However, as ominously noted in 1988: 'in Britain, the golden share has provided a tool of actual intervention, but in a half-hearted and confused way; indeed, the rationale for the use, and indeed the existence, of such provisions, seems ill thought out' (ibid.: 430).

A series of European directives sought to denude government authorities of the power to differentiate between contracting parties on anything but

economic bases (Arrowsmith et al., 2000: 219–21), an approach usefully summarised in *Mannesmann Anlagenbau Austria AG v Strohal Rotationsdruck GesmbH* (1998).

Over a series of judgments (*Commission of the European Communities v Portugal, France, Belgium*, 2002), the European Court of Justice substantially impaired the ability of EU member states to use golden shares. That said, the Court was willing to recognise the legality of golden shares, for policy reasons:

[D]epending on the circumstances, certain concerns may justify the retention by Member States of a degree of influence within undertakings that were initially public and subsequently privatised, where those undertakings are active in fields involving the provision of services in the public interest or strategic services. (*Commission of the European Communities v Portugal*, 2002: para. 48)

Thus, in certain circumstances, the ‘golden share’ in denationalised companies will continue to be a valid instrument of supplier protection.

*Flexibility of corporate constitution and governance structure* The British ‘golden shares’ were in essence just an attempt to achieve a public policy objective through a private law mechanism. In company law outside the realm of denationalized firms, there is no reason why the corporate structure could not be designed to include such ‘golden shares’. Indeed, many private companies and some public companies continue to have shareholding structures which disproportionately distribute control rights or contain weighted voting rights specifically designed to avoid changes in control (for example, *Bushell v Faith*, 1970). Although suppliers could voluntarily opt into such a structure, the efficiency arguments of doing so are not altogether clear. Such a scheme would be likely only if the company’s incorporators decided to prioritize a non-economic objective over economic efficiency, an approach which is likely to work only in the narrow confines where self-regulation generally is likely to succeed.

### **Formal company law protections: the stakeholder model in law**

Is it possible to adopt the stakeholder model in law as a mode of protecting suppliers? This section will examine the legal strategies which enhance the principal’s control in Hansmann and Kraakman’s agency approach (2004) with a view to understanding what may be offered.

#### *Protections based on enhancing the principal’s control*

*Corporate capacity* It has been seen that British company law grants a company’s incorporators significant discretion in defining the nature and scope



of the company's activities. At common law the *ultra vires* doctrine meant that a company could only act within the powers set out in its constitutional documents. In an 'exception' to the rule from *Foss v Harbottle* (1843), shareholders could sue to enforce the *ultra vires* prohibition.

The doctrine's most significant challenge, at least for large public companies, came with the introduction of what is now section 35 of the Companies Act 1985. This virtual abolition of the *ultra vires* rule arose in response to the requirements of European legislation,<sup>4</sup> although the *ultra vires* rule had been under critical scrutiny at least since the Cohen Committee reported in 1945.

Where no third party legal obligations have been created, s. 35(2) enables a member to injunct the company against breaching its object clause. This is not a toothless provision, but in practice will likely depend upon members enjoying sufficient informational rights that they are aware of any proposed *ultra vires* action before any third party legal obligations are created in consequence. A supplier could only enforce such a provision *qua* member, however, not *qua* supplier. In many cases, of course, the supplier will not be a member. The provision does at least mean that a supplier to whom a firm is contractually beholden will not be denied the ability to enforce the contract simply because its formation was *ultra vires* the company. This is an improvement on the former legal position.

*Gratuitous transactions* English common law provided a strong version of the decision rights strategy outlined above whereby, subject to its constitutional powers, a company was able to make a gratuitous transaction benefiting non-shareholder constituencies. Thus, if a company's constitution empowered it to serve the interests of non-shareholder constituencies, this would be a competent act for it to undertake. A clear illustration of this principle is to be found in *Simmonds v Heffer* (1983). There, The League Against Cruel Sports took the form of a company limited by guarantee. It was empowered to make donations to other bodies with similar objects. The court upheld a contribution to a political party's funds to publicise the party's commitment to animal welfare, but not an unconditional donation to the party. In the same way, a company's constitution could quite legitimately require or allow it to provide certain protections to suppliers. As we have seen, however, unless there is an efficiency or policy rationale for doing so, the company is unlikely to include such protections.

#### *Protections based on structuring the agent's decision*

Now let us examine strategies which concern structuring the agent's decision to understand what potential they offer to protect suppliers' interests.

*Directors' duties* In English law, the agent's decision is controlled at common law through the device of directors' duties. These are of two sorts: a

duty on directors collectively to act *bona fide* in the interests of the company as a whole, and a series of fiduciary duties owed by individual directors. Both sorts of duty were traditionally owed to the company, not to individual or collective groupings of shareholders (*Percival v Wright*, 1902). However, in certain circumstances, the fiduciary duty may be owed to a party other than the company. Thus, for example, in *Heron International Ltd. v Lord Grade* (1983), it was held that on the specific facts, a company's directors could owe a fiduciary duty to shareholders when the company was the target of a takeover bid.

The English courts have upheld a substantial donation to a higher education institution and the discretionary payment of a pension to the family of a deceased company officer (*Evans v Brunner, Mond & Co. Ltd.*, 1921; *Henderson v Bank of Australia*, 1888). Chancery, even in the golden age of *laissez-faire* economic liberalism, was able to give primacy to non-shareholder interests. By contrast, a charitable donation was rejected as *ultra vires* (*Tomkinson v South-Eastern Railway Co.*, 1887), as in some cases were pension provisions similar in nature to those previously allowed (*Re Lee Behrens & Co.*, 1932; *Re W. & M. Roith Ltd.*, 1967). Of course, with a suitably drafted constitution, such donations would in any case have been *intra vires*.

The underlying principle behind these cases seems to be that, where a company's act may benefit shareholders in an ongoing concern indirectly, even on a long-term outlook, then the court will not disallow it on grounds of deviating from the supposed principle of shareholder primacy. This provides an opportunity for the protection of suppliers' interests.

What of creditors more generally? Stakeholder theory may be of value to suppliers not simply *sui generis*, but also functionally in the sense that many suppliers are also creditors of their customers. The case law is mixed in the view which it suggests directors ought to take of creditors' interests (Keay, 2001). However, on balance it is clear that shareholder primacy as a normative description of company law rapidly diminishes when the company is either insolvent, or as we shall see, even within a certain distance of insolvency.

Numerous British cases contain *dicta* to the effect that directors ought not to consider creditors' interests (for example, *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd.*, 1991). But the British courts soon started to follow a gentle path in the direction of *Walker v Wimborne* (1976), beginning with Diplock's dictum in the case of *Lourho v Shell* (1980: 634). Since then, company law's approach has been to suggest that a duty to creditors does exist when a company is approaching insolvency. This is not a direct duty to creditors (compare *Nicholson v Permakraft (NZ) Ltd.*, 1985: 249 per Cooke J), but a duty to have regard to the creditors' interests. As this is owed to the

company, the creditors cannot enforce it and so must rely, for example, on a liquidator acting on behalf of the company.

Nourse LJ opined in *Brady v Brady* (1988: 552) that if a company was doubtfully solvent, the interests of the company are in reality the interests of the existing creditors alone. This part of the judgment was not questioned when the case came before the House of Lords and indeed the Lords' judgment arguably included a tacit acceptance of it (1989: 778). *Brady* even said that where a company is solvent, if significant dispositions are to be made, consideration should be given to the impact that this might have on creditors' interests (1988: 552).

So, there seems to be some support for the existence of duties to creditors even in the case of a company which is not yet insolvent. The 'doubtful solvency' test of *Brady* can be compared to the question of whether a company was 'nearly insolvent' (*Re Horsley & Weight Ltd.*, 1982: 455 per Templeman J) or even if it was simply in a 'dangerous financial position' (*Facia Footwear (in administration) v Hinchliffe*, 1988). *Liquidator of West Mercia Safetywear v Dodd* (1988) was possibly more extensive still. The position of duties existing has been followed in subsequent cases such as *Gwyer v London Wharf (Limehouse) Ltd* (2003).

However, even if there is such a duty, creditors would lack standing to enforce it, either individually or collectively. The House of Lords' decision in *Winkworth v Edward Baron Development Co. Ltd.* (1987) contained a suggestion that there might exist an independent duty, but this was firmly rejected in *Yukong Line Ltd. of Korea v Rendsburg Investments Corp'n* (1998: 884). All of the cases holding that directors owe some sort of duties to creditors have involved closely held companies in which a director is a shareholder.

*Incentive-setting strategies* The UK system also makes use of legislative incentive-setting strategies as a way of structuring directorial decision-making. This is done in two main ways. First is the concept of fraudulent or wrongful trading. Under a provision found in the insolvency legislation (Insolvency Act 1986 (UK), ss. 213 (fraudulent trading) and 214 (wrongful trading)), knowing parties to any of an insolvent company's business which was carried on 'with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose' may be ordered by the court upon the liquidator's application to contribute to the company's assets. This explicit recognition of creditors' interests appears not to be limited to the period immediately preceding or leading to insolvency. However, it is not necessarily enough that a single creditor was defrauded. Rather, it is necessary to show that the business was carried on with intent to defraud its creditors (*Morphitis v Bernasconi and Others*, 2003).

It might be argued that the inclusion of a sanction makes this a meaningful

provision. What are we to make of this in terms of a shareholder primacy analysis? There is a clear focus here on protecting creditors' interests and this is backed by a meaningful sanction. We may thus see the provision as a belated partial diminution of the effective contraction of suppliers' remedies, which as noted above accompanied the introduction of statutory incorporation with limited liability. The choice of personal liability for directors is an agent incentive-setting strategy and does not change the duties of the company itself. Functionally, however, this is at least as appropriate, not least in the event of insolvency. Wrongful trading is conceptually broader than fraudulent trading and seems to have been introduced in order that the provision might allow for creditors' interests to form a basis of decision even in the absence of actual dishonesty.

It is clear that the wrongful trading provisions allow for the protection of creditors' interests. By its very nature, wrongful trading looks to that period of a company's terminal decline when the shareholders' interest is most likely to have been effectively extinguished and the courts' interest shifts to a form of damage limitation for the benefit of creditors. This linking of the section with creditors' interests was clear from the first reported decision on the section: *Re Produce Marketing Consortium (In Liquidation) (No. 2)* (1989). It continues to be in clear evidence (*Walker v Secretary of State for Trade and Industry*, 2003).

Prima facie, creditors *qua* creditors lack the ability to pursue a wrongful trading action. However, if the liquidator failed to do so, there is a mechanism whereby creditors could bring a malfeasance proceeding (s. 212, Insolvency Act 1986).

Second, the Company Directors Disqualification Act 1986 (UK) allows for directors to be disqualified for a period not only from acting as a director to any company, but also from acting in a managerial position. Consider a decision on point by the House of Lords:

[W]inding up has, and has had almost throughout the history of company law, a dual purpose. One purpose is the orderly settlement of a company's liabilities and the distribution of any surplus funds, prior to the company being dissolved. The other is the investigation and the imposition of criminal or civil sanctions in respect of misconduct on the part of persons (especially directors of an insolvent company in compulsory liquidation) who may be shown to have abused the privilege of incorporation with limited liability. The first function is primarily a concern of a company's creditors and shareholders; the second function serves a wider public interest. (*Official Receiver v Wadge Rapps & Hunt (A Firm) and Another and Two Other Actions*, 2004: 180 per Lord Walker of Gestingthorpe)

Unfitness under section 6 of the act may attach a higher importance to creditors' interests than those of other members of the public, as reflected in *In re Sevenoaks Stationers (Retail) Ltd.*:

It is beyond dispute that the purpose of section 6 is to protect the public, and in particular potential creditors of companies, from losing money through companies becoming insolvent when the directors of those companies are people unfit to be concerned in the management of a company. (1991: 176 (CA) per Dillon LJ)

The 1986 Act may even have implications for the protection of a wider group of stakeholder interests than simply shareholders and creditors. There is authority that the act has a wider purpose, being ‘the protection of the public, including all relevant interest groups such as shareholders, employees, customers, lenders and other creditors’ (*Secretary of State For Trade and Industry v Collins and Others*, 1999: per Peter Gibson LJ).

So, suppliers may receive some sort of protection *qua* suppliers, without necessarily needing to be creditors. Yet hurdles face creditors or other stakeholders who seek to benefit from the Company Directors’ Disqualification Act. The implied duties (such as not acting in an unfit manner) are not directly enforceable by creditors *qua* creditors, but are reported on by insolvency practitioners to a dedicated unit of the DTI Insolvency Service. In practice, empirical evidence suggests that insolvency practitioners are not keen to report directors’ malfeasance (Hicks, 1999). In any case, there are no immediate compensatory benefits for creditors or suppliers. It may be argued that the mere threat of disqualification will act to raise standards generally by aligning agents’ incentives with good practice (*In re Swift 736 Ltd.*, 1993: 899, per Sir Donald Nicholls V-C). But where this has not happened the creditor lacks the opportunity for compensation which he might enjoy under, say, the wrongful trading provision.

## Conclusions

A number of themes have emerged in this chapter’s analysis of the various means by which suppliers may seek to protect their interests. First, a significant amount of supplier protection is self-protection. Many suppliers are able to afford themselves significant protection through their choice of business partners and the contractual terms and relationships adopted. But there are limits to this approach: the inappropriateness of the cooperative form for most supplier corporations and the inevitability in many instances of incomplete contracting. In addition, voluntarily adopted codes of conduct seem to offer only limited prospects for supplier protection. Any legal response to the challenges of supplier protection should respond to these failures of self-protection.

Second, a consistent theme which partly overlaps the question of supplier self-protection is the nature of corporate structure and personality. The choice of corporate structure can both help and hinder suppliers. It can allow them to organise their business affairs in a way which is conducive to their interests,

for example through a cooperative structure. But it can also isolate suppliers in corporate group structures where they receive all of the disadvantages but few functional advantages from the strict English approach to separate corporate personality. English courts continue to demarcate the shifting limits of the corporate personality doctrine, without clearly signalling a consistent intention either to reduce or expand it. This ongoing judicial process will inform future possibilities for supplier protection.

Finally, the 1980s onwards have witnessed an increase in judicial acceptance of some form of duties to stakeholders. But these remain very limited in scope and application and in any case often of doubtful utility to suppliers. Suppliers *qua* suppliers often lack any enforcement rights because company law continues to focus on the shareholder as the primary recipient of rights. The unfolding stakeholder debate may well bear further on suppliers' protection.

### Notes

1. As amended. Davies (2002: 120), referring to a later version in Hansmann and Kraakman (2004: 23), although the table in that book is a revised version of Davies's earlier one preferred in this chapter.
2. A series of 'undue influence' contract cases illustrate some of the difficulties involved, culminating in *Royal Bank of Scotland Plc v Etridge (No. 2)* (2002).
3. In the United Kingdom, these are primarily implemented through the Public Works Contracts Regulations 1991, SI 1991/2680 as amended, Public Services Contracts Regulations 1993, SI 1993/3228 as amended, and Public Supply Contracts Regulations 1995, SI 1995/201 as amended.
4. Article 9 of the First EC Company Law Directive (Directive 68/151/CEE). However, whereas the directive was concerned with the protection of third parties, s. 35 in its current (revised) form is arguably more expansive.

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122 *Research handbook on corporate legal responsibility*

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## PART II

# SUBSTANTIVE GROUNDS FOR CORPORATE LEGAL RESPONSIBILITY



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## 7 ‘Never say never jurisprudence’: comparative approaches to corporate responsibility under the law of torts

*Stephen Tully*

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### **Introduction**

This chapter examines corporate responsibility under the law of torts with particular reference to the prospective liability of parent corporations for national and international legal violations committed by their overseas subsidiaries. The next section reviews fundamental principles of tort law within the North American, European and Australian jurisdictions and illustrates their application to corporations. The following section furthers this comparative approach by reference to the doctrine of *forum non conveniens* to demonstrate the importance of the choice of forum for corporate responsibility. The subsequent section discusses the choice of applicable law in conducting transnational litigation against corporations, including the implications of the recent *Sosa* decision of the US Supreme Court under the Alien Tort Claims Act. The purpose of reviewing these jurisprudential developments is to show how the operation of the burden of proof can disadvantage claimants and how the application of legal doctrines (such as act of state, sovereign immunity and *forum non conveniens*) can be manipulated to commercial advantage. Together these arguments support the overall theme that corporate legal responsibility can be shielded by governmental responsibility, thus enabling corporations to evade true accountability. The final section concludes.

### **Tort law as a mechanism for corporate responsibility**

Tort law allows injured parties to commence actions against wrongdoers (known as tortfeasors) claiming damages for injuries caused by the commission of a civil wrong. There are several preconditions to initiating an action. First, claimants must establish that they enjoy sufficient standing (*jus standi*) to bring the claim, either as an individual who suffered the injury or being representative of a particular class. Second, they must establish that the tortfeasor owed them a duty of care in the circumstances. Third, claimants must demonstrate that this duty has been breached, including the necessary element of causation (that the damage suffered resulted in fact from the disputed act).

Like criminal offences, responsibility in tort arises where the physical and

mental elements of the wrong have been established. Any classic treatise on tort law (for example, Fleming, 1998) will identify the *actus reus* and *mens rea* requirements for each tort. The former is the physical element (a specific act or omission) and the latter is the mental component (either a specific intention to commit the act or being negligent to varying degrees in that respect). The degree of actual or constructive knowledge – whether the individual knew or ought to have known of the consequences of their actions – will be relevant. However, proof of fault by the tortfeasor is unnecessary for strict or absolute liability offences. Such offences increase prospective liability and lessen prosecutorial burdens but need not encourage corrective behaviour (Laufer, 1999: 1367).

Where a fault element is required for an offence, it will also be necessary to establish that the corporation and not just the individuals involved possessed the necessary intention. The problems of attributing individual actions to a corporate body (see, for example, Grantham, 2001) also arise in this context. Under Australian law, if it cannot be demonstrated that any individual employee, agent or officer was negligent, the fault element will be imputed to the body corporate if its conduct is negligent when viewed as a whole, that is, by aggregating the conduct of any number of employees, agents or officers. Evidence of negligence may exist if the conduct is substantially attributable to either inadequate corporate management, control or supervision, or the failure to provide adequate systems for conveying information to relevant individuals within the organisation. This is consistent with the notion of organisational blameworthiness as the basis for corporate liability (Fisse, 1991: 374). However, the practice of Australian prosecutors for environmental offences is to impose liability upon directors and other corporate officers rather than the corporation itself where they knew or were reckless or negligent as to whether a contravention of environmental legislation would occur, were in a position to influence corporate conduct and failed to adopt all reasonable measures to prevent that contravention (Howard, 2000). Furthermore, litigation against directors typically accompanies high-profile corporate collapses (Moodie and Ramsey, 2002).

Corporations will be adjudged vicariously liable for the actions of employees, servants and agents under their control for activities undertaken within the scope of their employment. For example, in *Hollis v Vabu Pty Ltd (the Bicycle Couriers case)* (2001), a courier company was held vicariously liable for the negligent acts of a courier when he seriously injured a pedestrian while riding on the footpath. Australian courts have held employers liable when employees perform authorised acts in an unauthorised manner (*Hanley v Automotive, Food, Metals, Engineering, Printing & Kindred Industries Union*, 2000) and where employees act contrary to explicit work instructions (*Tiger Nominees Pty Ltd v State Pollution Control Commission*, 1992). Any available defences

will be taken into consideration in determining liability. For example, a corporation will not be held liable for the conduct of an agent where the body corporate proves that it exercised all due diligence to prevent that conduct.

The policy rationale for vicarious liability is twofold. The first reason is to provide a practical remedy for harm suffered as a result of wrongs committed in the course of conducting commercial operations. It is therefore just and fair to require a body which introduces potential harm into a community to be held responsible should that harm eventuate (*Bazley v Curry*, 1999: 552). The notion of enterprise risk considers who is best able to provide direct and effective compensation (which in practice means who has the 'deep pocket'). Second, assigning liability to employers for the conduct of employees encourages the former to take steps to prevent future harm. This deterrence objective acknowledges that employers are in a position to reduce accidents and intentional wrongdoing through efficient organisation and supervision.

The compensatory and deterrence functions served by tort law make it an appealing legal system for corporate accountability. The remedies offered by tort law classically include damages, injunctions and declaratory relief. Although it can be difficult to accurately quantify the extent of harm sustained, damages typically include the financial costs associated with personal injury, pure economic loss and remediation. Since the actual wrongdoer is compelled to financially remedy any damage caused they and others are deterred from conducting commercial operations in an inappropriate manner.

Civil liability is most evolved under the national law of industrialised states and is subject to ongoing refinement (Acquaah-Gaisie, 2000). For example, the Toxic Substances Control Act (15 USC ss. 2601–71 (1988)) may encompass corporations which have formerly owned or operated upon contaminated property, shareholders who have substantial ownership interests and employees who actively participated within management. Under the Comprehensive Environmental Response Compensation and Liability Act (42 USC ss. 9601–75 (1988)) funds to finance environmental restoration may result from damage awards without the need to establish fault (*United States v Bestfoods*, 1998).

Particular problems arise in respect of tort litigation against transnational corporations. Subsidiaries operate in several jurisdictions and are therefore subject to different legal regimes. The 'home' state where the parent corporation is based lacks the territorial jurisdiction to regulate the activities of subsidiaries and the 'host' state where subsidiaries are located lacks national jurisdiction over the parent responsible for decision-making. Home and host governments may disagree as to whether corporate nationality or effective territorial control is the appropriate basis for exercising jurisdiction. In this manner civil disputes between private litigants can affect inter-state relationships.

Attempts to regulate the overseas conduct of subsidiaries by extending the application of national law extraterritorially is undertaken on an uncertain legal footing (Kamminga, 1999: 565). The willingness of governments to undertake enforcement measures may be compromised by their dependency upon foreign direct investment, taxation revenue or national employment benefits. Furthermore, the threat of corporate migration, that is, relocating commercial operations to another state, may inspire a ‘race to the bottom’ of regulatory standards. Subsidiaries are unlikely to voluntarily comply with the legal standards of the home state if this entails abdicating sources of competitive advantage. Although corporations are nominally subject to the authority of national law, they are not truly accountable for their extraterritorial conduct.

The rules of private international law also apply in the context of transnational litigation. These rules ordinarily apply the law of the place where the wrong occurred (the *lex loci delicti*). Litigation within the host state against the subsidiary is therefore attractive since (a) this is where the evidence including witnesses is located; and (b) claims should be vindicated where damage occurs. The alternative is to apply the *lex loci actus* or the law of the place where the relevant action or decision was taken. Several considerations favour the latter choice. First, tortfeasors should be subject to a known and local legal framework since they cannot be expected to be familiar with changes to foreign law in every jurisdiction in which they conduct commercial operations. Second, decisions made at company headquarters typically have ramifications for every state where subsidiaries are located. Litigation within the home state against the parent company is moreover desirable since (a) the parent company rather than the subsidiary enjoys access to the assets of the corporate group necessary for proper compensation; (b) control of the group’s activities is invariably located within the parent company; and (c) subsidiaries should adhere to standards of care within other states to a level commensurate with that expected from parent companies at home.

Attempts to hold parent companies tortiously responsible for the operational acts of overseas subsidiaries encounters two fundamental principles of corporations law: the doctrine of separate legal personality between parent and subsidiary firms and limited shareholder liability including that of parent companies (Blumberg, 1993, 2001). In respect of the former, the law ‘pays scant regard to the commercial reality that every holding company has the potential and, more often than not, in fact, does, exercise complete control over the subsidiary’ (*Briggs v James Hardie & Co*, 1989: 577). That said, courts have held holding companies liable where the corporate conglomeration is structured as a unity (the economic entity or enterprise approach) or where they exercise effective control (*ICI Ltd v Commission of the EC (Dyestuffs Case)*, 1972: 661–3; *The Amoco Cadiz*, 1984: para. 43; *Meterlogic Inc v Copier Solutions Inc*, 2000: 1357).

An additional complication is that the act of state doctrine may preclude national courts from inquiring into the validity of public acts performed by recognised foreign governments within their own territory (*Banco Nacional de Cuba v Sabbatino*, 1964: 428). By way of illustration, proceedings were commenced against an Australian mining company following the collapse of a tailings dam from a copper mine in Papua New Guinea. The Australian court was reluctant to adjudge several preliminary points such as possessory title over foreign territory and the validity of mining legislation (*Dagi & Ors v BHP Minerals Pty Ltd and Ok Tedi Mining Ltd (No. 2)*, 1997). However, Judge Byrne observed that '[t]o my mind, it is not at all improbable to suppose that the law imposes a duty of care in favour of persons who may use the water downstream as a food source or for a livelihood' (ibid.: 456–7), possibly prompting the out-of-court settlement which ultimately concluded that case. Further considerations include the limited ability of national courts to compel subsequent compliance with their judgments overseas, the desirability of the executive and judiciary espousing a coherent voice and, perhaps most pertinently, the most convenient forum for adjudging the matter.

### **The doctrine of *forum non conveniens***

The classic question which arises when plaintiffs and defendants are situated within different jurisdictions is identifying the proper forum for the suit. In short, which national court is the most appropriate one for conducting proceedings. Courts generally hesitate before impugning the competence or impartiality of another state's judicial system. However, ubiquitous to such proceedings is that governments may either promote or question the adjudicatory competence of national courts and defend national policies. Generally courts will respect the claimant's choice of forum. However, they will additionally consider relevant public interest factors such as court congestion, the desirability of conducting local cases locally and familiarity with another national law. Moreover pertinent is whether national legal systems offer the opportunity for class claims and the role if any of public interest or contingency-fee lawyers.

The dominant European approach pursued by most civil law systems (see, for example, Betlem, 1993) is to locate the proper forum for resolving disputes where defendants are domiciled. Thus defendants 'shall' be sued within their state of domicile even when plaintiffs originate from non-member states (Art. 2, 1968 Brussels Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters; *Group Josi Reinsurance Co SA v Universal General Insurance Co (UGIC)*, 2000; EC Regulation 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, 2001). Thus the doctrine of *forum non conveniens* (where courts decline to exercise jurisdiction on the basis that another is more appropriate)

may no longer be unavailable within the EC as a result of deliberations at the 2001 Special Commission of the Hague Conference on Private International Law (see also the Special Commission of the Hague Conference on Private International Law, Preliminary Draft Convention on Jurisdiction and Foreign Judgments in Civil and Commercial Matters, 1999), and recent rulings of the European Court of Justice (*Owusu v Jackson & Ors*, 2005: paragraph 46). However, member states still retain the option of hearing tort claims for damage arising in third states against transnational corporations registered or having their headquarters located within the EU (European Parliament Resolution A5-0159 (2002) on the social responsibility of companies, para. 50). Alternatively, states may declare that their national courts are incompetent to adjudicate disputes covered by exclusive choice of court agreements in circumstances where, aside from the location of the chosen court, there is no connection between those states and the parties or the dispute (Special Commission on Jurisdiction, Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters, 2004: Article 7; see also the exceptions listed in Article 18).

Although the domicile approach carries the advantages of predictability and removing judicial discretion, it also presumes parent company liability, conflates jurisdictional questions with substantive liability and increases the risk that companies will be sued for activities conducted elsewhere (Muchlinski, 2001: 11–14). The domicile approach could also deter incorporation in so far as liability questions are influenced by mere presence. However, jurisdictional exceptions apply and the requisite elements of an offence must be established.

The second (and generally preferred) approach is to permit actions to proceed in the place where harmful events occur (the *forum delicti*). For example, Malaysian residents unsuccessfully initiated civil litigation before Malaysian courts against the Rare Earth Corporation, a joint venture part-owned by Mitsubishi, alleging physical injury from exposure to radioactive tailings (*Woon Tan Kan v Asian Rare Earth*, 1992). Plaintiffs may be able to bring claims for transborder injuries within the national courts of either adjoining state (*Case 21/76 Handelskwekerij GJ Bier BV v Mines de potasse d'Alsace SA*, 1976).

The third approach observed by most common law jurisdictions is to give effect to the choice of forum selected by the plaintiff. However, defendants may invoke the *forum non conveniens* doctrine to stay proceedings. This can prove to be a potent tool for ultimately dismissing complaints against corporations. For example, in a suit brought against a Canadian mining company following a cyanide-polluted water leak at a mining operation in Guyana, Canadian courts adjudged Guyana to be the more appropriate forum (*Recherches Internationales Quebec v Cambior Inc*, 1998).



The *forum non conveniens* doctrine may enable corporations to effectively choose the forum in which they may be held accountable ('reverse forum shopping'). Furthermore, in a survey of 180 cases dismissed on the basis of that doctrine by US federal courts between 1947 and 1987, only three cases were eventually decided in foreign forums and the plaintiff lost in all instances (Robertson, 1987: 418–20). The *forum non conveniens* doctrine has accordingly received judicial criticism for being overly protective of corporate interests (*Dow Chemical Co v Castro Alfaro*, 1990: 680–81). Additionally noteworthy is that the burden of proof shifts: where defendants demonstrate that another forum is more convenient, claimants may then be expected to establish that the interests of justice will not be served within the alternative forum. However, corporations can also obtain anti-suit injunctions restraining claimants from initiating proceedings within other states where those states are not the 'natural' fora for resolving disputes (*Airbus Industries GIE v Patel et al.*, 1998).

Differences in applying the doctrine are discernible within American, English and Australian courts. Most notoriously, Indian litigants were compelled to pursue their tort claims against Union Carbide Corporation before Indian courts following the Bhopal gas leak (Westbrook, 1985; Muchlinski 1987). US courts deferred to Indian legislation nominating the Indian government as custodian of its citizen's legal rights (*parens patriae*). Judge Keenan remarked that 'to deprive the Indian judiciary of this opportunity to stand tall before the world and to pass judgment on behalf of its own people would be to revive a history of subservience and subjugation from which India has emerged' (*In re Union Carbide Corporation Gas Plant Disaster at Bhopal, India*, 1986, 1987). This was notwithstanding the opinion of the Indian government as well as its Supreme Court that such litigation should be pursued within the US (*Union Carbide Corporation v Union of India*, 1989; *Charan Lal Sahu & Ors v Union of India*, 1990; *Bi v Union Carbide Chemicals & Plastics Co*, 1993; *Keshub Mahindra v State of Madhya Pradesh*, 1996). Claimants have also sought to challenge as inadequate the settlement agreement concluded between Union Carbide and the Indian government. However, the act of state doctrine precluded judicial scrutiny by US courts.

By way of an alternative to evaluating the conduct of overseas subsidiaries, English courts are willing to consider whether negligent acts or omissions have been committed by parent companies within the UK. However, there must be evidence of a real and substantial connection between the circumstances giving rise to such claims and asserting English jurisdiction. Relevant considerations include party convenience, expenses incurred, access to witnesses and evidence, governing law, place of residence, location of business operations and the interests of justice (*Spilada Maritime Corporation v*

*Cansulex Ltd*, 1987: 476–8). The last-mentioned factor includes where claimants do not have sufficient funding to obtain legal or expert representation within the national courts of home States (*Connelly v RTZ Corp plc*, 1997). For example, South Africans recently won the right to sue Cape Industries in the UK for asbestosis resulting from exposure in South Africa (*Adams v Cape Industries plc*, 1990; *Lubbe & Ors v Cape plc*, 1998, 2000; Meeran, 1999). The South African government argued that it had no public interest in requiring its courts to adjudicate disputes arising from the alleged acts of English companies under the laws of the old South Africa. Proceedings (ultimately settled out of court) were also commenced against a UK company by former workers of a mercury recycling plant which had relocated to South Africa following criticism from UK occupational health and safety inspectors (*Sithole & Ors v Thor Chemical Holdings Ltd*, 1999).

The Australian standard for assessing inconvenience to the defendant is whether plaintiffs have chosen particular national legal systems merely to vex, harass or oppress them. It may therefore constitute an abuse of process to permit proceedings to continue. Prince (1998: 595) proposes that this stricter test is preferable since it is more difficult for Australian companies to escape local jurisdiction. Australian courts would only dismiss litigation where they were ‘clearly inappropriate’ (*Voth v Manildra Flour Mills*, 1990). As illustrated by *Regie National des Usines Renault SA v Zhang* (2002), the burden lies upon applicants to demonstrate that local trials would produce injustice because it would be oppressive (in the sense of seriously and unfairly burdensome), prejudicial, damaging or vexatious (in the sense of producing serious and unjustified trouble or harassment).

In the light of these points it may be considered that international adjudicatory mechanisms are more favourably positioned to resolve transboundary questions by overcoming the limitations applicable to national courts. However objectionable they may be, commercial practices escape formal censure within international fora since state responsibility is typically the singular conclusion. For example, the jurisdiction of the International Court of Justice is limited to disputes between states notwithstanding that the adverse environmental and economic impacts of corporate nationals is the subject of judicial scrutiny (*Certain Phosphate Lands in Nauru (Nauru v Australia)*, 1989: para. 21). Similarly when confronted with human rights violations jointly committed by governments and corporations during development projects, the mandate of the UN Human Rights Committee is limited to determining governmental responsibility (*Hopu and Bessert v France*, 1993).

The question of compliance with labour standards usefully illustrates how the limitations of international fora affirm the primacy of national courts. That topic also illustrates the relationship between state and corporate responsibility and the regulatory role of governments. For example, state compliance

with ratified labour conventions is ordinarily assessable within the formal complaints process of the International Labour Organisation (ILO), either through the tripartite Conference Committee on the Application of Conventions and Recommendations or specially appointed expert committees. In 1998, employee delegates to the ILO alleged that the Myanmar government authorised or condoned forced labour and suspected commercial pressures to that end. Employer organisations and individual corporations provided information including codes of conduct and supportive NGO reports to suggest that legal responsibility for project security and labour relations properly rested with government (ILO, 1998: paras 53–4, 75–6, 504–10). Although the Commission of Inquiry determined that Myanmar had failed to effectively observe the forced labour convention, evidence of corporate complicity was lacking. Myanmar's corrective efforts were also subsequently adjudged inadequate (ILO, 2000). However, national employers groups were encouraged to voluntarily abstain from economic cooperation with Myanmar consistent with the policy of their home states and the International Organisation of Employers called upon its membership to ensure the non-perpetuation of forced labour (ILO, 2001: paras 22–31). Simultaneous claims initiated by individuals within US courts against the Myanmar government and a national gas company were dismissed on the basis of state immunity as well as proceedings against Total, the joint-venture partner involved, for lack of personal jurisdiction. Following unsuccessful shareholder resolutions seeking the adoption of a code of conduct, tying executive remuneration to social performance and abandoning the Myanmar project, litigation was also initiated against Unocal, the US company involved, under the Alien Tort Claims Act (Peters, 1998), a topic to which this chapter now turns.

### **The Alien Tort Claims Act**

The Alien Tort Claims Act (ATCA) (1994) has justifiably been described as a legal Lohengrin. The act grants federal district courts jurisdiction over 'any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the US'. Early precedents under the ATCA established the civil liability of individuals (principally former and current foreign government officials) for human rights abuses committed in conjunction with official action (see *Xuncax v Gramajo*, 1995; *Abebe-Jira & Ors v Negewo*, 1996). For example, *Filartiga v Pena-Irala* (1980) concerned a Paraguayan national tortured to death in Paraguay by a local police officer subsequently found to be residing within the USA. *Kadic v Karadzic* (1995), an action initiated against the leader of an unrecognised state entity for genocide committed in Bosnia, established that particular conduct could violate the law of nations even when undertaken by private individuals.

The ATCA has since become the basis for blossoming jurisprudence

involving litigation against prominent American and other multinationals (Rosencranz and Campbell, 1999). Tort claims for death or personal injury resulting from commercial operations may also rise to the level of human rights violations and environmental damage. Mineral resource extraction firms in particular also become entangled in competing property claims over natural resources between governments and indigenous groups with resulting insecurity of tenure and adverse publicity. Development projects accordingly become associated with detrimental cultural impacts, social dislocation and forcible resettlement. For example, Ken Wiwa and several others from the Ogoni region of Nigeria commenced suit against Royal Dutch/Shell alleging collusion with the Nigerian government in the imprisonment, torture and killing of environmental activists opposed to oil exploration activity (*Wiwa v Royal Dutch Petroleum Company*, 2000: 106). Other oil companies are also alleged to have acted in concert with the Nigerian government to commit human rights abuses including torture (*Bowoto v Chevron*, 2004).

ATCA proceeding also include Costa Rican banana plantation workers initiating claims against Dow Chemical alleging injury including sterility from exposure to Dow-manufactured chemicals in Costa Rica (*Dow Chemical Co v Castro Alfaro*, 1990: 679). Litigation against Coca-Cola which alleged that it *inter alia* deployed paramilitary troops against trade unionists in Columbia was dismissed on the basis of lack of control by the parent company over operations conducted at its bottling plant (*Sinaltrainal v Coca-Cola Co*, 2003). Once again it is not the only corporation alleged to be complicit with foreign governments in financially and materially supporting paramilitary groups to murder and torture trade union leaders (see, for example, *Estate of Rodriguez v Drummond Co*, 2003). It was also alleged that Coca-Cola knowingly purchased property following its expropriation by the Egyptian government (*Bigio v Coca-Cola Co*, 2000). Allegations against other firms include corporate complicity in ethnic cleansing (*Presbyterian Church of Sudan et al. v Talisman Energy Inc & the Republic of Sudan*, 2003), engaging in cruel, inhuman and degrading treatment (*Jama v Immigration and Naturalization Service*, 1998) and violating child labour standards (*Deutsch v Turner Corp*, 2003).

Additionally noteworthy is that other plaintiffs sued companies for allegedly cooperating in human rights abuses committed by the Axis powers during the First World War (*In re Austrian and German Holocaust Litigation*, 2001). The expiry of applicable time periods and a Treaty of Peace precluded proceedings continuing in the matter of *In re World War Two Era Japanese Forced Labour Litigation* (2001). Although forced labour amounting to slavery was recognised as a violation of the law of nations in *Iwanowa v Ford Motor Co* (1999), the claim in that case was also foreclosed by postwar interstate reparation agreements, applicable limitation statutes, the political question doctrine and considerations of international comity.

The litigation against Unocal introduced above proceeded on the basis that corporations could be held legally responsible under the ATCA for violating international human rights law (*National Coalition Gov't of the Union of Burma v Unocal Inc*, 1997). Significantly, the court rejected the contention that corporations could not be held liable simply because international law applied only to states. First, it adjudged that corporations could be as liable as state actors where they jointly violated international law in conjunction with host governments. Second, several violations such as forced labour were not preconditioned by joint state action and thus corporations could be directly liable for their purely private actions. The California District Court subsequently accepted Unocal's argument that it lacked any direct participation in the alleged offences (*John Doe I v Unocal Corp*, 1997). However, in 2001 the Court of Appeal for the Ninth Circuit determined that Unocal could be held liable for aiding and abetting where it offered 'knowing practical assistance or encouragement which has a substantial effect on the perpetration of the crime'.

Hearings against Unocal before a full bench of the federal court were stayed pending the outcome of the *Sosa* matter before the US Supreme Court (*John Doe I v Unocal Corp*, 2003). In *Sosa v Alvarez-Machain et al.* (2004), Alvarez-Machain sought damages under the ATCA for his unlawful arrest against Sosa, the principal Mexican national involved in his abduction by US government officials contrary to an extradition treaty, as well as against the US government under the Federal Tort Claims Act for 'outrageous governmental conduct'. The latter aspect will not be considered further, suffice it to say that the Federal Tort Claims Act waives sovereign immunity in respect of personal injuries caused by the negligent or wrongful acts or omissions of US government employees while acting within the scope of their office or employment (28 USC 1346(b)(1)).

It has been uncertain for a considerable period whether federal courts were precluded from developing customary international law as federal common law (Ryngaert, 2004). *Sosa* was in a sense a 'test case' since the judgment would also have implications for litigation then pending against corporations. Hence the National Foreign Trade Council, USA Engage, the International and US Chambers of Commerce, the US Council for International Business, the US Business Roundtable and the American Petroleum Institute submitted an *amicus curiae* ('friend of the court') brief arguing that companies were being treated as surrogates for foreign governments. This proposition is not without merit since government officials may enjoy head-of-state immunity and actions in tort against foreign states or their instrumentalities are unlikely to succeed in view of the act of state doctrine (considered above) and sovereign immunity. For example, Kuwait was adjudged to be immune from civil claims initiated within the UK for alleged acts of torture committed outside its jurisdiction (*Al-Adsani v Kuwait*, 1996; *Al-Adsani v UK (No. 2)*, 2001). Only

as a consequence of that outcome has it been proposed under the Redress for Torture Bill 1994 (UK) that a state should be civilly liable for damages when it authorises and condones torture or fails to adopt reasonably preventive steps. That said, section 1 of the State Immunity Act 1978 (UK) provides that states do not enjoy immunity for acts causing personal injury committed within the UK (compare the Foreign Sovereign Immunity Act (US) 28 USC 1330, 1602 et seq.).

The upshot is that enterprises are left to defend themselves against alleged violations of international law committed by exempt or absent governments. The US business community and others argue that ATCA litigation discourages foreign direct investment by US corporations, deters economic development and dampens international trade (Ramsey, 2001; Woodsome and White, 2002; Hufbauer and Mitrokostas, 2004). Since damages awards may be higher within home rather than host states, civil liability could become a form of protectionism in so far as compensation awards differ between jurisdictions. US firms moreover fear that the ATCA puts them at a unique and unfair competitive disadvantage internationally since it only potentially applies to companies incorporated within the USA or subject to the personal jurisdiction of US courts. The possibility that ATCA could be statutorily amended is slight but cannot be completely discounted. Alternatively American multinationals could attempt to 'level the playing field' by internationalising civil liability. A convention emanating, for example, from the Organisation for Economic Co-operation and Development, could formally delimit state, corporate and individual responsibility and clarify in what circumstances corporations would be complicit with governments in violating international law.

The amicus brief submitted by the Australian, Swiss and UK governments in *Sosa* opposed the extraterritorial application of national law as inconsistent with international law. Judges Higgins, Kooijmans and Buergenthal of the International Court of Justice have earlier observed that the ATCA represents 'the beginnings of a very broad form of extraterritorial jurisdiction' within the civil sphere (*Case concerning the Arrest Warrant of 11 April 2000 (Democratic Republic of the Congo v Belgium)*, 2002: para. 48). Australian, Swiss and English firms may become subject to conflicting legal commands and moreover run the risk of defending themselves against private lawsuits initiated under the ATCA before US courts. The three governments pointed to national differences under the law of torts: conduct unlawful within one state could be permissible within another, some states may impose statutory limits on damages and others may allow punitive damages. In their view it was inappropriate for national courts to adjudicate foreign policy matters – particularly where the 'law of nations' as perceived by US courts need not reflect more widely accepted international law – and moreover could undermine governmental efforts to promote international standards within foreign jurisdictions.

In rebuttal non-governmental organisations such as Amnesty International, Human Rights Watch and Friends of the Earth argued in their amicus brief that the ATCA is consistent with international law and the practice of other national legal systems. Finally, the European Commission in its amicus brief in support of neither party urged a more rigorous application of international law by US courts and suggested that transnational corporations were only subject to a narrow subset of customary international legal norms.

The US government under the Bush administration also filed an amicus brief in *Sosa* as it had in *Unocal* and *Exxon Mobil*, inviting the court to overturn the entire line of ATCA jurisprudence. It argued that the case law impaired its ability to cooperate with other governments in the fields of counterterrorism, anti-crime and economic or judicial reform. For example, *John Doe & Ors v Exxon Mobil Corp & Ors* (2001) involved a damages claim by 11 individuals alleging corporate complicity in human rights violations committed by Indonesian army units recruited to protect gas fields. Koh (2004) counter-argues that the 'perverse' position of the US administration would in fact exclude legal recourse against other private actors such as terrorist groups or states sponsoring such activity (*Tel-Oren v Libyan Arab Republic*, 1984, 1985; *Doe v Islamic Salvation Front*, 1998, 2003). It would also shift similar lawsuits against US corporations into foreign fora 'where they would lack the protections of US law' (Koh, 2004: 272). The administration also objected to judicial reliance upon non-binding instruments such as General Assembly resolutions as evidence of customary international law. Indeed, in *Sarei v Rio Tinto plc* (2002: 1161–62) it was held that corporations could be liable for violating the UN Convention on the Law of the Sea notwithstanding that the USA was not a party. However, it is noteworthy that such proceedings are typically susceptible to dismissal for lack of evidence.

The Supreme Court in *Sosa* resolved longstanding differences of opinion as to whether the ATCA merely conferred original jurisdiction upon federal district courts or purported to create a separate or 'roaming' cause of action amenable to private litigation. As an example of the latter, the Torture Victim Protection Act (28 USC s. 1350) explicitly provides that torturers 'shall, in a civil action, be liable for damages' to their victims. *Sosa* concluded that the ATCA constituted both. The Supreme Court (Justices Ginsberg and Breyer concurring) opined that although the act is a jurisdictional statute creating no novel cause of action, it was intended to be given practical effect through the common law for a modest number of international legal violations thought to carry personal liability at the time of its enactment in addition to their modern-day equivalents.

Justice Scalia, the Chief Justice and Justice Thomas characterised the majority's reasoning as 'nonsense upon stilts': such a discretionary framework permitted creating rights of action without legislative authorisation, an 'illegitimate lawmaking endeavour' for judges. The majority accordingly

observed that federal courts should exercise restraint when considering novel causes of action under the ATCA. Since there is no judicial mandate to seek out and define new and debatable violations of international law, in the Supreme Court's view federal courts should be averse to innovate in the absence of legislative guidance. Prospective claimants must therefore be mindful that 'judicial power should be exercised on the understanding that the door is still ajar subject to vigilant doorkeeping'.

On account of the 'collateral consequences' for governments, federal courts should also be wary of creating private rights of action for violations of international legal norms having a less definite content and acceptance among civilised nations than the familiar historical paradigms when the ATCA was first enacted. In 1789 'the law of nations' was limited to protecting foreign ambassadors from assault, preserving rights of safe conduct, issues of prize and prohibiting piracy (Sweeney, 1995). Justice Breyer added that exercising ATCA jurisdiction should be consistent with notions of comity, thus permitting in His Honour's view substantive claims in respect of offences for which there is universal jurisdiction. The majority of the Supreme Court also identified a 'strong argument' that federal courts should give 'serious weight to the Executive Branch's view of the case's impact on foreign policy'.

Overall, the ATCA jurisprudence since *Filartiga* has been left largely untouched. The Supreme Court did introduce an additional consideration that plaintiffs should have exhausted their remedies within other domestic legal systems 'and perhaps in other fora'. Federal courts have been called upon to exercise caution and lip-service has been given to case-specific deference to the political branch. To quote Justice Scalia:

In today's latest victory for its Never Say Never Jurisprudence, the Court ignores its own conclusion that the [ATCA] provides only jurisdiction, wags a finger at the lower courts for going too far, and then – repeating the same formula the ambitious lower courts themselves have used – invites them to try again.

Justice Scalia is correct in so far as US courts have generously construed international law, for example, by identifying the 'existence of a universal and obligatory international proscription of the tort of "causing disappearance" ' in *Forti v Suarez-Mason* (1988: 711). The US Supreme Court has expressly noted but did not decide whether corporations could be liable under federal common law for violating international law, nor did it determine whether corporations could be liable for aiding and abetting international legal violations committed by governments. The *Sosa* decision leaves considerable judicial discretion under the guise of *forum non conveniens*, comity (see further Paul, 1991) and exhausting domestic legal remedies. The non-justiciability or political question doctrine will require additional consideration of the impact of adjudication upon the conduct of foreign policy.



What then are the implications for corporate legal responsibility under tort law post-*Sosa*? First, international norms the subject of violations must be sufficiently specific or definable, universal and obligatory (*Hilao v Estate of Marcos*, 1994: 1475; *In re 'Agent Orange' Product Liability Litigation*, 2005: 184). Norms must enjoy universal consensus within the international community as to their binding status and content. US courts have already rejected many supposed norms as actionable violations of the law of nations on this basis. These include the right to collective bargaining (*Aldana Villeda v Fresh Del Monte Produce Inc*, 2003); fraud, bribery, extortion and corruption (*Maugein v Newmont Mining Corp*, 2004) and Principle 21 of the Stockholm Declaration (*Amlon Metals Inc v FMC Corp*, 1991). Furthermore, claims based upon cultural genocide were dismissed in *Beanal v Freeport-McMoRan Inc* (1997, 1999; see also *Alomang v Freeport McMoRan Inc*, 1996) as were allegations of racial discrimination in *Mendonca v Tidewater Inc* (2001, 2004).

In particular, while theoretically plausible, ATCA-based claims asserting violations of international environmental law are typically dismissed. Environmental pollution did not amount to violating the rights to life or health or the principle of sustainable development in *Flores v Southern Peru Copper Corporation* (2002, 2003). Litigation against Texaco failed on the grounds of *forum non conveniens*, international comity and failure to join an indispensable party (*Aquinda v Texaco Inc*, 1994, 1996, 2002; *Sequihua v Texaco Inc*, 1994; *Jota v Texaco Inc*, 1998). Similarly, proceedings against Union Carbide were dismissed on account of settlement orders issued by the Indian Supreme Court, the *forum non conveniens* doctrine and the view that the company had satisfied its environmental restoration obligations (*Bano v Union Carbide Corp*, 2001, 2003).

Although normative standards necessarily involve exercises of judgement, sufficient specificity may be satisfied where there exist concrete criteria for identifying violations, even if every normative aspect is not immediately apparent (Earthrights International, 2004: 41–2). US courts have hitherto recognised the customary international legal status of torture, crimes against humanity, war crimes, genocide, disappearance, summary execution, arbitrary detention, forced labour and cruel, inhuman and degrading treatment. *Sosa* affirmed a proposition first enunciated in *Filartiga* that since the content of the law of nations evolves over time so too does the scope of actionable torts change under the ATCA. Much turns upon the precision of the substantive statement of claim framed against corporations. For example, breaches of an alleged duty to provide the best-proven diagnostic and therapeutic treatment or to treat patients with dignity during drug trials conducted within other states are unlikely to succeed (*Abdullahi v Pfizer Inc*, 2002, 2003). Establishing the requisite elements of an offence can be demanding, particularly genocidal intent, and intergovernmental opinion may only be hortatory.

Second, corporations are likely to be held to account only where they have aided or abetted foreign states to violate the law of nations (Edwards, 2001). For example, *Carmichael v United Technologies Corp* (1988: 113–14) established that corporations could be held liable for acts of imprisonment and torture where they aided, abetted and conspired with foreign government officials (although that case was ultimately dismissed *inter alia* for lack of sufficient service). Firms have also been held accountable under the ATCA for employing coercive government power to arbitrarily detain individuals and extract favourable concessions (*Eastman Kodak Company v Kavlin*, 1997: 1091). US courts have labelled this joint action requirement as corporations acting ‘under the colour of law’, that is, cooperation with state officials or supported with significant state aid. From the *Unocal* case the *actus reus* is practical assistance or encouragement having substantial effects upon perpetrating the crime whereas actual or constructive knowledge is the appropriate *mens rea* (Herz, 2000: 559–62). One difficulty with these standards is that all commercial activity within another state short of divestment requires at least some degree of governmental permission or facilitation. However, substantial action rather than mere presence is presently the basis for corporate liability and indirect economic benefit from unlawful state action is insufficient to establish action committed ‘under the colour of law’. In short, corporate passivity is not yet equated to complicity. None the less, corporations will re-evaluate the extent to which they should rely upon the military or police forces of foreign governments and independent measures for ensuring security for their investment infrastructure.

The consequences of *Sosa* have already become evident. In *In re South African Apartheid Litigation* (2002) it is alleged that by conducting business under South African apartheid several US-based corporations are liable for human rights violations committed during that period. In *Khulumani v Barclays* (2002) it is alleged that banks provided computers, supplied armoured vehicles, violated embargoes and provided funding to further the apartheid apparatus. The South African Minister for Justice expressed the opinion in an amicus brief that pre-eminently domestic matters such as national reconciliation should be respected in all fora and not pre-empted by litigation in foreign courts. Claimants acting as a surrogate government to resolve reparations questions may discourage foreign direct investment and undermine economic stability. The US State Department also considers the litigation to be detrimental to US foreign policy interests given the resulting tensions with Canada and the UK, whose national corporations are identified as defendants.

It appears that corporations continue to enjoy support from their home governments, notwithstanding that (or because) they may have financially benefited from apartheid, sustained the illegal occupation of Namibia (UN

Secretary-General, 1985: 16–17), been officially condemned for collaboration with the regime (UN General Assembly Resolution 37/233A (1982); Economic and Social Council Resolution 1985/72 (1985), para. 6) and routinely flouted economic sanctions to avoid voluntary divestment (UNCTC, 1990: 7, 31). It is also ironic that such firms continue to be shielded by the South African government once again on account of the fear of capital withdrawal, if not for contributing to apartheid then their role in economic reconstruction.

The plaintiffs in *Ntsebeza et al. v Citigroup et al.* (2004) sought damages on behalf of all persons living in South Africa from 1948 to the present from defendants who supplied oil, money and technology to the apartheid regime. Although it may have been 'morally suspect' or 'embarrassing' for the defendants to conduct business, the plaintiffs had failed to demonstrate that the defendants has acted under colour of law. This was notwithstanding that the independent criminal responsibility of organisations and institutions is contemplated by Article 1(2) of the 1973 International Convention on the Suppression and Punishment of the Crime of Apartheid (1015 UNTS 243). However, in the District Court's view that convention was not binding as international law since it lacked support from the major world powers and the UN Charter or General Assembly Resolutions did not provide an alternative cause of action under the ATCA. Although the court did not exhaustively review the legal position under customary international law, it was perhaps inevitable that the ambitious remedies sought – compensation, creating an historical commission, affirmative action, educational programmes, punitive damages and document disclosure – were unlikely to prevail.

## **Conclusions**

Civil litigation is slow, expensive and inappropriate as a prospective regulatory framework since caselaw grows by accretion, is case specific and lacks the overarching rationality of an equivalent political mechanism. Litigation typically discourages cooperation, deters transparent decision-making, increases costs (production, insurance and capital acquisition), threatens share prices and encourages a siege mentality. Furthermore, claimants frequently do not enjoy the same financial resources as defendant companies for properly conducting proceedings and inequalities (for example, with respect to pre-trial discovery) will arise. It may also be questioned whether contingency-fee lawyers should be permitted to target only those market leaders with deep pockets since this is not indicative of broader commercial conduct and may deter the adoption of socially-responsible initiatives by small and medium-sized enterprises.

It can be concluded from the review above that, relative to their counterparts in Australia and the UK, North American courts are more prepared to

impose tortious responsibility upon parent companies for the operational behaviour of their subsidiaries in foreign jurisdictions. That said, the *forum non conveniens* standard is more strictly applied within Australia when compared with the balancing of interests test employed within the UK and the USA. The likelihood of litigation will be evaluated by those corporations conducting commercial operations in other jurisdictions, particularly those involved in extracting natural resources. Commercial strategies include regulatory avoidance, subcontracting and preventing unfavourable legal precedents from emerging. Litigation and liability costs are inevitably passed to shareholders, creditors, consumers and insurers. Governments will intrude to avert market failure where duties of care owed by corporations extend beyond all manageable proportions and effectively deter operator entry into the marketplace.

Whereas the *forum non conveniens* doctrine suggests the importance of the choice of forum, the ATCA illustrates the controversies potentially surrounding the choice of applicable law. The significance of the ACTA jurisprudence should not be overstated: although several decisions are still pending, many cases have been dismissed, trial dates have to be established and a definitive judgment against a corporation including an award of damages is yet to eventuate. The application of the law of torts against corporations has appreciable limits if the real objective is to influence the behaviour of those foreign governments they partner with for the implementation of development projects. One could also query the merit of characterising crimes committed by individuals and ordinarily remedied through punishment by domestic or international criminal tribunals as torts committed by corporations and remedied by damage awards in civil proceedings. Civil law is useful as a deterrence mechanism since the burden of proof – the balance of probabilities – is lower than that for criminal offences (beyond reasonable doubt).

The direct application of international legal standards to corporations is an emergent paradigm. However, that development is contingent upon institutional evolution arising *en passant*. The contemporary environment is characterised by a relative paucity of appropriately qualified international tribunals and idiosyncratic national courts. Procedural obstacles common to tort litigation include establishing sufficient standing, securing access to evidence such as corporate documents, avoiding applicable limitation statutes, joining indispensable third parties and subsequent enforcement prospects.

The practical consequence of *Sosa* will be to knock out some but not all claims against corporations. Cases alleging corporate complicity in egregious human rights violations (for example, those amounting to slavery such as the Unocal litigation) are supportable in law but are yet to be determined as questions of fact. The possibility of largely symbolic default judgments where large damages awards remain unpaid is a path to be avoided. An alternative outcome is to prompt private settlements akin to those reached between banks

and their Jewish victims for aiding and abetting the Nazi regime in the plunder of assets during the Second World War (*Bodner v Banque Paribas*, 2000). Although a settlement did in fact transpire in the Unocal litigation during December 2004, such a result falls short of publicly declaring commercial impropriety. The opportunity to apply *Sosa* and clarify the legal dimensions pertaining to corporate complicity therefore continues to be left for future litigation (Coyle, 2003).

The appropriateness of employing pre-existing principles of negligence is by no means foreclosed. Complex management structures render it difficult to match such principles to the reality of control within corporate groups (Ward, 2001: 470). It may also be desirable to develop specific civil causes of action to remedy human rights violations or environmental damage. Whether tort law is an effective means for enforcing these universally agreed standards, 'one is forced to admit that it plays an important role in the absence of other means' (Anderson, 2002: 424).

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## 8 Corporate criminal responsibility

*Celia Wells*

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### **Introduction**

The recent emergence of corporate responsibility as a topic of debate reflects concerns about the safety of workers and of members of the public. Disasters such as rail crashes, ferry capsizes and chemical plant explosions have led to calls for those enterprises to be prosecuted for manslaughter. Cultural changes in risk perception have played an important role in prompting the evolution of legal principles of attribution. Doubts about the appropriateness of the two theories of corporate responsibility hitherto recognised by legal systems have set in. One of the more egregious examples of poor safety attitudes was seen when in 1987 a car ferry left the Belgian port of Zeebrugge with its doors open and capsized with the loss of nearly 200 lives. The subsequent inquiry in England, where P&O Ferries was based, found a history of open-door sailings, and management disregard of obvious safety measures such as a system of indicator lights informing the bridge whether the doors were closed. Although P&O were prosecuted for manslaughter, itself a historic event, it proved impossible to convict the company because of the restrictive identification theory. The very fact that safety was not taken seriously within the company, that no director had responsibility for safety, made the identification theory a clumsy tool of attribution.

### **Corporations and criminal law**

Corporations are legally deemed to be single entities, distinct and separate from all the individuals who comprise them. Legal personality means that corporations can sue and be sued, hold property and transact, and incur criminal liability in their own name and on their own account. Not all business enterprises are incorporated (partnerships, for example, are unincorporated groups, as are most clubs). Similarly, not all corporations are business enterprises (universities and local government bodies may be incorporated but are not necessarily engaged in business). However, since debate about corporate responsibility tends to concentrate on business corporations, and in particular on their responsibility under criminal laws, this will be the primary focus of this chapter.

Criminal law in some of its guises applies to corporations as it does to individuals. However, it is here that many of the difficult questions arise as to how

a legal entity such as a corporation can be responsible. Criminal law is pre-eminently concerned with standards of behaviour enforced, not through compensation, but through a system of state punishment negotiated via standards of fault such as intention, knowledge and subjective recklessness. Whether and how that system should be applied to corporations thus attracts more controversy than does the ascription of civil liabilities.

But criminal law is not a monolith. Its structure and scope varies within and between jurisdictions. Some laws, such as those against murder, assault and theft, apply to all persons of sound mind. Others have been created specifically to regulate areas of business activity. Trading standards laws, health and safety laws, and environmental protection laws all fit this category. While these regulatory schemes share some characteristics of mainstream or conventional criminal law – such as utilising the criminal procedural and penalty structure – are in other ways quite different, and are certainly perceived by the specialist enforcement agencies and those they regulate, as quite distinct from criminal law. Those differences are often reflected in the rules relating to corporate responsibility. Many continental European jurisdictions, however, do not recognise corporate criminal liability (or have not done so until very recently). Business enterprise is instead regulated through administrative law and penalties. Although administrative schemes such as these are not classified as part of the criminal law system, they are in many ways conceptual soulmates of the regulatory subsystems of criminal law that have developed in common law jurisdictions. Transnational harmonisation through the European Union (EU) and international harmonisation through the Organisation for Economic Cooperation and Development (OECD) and International Labour Organisation (ILO) also leads to more similarity than difference. Standard setting, compliance rather than punitive enforcement regimes, backed by fines or penalties, are some of the common features.

### **Concepts of blame**

Corporations are a challenge to criminal law because it is underpinned, even if only at the ideological level, by moral fault. How the corporation is conceived, the struggle between the nominalists and the realists, affects the rules by which responsibility is attributed. Since in the nominalist view the corporation does not exist apart from its members, any blameworthiness or responsibility can only derive from the culpability of an individual servant or employee. It remains open to question on this view whether the corporation will be responsible for all of its employees or only for some of them. For the realist, on the other hand, the corporation represents something beyond the individuals comprising it and this opens up completely different avenues for attribution.

Since a major area of controversy is whether an organisation, or corporation,

can *per se* be held responsible in criminal law, it is important to clarify the core concepts of blame. Accountability is a fundamental principle here. Corporations traditionally fell with animals, the children and the insane as non-accountable. There is a contingency even here since animals have not always been regarded as inappropriate subjects for punishment. In this view, fault ascription presupposes rationality and autonomy. Rationality implies that an agent acts for reasons and that those reasons both rationalise the action and causally explain it. Autonomy suggests an agent with causal power over his/her body and an inextricable link is thought to exist between fault ascription, autonomy and human bodies. It is clear that an account in this form will exclude corporations. Could a different form of argument rule them in? Three possible lines suggest themselves.

On an explanatory level it could be argued that the exclusion of corporations results from the vagaries and accidents of history, culture and language. We should perhaps not be surprised that the language of attribution or fault ascription reflects the fact that the main audience for law has been human persons. Deploying the descriptive language of an individualist rationality and autonomy will inevitably limit the debate about corporate responsibility, a debate which should be conducted at a different level. Perhaps a more useful or relevant notion than autonomy should be sought, for example that of a unified actor or decision-maker.

Second, an individualistic account of rationality makes a number of challengeable assumptions about human behaviour. As suggested here, ideas of responsibility cannot readily be separated from the social contexts in which they develop. People do not think or act *as* individuals but as products of particular cultures and social institutions. Third, a closely related argument casts doubt too on the aptness of the underlying assumptions of mentalism and autonomy in the conventional account of individual responsibility.

In addition to the unpacking of concepts such as rationality and autonomy, some clarification about the modes of accountability adopted in criminal law is needed. Criminal laws tend to be eclectic in their use of fault terms. Subjective mental states of intention, knowledge and recklessness require the prosecution to prove that defendants themselves realised that their actions would inevitably lead to a particular result (intention); that they themselves were aware of particular circumstances (knowledge); or that they themselves were aware that their actions might have that result or that a circumstance might exist (recklessness). It is often wrongly assumed that these are the only forms of culpability recognised in criminal law. But existing alongside are objective fault terms such as negligence (that defendants' behaviour fell short of that expected of a reasonable person even though they had not adverted to the relevant risk), and even offences where the need for a mental state is discarded altogether (usually dubbed strict liability). The association between

blame (the goal of criminal law) and specific fault requirements is more problematic than sometimes admitted. While we might agree that the actions for which a person might be held responsible consist in more than their bodily movements (and therefore more than in the unforeseen or unforeseeable results of these movements), there is less consensus on the precise scope of that additional culpability factor.

### **Responsibility attribution**

In general, three different theories for attributing blame to corporations compete for attention. The first is based on the agency principle whereby the company is liable for the wrongful acts of all its employees. US federal law employs a principle of this type, *respondeat superior*, while English law limits the application of vicarious liability to certain regulatory offences. The second theory of blame attribution, which English law utilises for all other offences, identifies a limited layer of senior officers within the company as its ‘brains’ and renders the company liable only for their transgressions, not for those of other workers. The third locates corporate blame in the procedures, operating systems or culture of a company. Company culture theory is beginning to achieve judicial recognition in Australia and in England.

The first two theories have in common that they seek in different ways to equate corporate culpability with that of an individual and both are therefore derivative forms of liability. Further, the second version adopts an anthropomorphic vision of company decision-making. The third theory, on the other hand, exploits the dissimilarities between individual human beings and group entities.

### *Vicarious liability*

In the civil (as opposed to criminal) law, an employer or principal is liable for the acts of any employee or agent. Criminal law has generally accepted this avenue of blame attribution in a limited range of strict liability offences. A full-scale vicarious liability principle is endorsed in South Africa as well as in the federal law of the United States, thus confirming that there is no difficulty in applying the vicarious principle to offences both of strict liability and of subjective knowledge. However, in the United States, it has to be remembered that jurisdiction over many criminal law matters lies at the state level. Some states follow the Federal rules, while others (mostly those which have adopted the Model Penal Code) adopt more closely the English common law binary scheme. Under this, vicarious principles apply only to certain regulatory offences. Some commentators make a distinction between vicarious liability and duty based liability such as that under the Health and Safety at Work Act 1974 (UK). Here the ‘employer’ (who may or may not be a corporation) is under a duty to ensure, so far as reasonably practicable, the health, safety and

welfare at work of all their employees. The employer is responsible when that duty is breached whether by a failure to institute a safe system or to control the wayward activities of an employee. While at one level it is distinct from vicarious liability (that is, taking responsibility for the act of another), it collapses into a conceptual identical twin that can be a distraction from the core concern of how to attribute blame to a non-human person.

Vicarious liability is regarded as too rough and ready for the delicate task of attributing blame for serious harms. It has been criticised for including too little in demanding that liability flow through an individual, however great the fault of the corporation, and for including too much in blaming the corporation whenever the individual employee is at fault, even in the absence of corporate fault.

This summary of the drawbacks of vicarious liability neatly encapsulates one of the major problems in any discussion of corporate responsibility – how to conceptualise ‘corporate’ fault. Vicarious liability attracts criticism as a mechanism for attributing fault because it is felt that there is some other way of measuring ‘corporate culpability’. The key question is to identify that way.

#### *Alter ego (identification) theory*

It was not until the middle of the twentieth century that English law contemplated a form of corporate liability that could apply to serious offences such as fraud, theft and manslaughter. One of the objections to finding corporations liable for felonies such as these was that they required proof of a mental element of intention, recklessness or negligence. Vicarious liability, at that stage the only recognised route of corporate attribution, was thought appropriate only for statutory offences. Many of these happened also to be offences of strict liability. This led to the orthodoxy that corporations could not commit any offence requiring proof of a mental element, even if these were statutory offences such as tax evasion that were clearly relevant to individuals and corporations alike. This dissonance was unravelled in the mid-1940s through judicial creativity in the form of ‘alter ego’ or identification theory. Drawing on parallel developments in the law of tort, key personnel in the company were said to act *as* the company (rather than on behalf of it, as is the case with vicarious liability). A distinction was drawn, in the words of Glanville Williams (1961), between ‘directive and executive servants’. Lowly company employees were declared to act as the ‘hands’ while directors and officers represent the ‘brains’ of the company. The anthropomorphic approach had its origins in the following observation by Viscount Haldane in an earlier civil case:

[A] corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is

really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation. That person may be under the direction of the shareholders in general meeting; that person may be the board of directors itself, or it may be, and in some companies it is so, that that person has an authority co-ordinate with the board of directors given to him under the articles of association, and is appointed by the general meeting of the company, and can only be removed by the general meeting of the company. (*Lennard's Carrying Co Ltd v Asiatic Petroleum Co*, 1915)

Translated into the criminal sphere, this became the basis for the identification principle. A company would be liable for a serious criminal offence where one of its most senior officers had acted with the requisite fault. Expounded in the leading case of *Tesco v Natrass* (1972), the relevant personnel were limited to those at the centre of corporate power.

### *Holistic theories*

Vicarious liability, as we have seen, is indeterminate in its sweep. It has rarely been applied to serious offences such as manslaughter. Identification liability regards the transgressions of only a limited number of people within the company as relevant to the attribution of culpability to the company itself. The rhetoric of identification liability asserts not merely a difference of degree between the two principles. It is said that under identification theory, the errant company officer acts as (rather than on behalf of) the company. However, on closer scrutiny, the distinction is of less substance than at first appears. In both vicarious and identification liability, the individual company employee can be prosecuted in his/her own right, and in each case, the company can only be liable if fault is found in one individual.

As Fisse and Braithwaite (1993: 47) cogently conclude:

[The *Tesco* identification] principle is highly unsatisfactory, mainly because it fails to reflect corporate blameworthiness. To prove fault on the part of one managerial representative of a company is not to show that the company was at fault as a company but merely that one representative was at fault . . . This compromised form of vicarious liability is doubly unsatisfactory because . . . it is difficult to establish corporate criminal liability against large companies. Offences committed on behalf of large concerns are often visible only at the level of middle management whereas the *Tesco* principle requires proof of fault on the part of a top-level manager. By contrast, fault on the part of a top-level manager is much easier to prove in the context of small companies. Yet that is the context where there is usually little need to impose corporate criminal liability in addition to or in lieu of individual criminal liability.

The limitations of these theories particularly in relation to corporate manslaughter prosecutions have led to a debate about more appropriate mechanisms for establishing corporate culpability. The ideas considered in this

section all have in common an attempt to escape from company liability derivative on the wrongdoing of one individual. In other words, they aim to capture the ‘corporateness’ of corporate conduct.

*Aggregation* In many large organisations, task specialisation means that, even among officers senior enough to count for alter ego purposes, one individual director will not have access to all the information on which to base a finding of knowledge or negligence. This was the case with P&O Ferries following the Zeebrugge disaster. Aggregation of pockets of knowledge from a number of individual employees has been accepted in US federal courts. However, it has not been adopted in jurisdictions reliant on the more restrictive identification theory for knowledge-based offences. While aggregation might appear attractive, it presents two difficulties. Reliance on individual, albeit disaggregated, knowledge suggests an incomplete shift to ‘corporateness’; and it relies on a fiction (that, if A knows that p while B knows that q, this allows knowledge of ‘p and q’ to be ascribed to the corporate person). Aggregation of knowledge is an incomplete solution. Organisational models of decision-making suggest that a scheme of corporate liability has to look further than individuals (atomised or aggregated) to the corporation’s structure itself.

*Systems theory* A developing theory for attributing fault to a corporation is based on internal decision-making structures. This owes its philosophical debt to Peter French (1984) who identified three elements in such structures: a responsibility flowchart, procedural rules and policies. Later theorists have been less concerned with matching corporate systems with human intentionality.

A legislative example can be found in the Australian Criminal Code Act 1995, which seeks to establish standard principles for federal offences, eventually extending to similar situations under state law. Under the code, intention, knowledge or recklessness will be attributed to a body corporate whenever it expressly, tacitly or impliedly authorised or permitted the commission of the offence. Such authorisation or permission may be established, *inter alia*, where its culture encourages situations leading to an offence. ‘Corporate culture’ is defined as an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in the part of the body corporate where the offence occurred. Thus evidence of tacit authorisation or toleration of non-compliance or failure to create a culture of compliance will be admissible.

*Reactive fault* In this third non-derivative theory, corporate culpability is not sought in antecedent fault. Instead, fault is inferred when a corporation fails to

take reasonable remedial measures in response to a harm-causing act or omission by any of its employees. This brings three particular advantages. It avoids the problem of proving antecedent fault; it gives the corporation an opportunity to show remorse and rehabilitative measures; and it introduces a forward-looking dynamic to the problem of corporate harm.

### **The state of play**

There has been something of a ‘quiet revolution’ in corporate liability in common law jurisdictions over the last decade. In the 1970s and 1980s courts had been complicit in allowing the restrictive identification principle to infect regulatory offences that would previously have been based on the broad vicarious rule. That process was brought to an end by the Court of Appeal in *R v British Steel* in 1995. In the second stage, the Privy Council laid the foundations for a broader conception of the identification principle itself in *Meridian Global Funds Management Asia Ltd v Securities Commission* (1995). In the third stage, legislatures have begun to respond. In addition to the Australian Criminal Code Act, mentioned above, Canada reformed its corporate liability rules in 2003. Liability for a crime will be attributed to an organisation, either on the basis that one or more ‘senior officers’ actually participated in the offence, or on the basis of a combination of the actions of one or more ‘representatives’ and the intent or negligence of one or more ‘senior officers’. Both ‘representative’ and ‘senior officer’ cover broader categories of personnel than the identification principle allows.

Rather than taking corporate liability principles as a whole, reform proposals in England and Wales have focused on manslaughter. This is partly a reflection of concerns about public safety and risk but can also be attributed to the difficulty of reforming general principles of criminal law.

For example, the UK Law Commission proposed in 1996 a separate offence of corporate killing and sought to overcome the problems of the identification principle by introducing a tailor-made test of corporate culpability based on ‘management failure’. The key to the Law Commission’s thinking lay in the collapse of the prosecution for manslaughter of P&O Ferries. The law applicable at the time presented three major hurdles to a successful prosecution of P&O (the judge directed an acquittal before the prosecution had presented all its evidence). First, could a corporation commit manslaughter? That question was resolved as an initial point of law. Second, the restrictive identification doctrine of corporate liability meant that the company could be liable only through its directing mind, in this case represented by some of its directors. Third, the substantive law of manslaughter relied on a test of whether the defendant (here one or more of the directors) had realised that there was an ‘obvious and serious risk’ of such an event occurring. This last difficulty was removed by the reintroduction of ‘gross negligence’ as the legal



test for manslaughter: 'The jury will have to decide whether the extent to which the defendant's conduct departed from the proper standard of care incumbent upon him . . . was such that it should be judged criminal'. (*R v Adomako*, 1995) Since then the Court of Appeal adopted a similarly narrow interpretation of corporate attribution in *Attorney General's Reference No. 2 of 1999* (2000).

The Law Commission recognised that it is difficult to apply the identification principle especially to large corporations with diffuse management structures. Rather than recommend any change to that rule, a separate offence of corporate killing was proposed adopting a 'holistic' theory of attribution, based on 'management failure'. This was endorsed by the Home Office in its 2000 Consultation Paper. A major weakness in the formulation was that 'management' was not defined. It could either have been exceptionally broad or very narrow test. John Coffee, the leading US commentator on corporate liability, put it well:

This standard if adopted could make the corporation a virtual insurer for any accidental killing. In any event, this . . . proposal suggests a high degree of cognitive dissonance within the British legal community; on the one hand, the prevailing legal rule on corporate criminal liability is understood to be very narrow and, on the other hand, the appropriate legal standard proposed by the leading law reform group is extremely broad. (1999: 15)

That cognitive dissonance has been resolved. After prevaricating, some might say procrastinating, the government published a draft Corporate Manslaughter Bill in 2005. This provides that a corporation or government department commits corporate manslaughter:

if the way in which any of the organisation's activities are managed or organised by its senior managers –

- (a) causes a person's death, and
- (b) amounts to a gross breach of a relevant duty of care owed by the organisation to the deceased. (CI. 1(1)).

A senior manager is defined as a person who plays a 'significant role in the making of decisions about how the whole or a substantial part of its activities are to be managed or organised, or [in] the actual managing or organising . . . of those activities'. (cl. 2).

This would leave the offence in an uneasy no man's land between the identification and system approaches. And given the judicial aversion to corporate liability evidenced thus far, it seems unlikely that the proposed reform will invite anything other than a narrow construction.

**Punishing corporations**

Even if the conceptual problems can be overcome, awkward questions will be asked about the efficacy of corporate punishment. Fines are ineffective, it is said; corporate prosecutions allow guilty individuals to escape penalty and the target is misdirected because ‘innocent’ shareholders, employees and consumers bear the real costs. One simple answer to the suggestion that corporate liability is ineffective is to point to the extraordinary efforts corporations frequently employ to avoid conviction.

To the objection that corporate liability can shield individual miscreants, the answer is that this is not inevitable and that the structure of liability and its practical execution should ensure that individuals and corporations are appropriately dealt with. A distinction has to be drawn between intended and unintended fall-out. Shareholders are often introduced into the discussion as ‘innocent’ but this emotive terminology obscures the very role which brings them into the net in the first place; their financial involvement and thus their intimate ‘interest’ in the company cannot be written out of the account. When it comes to unintended effects, then the argument against corporate sanctions gains strength. It is again important to remember that the rhetoric of individual responsibility is not borne out in reality; the families of offenders (often women and children in particular) are the hidden victims of individual punishment. In each case the question which is raised is whether those indirect, secondary costs are outweighed by the benefits (however they are calibrated) of the primary criminal sanction.

An important question is whether the activities of corporations concern us sufficiently to impose upon them criminal penalties. The real problem is that if a deterrent effect is sought through financial penalties, rather than through adverse publicity or other remedial measures, the size of the penalty might have to be so great that the unintended side-effects would indeed be intolerable. The almost exclusive reliance on fines in some jurisdictions has contributed to this sense of powerlessness. However, within some systems there is evidence of more imagination and commitment to overcome the limitations of financial penalties. It is trite to note that a company cannot be imprisoned. A combination of a fine and the incarceration of directors may be the most effective punishment. Fines are not the only option for the company itself. Equity fines (which effectively dilute the value of the company’s shares), corporate probation, adverse publicity and community service are all options.

Corporate probation is used in the United States in addition to or as an alternative to fines. Sanctions are aggravated by factors such as the aggregate harm or gain from the illegal activity and the involvement or condemnation by ‘high-level personnel’. Against ‘criminal purpose organisations’ a power to execute (corporate capital punishment) is available. Sentences are fine-tuned

to reflect culpability. Corporations which have effective programmes to detect violations, which report them when they occur and accept responsibility are rewarded with a lower fine. The guidelines thus seek to ensure that criminal penalties act as more than externally imposed costs.

A further dimension to corporate sanctions is the recognition that their effectiveness is increased if they are combined with prosecution and punishment of senior managers within the company. And paradoxically, despite a resistance to the notion of corporate liability, the civil law jurisdictions of Europe sometimes show more willingness to prosecute company directors following corporate negligence. The common law recognises corporate liability but is reluctant to employ it. What is evident is a tendency to harmonise. France and the Netherlands both now allow for corporate prosecutions and in the common law states, the issue of corporate responsibility is much more than a theoretical possibility and companies are alert to the threat of a manslaughter prosecution.

To conclude, corporate responsibility presents a conundrum. However hard one looks for the essence of the corporation, the role of individual employees, managers and directors cannot be above scrutiny. Since most economic activity is carried out by corporations, their potential for causing injury, both physical and financial, to their employees, their customers, the general public and the national economy cannot be overstated. Corporate defendants are highly motivated and well placed to exploit the metaphysical gap between 'the company' and its members.

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## 9 Corporate criminal liability in the United States

*Joseph F.C. DiMento and Gilbert Geis*

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### **Introduction**

The front pages of American newspapers today, when they are not displaying pictures of dead bodies lying about on mideast killing fields, are likely to show a corporate executive in business suit – with handcuffs on his wrists behind his back, being led into a criminal court by burly government agents. This development differs dramatically from earlier days when news of a business leader who had been charged with a criminal act (unless it was a sex scandal) was likely to be buried in the paper’s business section, if it was attended to at all (Dershowitz, 1961).

The current actions by American law enforcement agencies against corporate wrongdoing – and the dramatisation of such efforts – is one of the more significant developments in the arena of white-collar and corporate crime. The desire to focus attention on what they are accomplishing is one of the prime goals of American regulatory agencies. They live (and sometimes die) in terms of public perceptions of the success of their activities, matters that become of prime importance during congressional hearings on their budget request for the forthcoming fiscal year. The development and the particular nature of corporate criminal liability in the United States mirrors basic elements of the ideology and political arrangements of the country, many of which are congruent with those of the United Kingdom. The hiatus in England after the South Sea Bubble Act of 1720 when the formation of joint-stock companies was inhibited (Davies, 1952, 1975) could have provided an important benefit – the advantage of being able to learn how other nations had dealt with the emergent corporate world, such as France with its *en commandite* approach to limited liability (Shannon, 1931). England then could have selected and updated the most impressive corporate control mechanisms developed elsewhere, and the United States, when it achieved independence, could have built on this record. But both in England and subsequently in the United States, lawmakers have not been notably hospitable to the importation of legislative and jurisprudential wisdom from continental sources. Part of the reason is that often there is an awkward fit between indigenous patterns and what outsiders have done; another part is national ethnocentrism. There also is the important matter of a country’s ethos. Virtually all continental countries, for example,

require persons who reasonably can offer aid to those in distress to do so under the threat of criminal punishment: England and America (with some few exceptions in state law in the latter) do not penalise bad Samaritans, largely because of a belief that to do so would interfere with the individual freedom of their citizens to do what they please in such matters (Geis, 1993). This philosophical principle might be extrapolated to explain in part the early resistance in the Anglo-American world to imposing criminal liability on corporations rather than concentrating on punishing blameworthy individuals. In Japan, where the group plays so much more dominant a role, corporate criminal liability pervades the criminal law because, as Lee Hamilton and his colleagues (1983: 199) have reported from survey findings: 'Japanese placed greater emphasis on an actor's role position and on the act's social context, relative to an American emphasis on aspects of an actor's deed *per se*'.

This chapter considers the major attributes of the doctrine of corporate criminal liability in the United States. Almost exclusively, corporate criminal liability is imposed as a result of the work of federal agencies. Election to federal office (and the concomitant power to control such agencies) is heavily dependent upon money contributed by those who have it to spare and who anticipate gains from its donation – most notably persons in the upper echelons of the corporate world and the entities they represent. Presidents and members of Congress, however reluctantly, will endorse punitive actions against business interests if it is necessary to do so to remain in office. Even then, they will often try to wield a symbolic big stick that is fashioned of straw (Geis and Salinger, 1998). It is an appreciation of this situation that is essential for an adequate understanding of the doctrine of corporate criminal liability as it came to be formulated and enforced in the United States.

### **The background**

Corporate criminal liability builds on the legal fiction that a corporation can be transmuted by some alchemic verbal slight of hand into a human being with no affront to logic and no abuse of common sense. A corporate entity has no soul to damn and no body to kick, Edward, the first Baron Thurlow, observed in the nineteenth century (Coffee, 1981). The law in the United States has chosen to humanise the corporation, despite the fact that, among other matters, and unlike the rest of us, it has no necessary span of existence on this earth and no corporeal substance that can be brought before a court.

The doctrine of corporate criminal liability is paradoxical and pragmatic. The paradox lies in the distinction between a corporate entity and all other entities that are exempt from liability for the criminal acts of their members. If the father in a family steals from a neighbour's house, no criminal charge will be framed in terms of the *State v The Olivers*, with the accused being not only the particular violator, but also the entire family that was accorded its

identity by means of a state-granted licence. This remains true despite Sir Henry Maine's (1875: 184) statement that the family is a corporation and the patriarch the equivalent of what today would be the chief executive officer. When war criminals are indicted by the victors (it is inevitably the victors who find themselves in a position to identify the losers' war criminals), it is individuals who are named, not nations. Otherwise, matters would become unmanageable. Nations are made up of a massive number of persons who contributed to an outcome in diverse and tangled ways, presuming that they have contributed in any way whatsoever. But corporations, although some in the United States have larger populations and more financial resources than many independent nations, are presumed to be more reasonably responsible for law violations than the people or the political entity that constitutes a rogue country.

The pragmatism that underlies the doctrine of corporate liability in the United States includes the belief that corporate bodies have become so powerful that it is necessary at times to use the force of the criminal law – its potentially tough penalties and its ability to damage and destroy reputations – to deal with corporate malfeasance. In addition, corporations often possess deep pockets that can be made to disgorge monies to compensate those they have injured. Finally, the web of decision-making inside a large institution often proves to be distressingly difficult to unravel in order to pinpoint a culpable wrongdoer. It can be much simpler to indict the entity; and, culpable executives may be wont to cooperate in a corporate guilty plea rather than endure a courtroom battle, particularly if they can bargain with prosecutors to limit their own punishments.

Corporate criminal liability in the United States finds support not only in juridical developments but also in philosophical observations that see a corporate entity as differing from its component human parts. It has been claimed that 'a corporation has a personality of its own distinct from the personalities which compose it, a group personality different from and greater than . . . the sum of the parts' (Abbott, 1936: 2). This claim was reinforced with the observation that 'in the same way that a house is something more than a heap of lumber and an army something more than a mob . . . a corporate organization is something more than a number of persons' (ibid.: 15).

Our focus is on corporate entities that may be held accountable for the misdeeds – or omissions – of their executives or their employees. It is well to keep in mind the full range of possible collective sanctions, particularly the concept of absolute liability, so that corporate criminal liability can be seen to be part of a broader pantheon of approaches that may punish people or institutions for things that they themselves have not done, nor even necessarily condoned, presuming for the sake of argument that an institution might be capable of doing or condoning anything.

Corporate criminal liability is built upon a foundation of a deep distrust of the potential threat of free-ranging commercial power. That distrust over time has become increasingly manifest throughout the world in attempts to use the criminal law, which is viewed, though not necessarily altogether correctly, as the most potent weapon to control corporations.

### **Railroads and reform**

The principle of corporate criminal liability developed slowly but inexorably in the United States. It began in a rather inconspicuous manner, with regulations against boroughs and municipalities for such nonfeasance as failure to keep roadways clear and to attend to bridge repairs. Resistance to further expansion of corporate criminal liability rested on the incorporeal nature of the corporations. In a famous early Supreme Court ruling, Chief Justice John Marshall declared that the corporation was but ‘an artificial being, invisible, intangible, and existing only in contemplation of law’ (*Dartmouth College v Woodward*, 1819: 636). Similarly, John Salmond (1920: 285), another preeminent legal figure, argued that ‘ten men do not in fact become one person because they associate themselves for one end, any more than two horses become one animal when they draw the same cart’. At the time, these positions were little more than debating points. The first corporation in the United States was not organised until 1786, and by 1801 there still were only eight manufacturing companies in the country and only 317 corporations of all types (Blumberg, 1993: 6). Then came the railroads, swashbuckling across the country, killing unwary bystanders, setting fire to fields adjacent to their tracks, and using their extraordinary power to establish discriminatory and exorbitant haulage rates. After this and the proliferation of additional corporate entities, one writer could observe: ‘Given the ubiquitous nature of corporations in our society, economic and social considerations have preempted the importance of anachronistic theories and conceptual consistency’ (Clark, 1979: 917). More simply put, it had become high time to rein in the corporate world.

The rapaciousness of the railroad corporations elicited a call for reform from President Theodore Roosevelt in a 1905 message to Congress:

The fortunes amassed through corporate organization are now so large, and vest such power in those that wield them, as to make it necessary to give to the sovereign – that is, the government, which represents the people as a whole – some effective power over their corporate use. (Quoted in Litman and Litman, 1981: 650; for a similar view by the highly regarded Supreme Court Justice Louis Brandeis, see *Louis K. Leggett Co. v Lee*, 1933: 565)

The railroads were America’s first big business, and they made other businesses possible and necessary (Chalmers, 1976: 1); ‘in one way or another, every new economic disruption that arose was related to the railroads and their



practices' (Rubin, 1986: 1194). The manipulative actions of corporations were aided by a 1896 Supreme Court decision that guaranteed them the protections granted citizens by the Fourteenth Amendment to the constitution (*Santa Clara County v Southern Pacific Railroad*, 1896), with the prominent exception of the Fifth Amendment privilege against self-incrimination (*Hale v Henkel*, 1906; see also Henning, 1996). The so-called railroad 'Robber Barons' were described as 'cold-hearted, selfish, sordid men' (Boardman, 1977: 62) or, put another way, they were said to be 'scrupulously dishonest' (Lewis, 1938: 11; see also Haward, 2000).

It was against this background that the landmark court ruling in the United States endorsing corporate criminal liability was enunciated. The issue before the court concerned the payment by a railroad company of a rebate to the American Sugar Refining Company for shipments made from New York to Detroit. Such payments had been forbidden in 1903 by the Elkins Act which declared that if corporate officers, acting within the scope of their employment, gave rebates, the criminal offence could be imputed to the corporation itself. In its unsuccessful appeal to the United States Supreme Court, the corporation primarily relied on the argument that the punishment fell upon shareholders who were unable to defend themselves in court. The judges ignored this argument, and in what reads like an 'isn't-it-obvious' ruling asked rhetorically, if the authorities could not punish the corporation (although the assistant traffic manager was also convicted) how could they effectively deal with what they deemed a harmful and impermissible way of doing business? (*New York Central & Hudson River Railroad Co. v United States*, 1908).

The *Hudson River* case was the definitive declaration of the legitimacy of the principle of corporate criminal liability in the United States, although the court was able to cite a dozen or so prior rulings to buttress its conclusion, including what today stands as the rather painful decision of the Supreme Court earlier that year that upheld the criminal conviction of Berea College in Madison County, Kentucky, for admitting black students along with whites in violation of Kentucky's racial segregation law (*Berea College v Kentucky*, 1908).

### **Enforcement patterns**

Once accorded the imprimatur of the Supreme Court, the doctrine of corporate criminal liability expanded in regard to the acts proscribed. There was, for instance, a 1980 murder prosecution against the Ford Motor Company for the alleged defects of its Pinto model in which three young women were burned to death after a van crashed into the back of their car and the rear-end gas tank exploded (Cullen et al., 1987; but see Lee and Ermann, 1999). The state lost the case but not on the ground that it was barred from prosecuting a corporation for a homicide.

Much earlier a federal appellate court had held that a corporation that failed to provide adequate life preservers on one of its steamships could be guilty of manslaughter under a law specifically dealing with seagoing vessels. The wooden sideboard steamboat *General Slocum* had caught fire in New York's East River and, according to court records, 900 persons – 90 per cent of the passengers – perished by burning or drowning. The court ruled that the absence in the law of an appropriate punishment that could be visited on the Knickerbocker Steamship Company, which owned the vessel, did not exempt it from criminal liability, since this was but an inadvertent oversight on the part of the Congress and not indicative of an intention to immunise corporations (*United States v Van Schaick*, 1904). The captain of the ship was sentenced to ten years in prison, and pardoned by the president after serving three years. The company and its officers received nominal fines (O'Donnell, 2002).

The most important push favouring corporate criminal liability came from the American Law Institute's Model Penal Code (MPC) in the late 1950s (Brickey, 1988). Although the code writers had trouble justifying so unusual a variation from traditional criminal law precepts, they never seriously considered abandoning the principle and thereby unsettling what had become widespread precedents. There was, however, a dissenting voice among those commenting on the draft proposal: Glanville Williams, a Cambridge law professor, believed that it might have been preferable to re-examine the concept of corporate criminal liability *de novo* rather than to endorse what had developed. 'I know that the Reporter has told us that the whole trend of decisions is in favor of extending corporate liability', Williams observed, 'but he has also told us . . . that the case is not well reasoned on fundamental policy and it seems to me that the judges have not looked where they are going' (Williams, 1956: 159). Gerhard O.W. Mueller (1957), in a critique that remains valid almost half a century later (Geis and DiMento, 2002), maintained that the reflexive acceptance of corporate criminal liability was ill-advised because of the absence of empirical evidence regarding its utility. He surmised that enforcement efforts would largely produce monetary fines that would be seen as ordinary business operating expenses and would increase the cost of products and services to consumers. As we subsequently shall see, Mueller underestimated how virulent the doctrine of corporate criminal liability could become under particular circumstances.

The code set out three major foundations for corporate criminal liability. First is the respondeat superior standard. A corporation may be criminally liable for offences committed by agents acting within the scope of their employment and on behalf of the corporation if the legislature had clearly proscribed the alleged behaviour. The rule is moderated by a due diligence clause that specifies that criminal liability will not follow if 'the high

managerial agent having supervisory responsibility over the subject matter of the offence employed due diligence to prevent its commission' (American Law Institute, 1956: s. 2.07(4)). This caveat would be eroded in time so that any corporate employee, even if specifically warned to abstain from a particular illegal act, would render the corporation criminally liable if he or she none the less carried out the act. In the leading case, the president of the Hilton Hotel chain and the manager of the Hilton hotel in Portland, Oregon, told a purchasing agent that he was not to threaten suppliers with loss of business if the suppliers did not contribute to a fund to promote tourism. The court upheld the criminal conviction of the Hilton corporation, insisting that the Congress had intended to impose liability upon business entities for the acts of those to whom they chose to delegate their affairs, 'thus stimulating a maximum effort by owners and managers to assure adherence by such agents to the requirements of the [law]'. In this case, the agent was acquitted; the corporation convicted (*United States v Hilton Hotels Corp.*, 1972).

A later due diligence case involved the federal Currency Transaction Report Act which requires banks to report all withdrawals of more than \$10,000. On 31 occasions James McDonough wrote multiple cheques, each one for an amount under \$10,000, but together totalling more than that amount. The Bank of New England was convicted of failure to obey the law, and its appeal claim that it had exercised due diligence was rejected by the trial judge whose instructions to the jury would be endorsed by the appellate court: '[I]f any employee knew multiple checks would require the filing of reports, the bank knew it, provided the employee knew it within the scope of his employment' (*United States v Bank of New England*, 1987: 855).

The US Sentencing Commission, while promulgating a schedule of tougher sentences for corporate criminal activity in 1991, supplemented the due diligence principle with a provision that permitted judges to mitigate penalties if the entity could demonstrate implementation of policies and programmes aimed at inhibiting the offence before it occurred. At first, such mitigation was not permitted if the crime was committed by more senior employees with managerial responsibilities, but this exception was eliminated when the Commission in early 2004 made its first overhaul of the organisational sentencing guidelines. The Commission originally had proposed longer possible sentences for corporations but retreated in the face of powerful business lobbying efforts (Rodriguez and Barlow, 1999). In practice, however, relatively few corporate crime cases reach the trial and sentencing stages; settlements are very much more common (United States Sentencing Commission, 1991; see also Fatino, 2002; Laufer, 2002; Murphy, 2002). The accused's awareness of the stringent mandatory penalties demanded by the sentencing guidelines often serves to induce negotiated guilty pleas.

A second provision of the MPC declared that a corporation may be held

criminally responsible 'if the offence consists of an omission to discharge a specific duty imposed on the corporation by law' (American Law Institute, 1956: s. 207.1(b)). The final section specified that a corporation can incur criminal liabilities that are defined under a penal code if what was done was 'authorized, requested, commanded, performed, or recklessly tolerated by the Board of Directors, or by another managerial agent acting on behalf of the corporation within the scope of his office or employment' (ibid.: s. 207.1(c)).

In time, the code was duplicated in many respects by state jurisdictions and relied on in judicial rulings, though it was not until 1974 that Texas, the final holdout, adopted the doctrine of corporate criminal liability (*Vaughan & Sons, Inc. v State*, 1987; Hamilton, 1968; Kramer, 1989). Legislatures and courts, however, as Brickey (1988: 631) points out, have 'picked and chosen at random from the grab bag of rules'.

That the penalties for corporate criminal acts are getting much tougher appears to be a consequence of the fact that the American middle class increasingly has become involved in stock transactions: at the turn of the present century some 40–50 per cent of Americans owned corporate shares compared to, for example, Germany, where only 5–7 per cent of the people did so (Benner, 1999: 57). However empathetic you might be, it is one thing to hear of others who suffer losses because of illegal behaviour; quite another thing when you personally are the victim.

It is notable that US regulatory agents typically (though by no means always, as we shall see in the initial case discussed below) adopt an adversarial stance, based on the assumption that a corporation will try to get away with everything it can (Kagan and Scholz, 1984), while in England the attitude of inspectors tends to be that cooperation is the best way to achieve mutually desirable outcomes (Hawkins, 1984). There is a 'perverse effects' thesis that argues that the tough enforcement patterns in the United States create disincentives to report and quickly remedy corporate legal problems (Khana, 1996).

The erratic nature of enforcement efforts in the United States can be seen in the two illustrative cases discussed below.

### **Occupational danger: the Moeves case**

The irresponsibility of regulatory agents was painfully illustrated by an investigative newspaper reporter who examined the deplorable performance record of the Moeves Plumbing Company in Fairfield, Ohio, and the pusillanimous bureaucratic response of the federal Occupational Safety and Health Administration (OSHA). The lead paragraph of the story sets the stage:

As the autopsy confirmed, death did not come right away for Patrick M. Walters. On June 14, 2002, while working on a sewer pipe in a trench ten feet deep, he was

buried alive under a rush of collapsing muck and mud. A husky plumber's apprentice, barely 22 years old, Mr. Walters clawed for the surface. Sludge filled his throat. Thousands of pounds of dirt pressed on his chest, squeezing and squeezing until he could not draw another breath. (Barstow, 2003: 1)

The OSHA law mandates safety training for persons who work in potentially dangerous digs in order to create a sheltered workplace. There must be inspections beforehand by a 'competent person', the construction of sloping walls, the use of a ladder, and the placement of a metal box shield in excavations more than five feet deep. None of these provisions had been met in the Walters case, nor had they been in place in 1989 when another Moeves worker was buried alive under nearly identical circumstances.

OSHA law, severely emasculated by the business community when it was enacted, calls for criminal penalties only when there is a death that is caused by a wilful violation of safety laws, meaning that the company demonstrated either 'intentional disregard' or showed 'plain indifference' (Clay and Geis, 1980). Linda Moeves had taken over Moeves Plumbing after her husband's death and her unfamiliarity with regulations and her promises of reform had shielded the business from criminal liability in 1989; it received a \$13,700 fine for the death of its employee at that time.

Efforts by Walters's family and some authorities to secure a criminal prosecution as retribution for his death ran into endless blockades. First, OSHA had to define the neglect as 'willful', and then it had to convince the Department of Justice to take on the case. Ultimately, OSHA issued a finding that Moeves had committed one 'willful' violation by failing to provide protection against a collapse. But a day later the word 'willful' was redacted and replaced by 'unclassified', a term coined by corporate lawyers. It disallows criminal action though it carries heavier fines than a regular charge and requires an agreement to make significant safety improvements. Walters's father, saying that the government betrayed his son's memory, vowed to fight OSHA for the remainder of his life. His son's body was interred in a mausoleum rather than buried.

### **Corporate corruption: the Enron/Andersen case**

Arthur Andersen, formed in 1913, had been the auditor for Enron since 1985, and had seen Enron grow into the seventh largest company in the United States. The relationship between the two organisations had become quite cosy; there was a revolving work pattern that saw employees move casually from jobs in one company to positions in the other (Fox, 2003; Schwartz and Watkins, 2003). Meanwhile, Andersen endorsed patently fraudulent book-keeping schemes that Enron executives had concocted. Enron had run up huge debts that it avoided declaring in its annual reports by transferring them to

paper partnerships that had been established to hide the company's true financial condition. The partnerships, allegedly as many as 3,000 of them, were defined as independent entities but actually were closely controlled by Enron executives who profited sensationally from such arrangements. Kenneth Lay, Enron's onetime CEO, had divested himself of stock and stock options worth more than \$200 million shortly before the company collapsed (Squires et al., 2003).

Arthur Andersen was one of the 'Big Five' of America's leading accounting firms, with 350 offices in 84 countries and 85,000 employees. It was receiving \$52 million a year in auditing and consulting fees from Enron, its major client.

The government essentially were fed up with Arthur Andersen's repetitive wrongdoing. A year before its Enron troubles, Arthur Andersen had paid \$110 million to settle a class action suit brought by stockholders of Sunbeam. Andersen's auditors had also failed to detect a Ponzi scheme (Wells, 2000: 23–70) run by the Baptist Foundation of Arizona, and settled complaints for \$217 million. Then there was a \$7 million payout in a suit involving an inflated earnings statement by Waste Management, a conglomerate controlling regional garbage collections, environmental companies and other businesses. As part of that settlement, Andersen had specified that it would not again engage in such behaviour. The end came after a six-week criminal trial in which Arthur Andersen was found guilty of complicity in the Enron law-breaking. The prosecution had focused its case on the shredding of relevant papers at Andersen offices in Houston, Portland (Oregon), Chicago, and London after managers had learned that the government was suspicious of their auditing of Enron. More than a ton of documents was destroyed as well as some 30,000 e-mails and computer files. Its reputation destroyed, its clientele fleeing to calmer harbours, the company went under, sentenced to death by the doctrine of corporate criminal liability, though the more reasonable interpretation might be that Enron was not killed but had committed suicide. Stephen Rosoff and his colleagues sum up the events aptly: 'The company now acknowledges that it made what it terms "errors in judgment". One could respond that wearing a striped tie with a plaid shirt is an "error in judgment". What Arthur Andersen did is a *crime*' (Rosoff et al., 2004: 294).

The Andersen case undercut the common observation in studies of corporate criminal liability that criminal penalties at best will have only a short-term effect on the guilty business. The argument has been that few customers will stop purchasing toothpaste if the company whose brand they prefer is accused of colluding in an antitrust agreement with competitors. Nor will an occupational health and safety violation impact profit margins of a multinational corporation. During the Vietnam war, the Dow Chemical Company, the manufacturer of Agent Orange and napalm, poisons used against Vietcong soldiers

and civilians, was boycotted by protesters in the United States and paid out \$180 million to American servicemen to settle their claims against it (Schuck, 1987). But it did not require the lapse of much time before Dow Chemical's role in the wartime tragedies that had aroused so much fury was largely forgotten – and the company prospered.

Arthur Andersen, however, relied not only on the integrity of the work it performed but also on its good name. Nobody truly had to have their auditing services; the same services were readily available elsewhere. Taint and dishonour drove a huge enterprise into the ground. The first to flee the sinking ship were the overseas branches which typically arranged to go independent or to merge with other firms.

But the story did not end there. In mid-2005, a unanimous US Supreme Court agreed with the company's claim that the shredding of papers – the core of the government's case – could have been part of a legitimate 'document rotation policy' (*Arthur Andersen, LLP v United States*, 2005). Most interpreted the court decision as evidence of the difficulty of successfully prosecuting even egregious corporate crimes. Others observed that the ruling was a meaningless victory. Arthur Andersen was defunct; its empire destroyed.

### **The Sarbanes–Oxley Act**

The demise of Arthur Andersen was probably the most eye-opening consequence in the panoply of corporate scandals that surfaced in the United States soon after the beginning of the new millennium. Previously, such law-breaking had been shrugged off as an unfortunate but exceedingly rare occurrence. But analysts now insisted that the kinds of scams that marked the affairs of Andersen, Enron, WorldCom, Global Crossing, Adelphia, ImClone, and Tyco International were not uncommon, but had remained in the dark during periods of financial prosperity. Earnings were wildly inflated but the manipulations could be camouflaged so long as onlookers were becalmed by a heady rise in the value of their holdings (Glasbeck, 2002). There was some irony in the situation because executives in competing companies, who operated honestly, were being downgraded for their failure to show a growth rate equivalent to that of the cheaters.

Legislators in the United States commonly react, as we noted earlier, to scandals such as that at Enron and its criminal compeers with new laws that often are more symbolic than satisfactory. They try to close loopholes, almost invariably increase penalties, and hope for the best.

The Sarbanes–Oxley Act (more formally known as the Public Company Reform and Investor Protection Act, 15 USC 7245–7256, 2002) is the legislative consequence of the outbreak, or perhaps the discovery, of corporate law-breaking. It applies to publicly held companies and to certified public

accountants, though companies not registered in the United States, a growing roster, remain beyond its reach. The legislation addresses one of the more egregious outrages of the Andersen case by forbidding auditors to engage in non-audit services for a client unless such services are approved by the client's board of directors. It mandates that CEOs and CFOs attest to the honesty of the company's quarterly profit-and-loss statements. If the certification is false, the CEO and/or the CFO must reimburse the company for any equity-based compensation and any profit from the sale of stock received during the year following the non-compliant audit report. It also prohibits executives and other specified company officers from accepting employment with the company's auditor for at least two years after they have given up their original position. In addition, the statute of limitation for corporate offences was changed to two years from the time of the discovery of the act or five years from the time of the commission of the alleged crime, thus overturning a Supreme Court decision that had invoked a shorter time period during which an offender could be prosecuted (*Lampf v Gilbertson*, 1991). Lead auditors must be rotated every five years, and an audit cannot be done by a firm for whom the CEO or CFO worked within the past five years. Also, audit documents must be retained for at least five years, and no personal loans can be made by a company to its executives.

The act created two new felonies. The first punishes any person or company that knowingly alters, destroys, mutilates, conceals or covers up any document or tangible object with the intent to obstruct or impede procedures of federal agencies or bankruptcy investigators. This represents what is undoubtedly the most severe – and arguably the most controversial – section of the act. Obstruction of justice is a rather ambiguous action, and it provides prosecutors with what can become a very heavy-handed weapon. John Ashcroft, the Attorney General, stressed the intent of the Department of Justice to employ this power whenever the department deemed it necessary: '[C]orporations that choose to prolong the damage to the public by refusing to cooperate with investigators should be forewarned – if you obstruct, if you impede – you leave your company vulnerable to public indictment, prosecution, and conviction' (Brief and McSweeney, 2003: 339).

The second new felony relates to the wilful destruction or secreting of corporate audit records. Punishments are set at a maximum of 20 years for the first-named offence; ten for the second. But these standards will automatically be pre-empted by the already-extant sentencing guidelines. This being so, the Sarbanes–Oxley Act encourages the sentencing commission to re-examine those standards with an eye to making penalties more severe (Zelitzer, 2002).

That the Sarbanes–Oxley Act is no panacea although it may be an improvement on current arrangements was highlighted by developments soon after it was signed into law. The measure calls for the appointment of a Public



Accounting Oversight Board that is to establish auditing standards. The first person appointed chair of the committee was seen as so beholden to corporate interests that he had to resign before he was confirmed in office. When the board first met it voted each member an annual salary of \$432,000 and its chair more than half a million dollars. These initial moves seemed to many onlookers more in the spirit of the financial piracy that had led to the creation of the board than in the spirit of commendable public service.

### **Conclusion: corporate governance**

The doctrine of corporate criminal liability has produced a voluminous outpouring of scholarly analyses. An attempt by the current authors and a colleague to put together a bibliography of this material located 718 references, most of which have appeared in the last three decades (DiMento et al., 2000–01). Today, the spotlight is focused on what is labelled ‘corporate governance’.

Basically, corporate governance guidelines call for sufficient oversight by boards of directors to ensure that the business obeys the law and the interests of customers and shareholders are adequately protected. Warren Buffett has indicated that ‘the ability and the fidelity of managers have long needed monitoring’ and that ‘accountability and stewardship withered in the last decade’ because ‘too many people in recent years have behaved badly at the office, fudging numbers, and drawing obscene pay for mediocre business achievements’ (Buffett, 2003: 16). This last observation was reinforced by a survey based on corporate proxy statements that found that the total direct compensation of the highest officer of major American companies – a figure that includes salary, bonuses, gains from options exercised, other long-term incentive payouts and the value of restricted shares – advanced 16.4 per cent from 2002 to 2003, and reached an average annual sum of \$3.6 million a person (‘The boss’s pay’, 2004).

Buffett indicated that boards of directors must be more diligent in discovering and firing inept and/or corrupt managers, and suggested, on the basis of his own lifetime service on the boards of 19 companies, that the problem often lies in the unwillingness of well-mannered directors to rock the boat by questioning what might be unsavoury activities. Buffett suggested that boards meet outside the presence of company executives. At Berkshire-Hathaway, the company he runs, Buffett pointed out that directors are paid but a pittance so they have little to lose by speaking up when they think something is awry. In addition, and uncommonly, they are not provided with liability insurance. This approach, Buffett said, had saved the company millions of dollars over the years (Buffett, 2003).

The dramatic consequence of the failure of corporate governance is reflected in the results of the 2004 survey of the reputations of American

corporations. 'Big corporations', the report noted, 'are stuck in the doghouse', despite the two years that had gone by since the height of the scandals in the corporate world. Conducted by the Hartt Interactive and the Reputation Institute, a Rochester, New York survey organisation, the questioning of 22,000 respondents found that 'the public's scorn runs deeper than the scandals'. Company scores had dropped in regard to customer service, environmental policies, and the treatment of employees. A senior vice president of the survey firm noted that 'too many companies think they can simply advertise their way out of a bad reputation' (Alsop, 2004: B1).

Corporate criminal liability, it appears, reflects that age-old distrust of the power and the temptations that permeate the world of business. A primary reason for the failure of law to be able to control corporate crime satisfactorily may lie in the fact that legal institutions are made to last, whereas business institutions are designed for rapid adaptation to changing economic and technological realities (Ayres and Braithwaite, 1992: 110).

Whatever the core explanation, it is clear that the use of the doctrine of corporate criminal has captured the attention of Americans, at least temporarily. Our crystal ball becomes a bit murky when we try to peer into the future of the doctrine in the United States. But two matters stand out, working in opposing directions. First, the plethora of corporate scandals that recently have come to light has alerted politicians and their constituents to the possibility of serious corporate wrongdoing. It is arguable whether the wrongdoers are bad apples in an untainted barrel or whether they are part of a large group of malefactors who pervade the corporate world, only a few of whom happened to get caught.

Second, although there was a great flurry of community concern and extensive law enforcement action in the wake of the scandals, the subject of corporate crime lost a good part of its hold on the public imagination when the country's armed forces invaded Iraq and the uncertainty and horrors of the Iraqi occupation came to dominate public discussion.

It seems evident that corollary conditions will have a very strong effect on the future of corporate crime control. If there are no overshadowing events, we would predict that there will be a serious and continuing effort to place corporations on a much tighter leash. For one thing, the American public is deeply concerned about the migration overseas – the outsourcing – of jobs, and if unemployment and inflation grow to unacceptable proportions it is likely that further criminal sanctions for corporate misconduct will be the order of the day. In addition, with the very large deficit that the country now runs, it is likely that corporations will be taxed much more heavily and criminal penalties imposed to make certain that they pay what they honestly owe.

It is likely that in certain areas of law, such as that related to environmental protection, focusing on the corporate entity as defendant will fluctuate

dramatically with changes in administration and publicity given to major environmental violations (DiMento, 1993; Page et al., 1999; DiMento and Forti, 2001; Jalley et al., 2002).

The Internal Revenue Service (IRS) now requires 38 months to audit corporate tax returns, an important explanation for why the IRS was not involved in uncovering any of the notorious scandals. Tax collections from corporations fell to \$133 billion in the 2003 fiscal year that ended on 30 September, the second lowest total since 1983. In 1970, corporations contributed 17 per cent of the nation's budget by their tax payments; today, that figure has dropped to 7 per cent. The 1,300 largest corporations are audited rather scrupulously by the government, but the 148,000 other corporations have but a 4 per cent chance that their tax return will be scrutinised by IRS agents.

The decline in assessments paid by corporations, nobody seriously disputes, is in some considerable measure the result of fraud that goes undetected, with estimates ranging as high as \$20 billion a year being illegally withheld from the government (Weisman, 2003). Besides more efficient, timely, and comprehensive auditing, it is not beyond imagining that criminal enforcement agencies might begin to intrude more directly into corporate affairs, perhaps to the extent of placing undercover agents on the premises of suspected law violators.

Beyond these measures, there probably will come a time when corporations will be required to register in the federal jurisdiction, thereby homogenising what now are the variegated requirements of the states, some of which compete for business by making particularly indulgent rules for corporate bodies. There also inevitably will be unpredictable developments, but there is no question that corporate criminal liability is a growth industry.

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# 10 Moral indifference and corporate manslaughter: compromising safety in the name of profit?

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Evil should not be unrecognised merely because it is as banal as indifference; indifference rather than intent may well be the greater cause of avoidable human suffering . . . (Box, 1983: 21)

## **Introduction**

Many of us in western societies view corporations to be integral to the high standards of living we experience. Equally, it is true to say that few of us reflect upon the harmful consequences of corporations' profit-seeking activities. In fact to some readers it may come as a bit of a shock to read the levels of fatalities caused by corporate activity. In 2002/03, according to the figures of the Health and Safety Executive (HSE), 227 workers died from fatal injuries (HSE, 2003). Unfortunately, this figure is only the tip of the iceberg. Tombs (1998: 78) suggests that the data are 'far from complete'. Glaring omissions include the exclusion of deaths in certain sectors (for example, sea fishing; deaths of workers in road traffic accidents; and deaths resulting from occupational-related diseases), thus, taking the employee death toll each year into the thousands. Slapper's (1999) empirical study of deaths at work revealed that between 1965–95, there were a total of two manslaughter convictions. However, during this period 20,000 people were killed in work-related accidents and this does not include the estimated 10,000 or more who die every year from work-related medical conditions. While workers are the more likely victims of corporate activity, members of the public, consumers and passengers have also paid the ultimate price. Corporations have also been implicated in a series of 'disasters' including the Zeebrugge ferry sinking, the King's Cross fire, the Piper Alpha oil rig fire, the Clapham train crash, the Purley train crash, the *Marchioness* sinking, and more recently, the Southall, Ladbrooke Grove and Hatfield train crashes (Slapper, 1999). A total of nine disasters, 524 people dead and yet not one successful manslaughter prosecution.<sup>2</sup> In short, corporations would appear to be getting away with murder on an unimaginable scale.

This chapter will explore why in spite of these levels of harm only three corporations have ever been successfully prosecuted for gross negligence

manslaughter. The focus of this chapter is upon the inadequacies of the criminal law which it is acknowledged is not the sole reason for the low conviction rate. As other writers correctly note, the enforcement policy of the HSE and police and the reluctance of the Crown Prosecution Service to prosecute are all contributory factors (Bergman, 1997; Slapper, 1999). The specific concern of this chapter relates to the failure of legal thinking to protect workers, passengers and consumers from the root causes of corporate killing. As Box (1983) suggests in the quotation above, indifference rather than intent may well be the greatest cause of avoidable human suffering. In the context of corporate manslaughter, it will be argued that the cultures of indifference to human safety in the pursuit of profits that have come to be ingrained within corporate policy and management should be the concern of criminal law.

The rest of the chapter is divided into four sections. The first draws upon criminological and sociological literature to identify the ‘causes’ of these deaths. The second develops the notion of indifference, to explain the features of corporations that subjugate ‘moral’ considerations for the safety of others to company profit and self-interest. The third will review the contemporary legal position in relation to corporate manslaughter in the UK. It will be demonstrated that the current legal approach fails to tackle the root causes of corporate manslaughter. The final section reflects upon the suggested policy reforms in the UK to the law of corporate manslaughter.

### **A political economy of corporate manslaughter**

Before outlining the underlying causes of corporate manslaughter it is first necessary to rebut a common misconception attached to workplace ‘fatalities’ and ‘disasters’: that they predominantly result from human error. As Pearce and Tombs (1998: 128) argue:

And for human error one should actually read employee error, a general category covering a variety of particular causes – for example carelessness, recklessness . . . such arguments are unsustainable either at an empirical or a theoretical level . . . [C]ertainly, where any *particular* accident is subject to critical scrutiny, the results typically suggest that causation is more adequately located within management or, indeed, within organisational structures or standard operating procedures.

Slapper (1999) has reviewed a number of HSE reports identifying the circumstances of death in certain industrial sectors. These reports concluded that management failings were responsible for accidents in 70 per cent of cases within the construction industry and in 62 per cent of cases within agriculture.

This section seeks to understand the management failings which result in these accidents. A considerable body of criminological literature has drawn upon Émile Durkheim’s concept of ‘anomie’ and Robert K. Merton’s later



adaptation to explain the social psychology of corporate offending (Slapper and Tombs, 1999). Merton described social situations and individual behaviour arising from the disparity between culturally defined goals and the availability of institutionalised mechanisms to fulfil these goals. While Merton primarily applied this concept to 'blue-collar' crimes, Box (1983) later used this notion in the context of corporate 'deviance'. For Box, corporations are breeding grounds of deviance from the norms and moral codes of wider society where concerns for human safety give way to the pursuit of profit. As Box succinctly remarks:

It is a goal-seeking entity which makes a corporation inherently criminogenic, for it necessarily operates in an uncertain and unpredictable environment such that its purely legitimate opportunities for goal achievement are sometimes limited and constrained. Consequently, executives investigate alternative means, including law avoidance, evasion, and violation and pursue them if they are evaluated as superior to other available strictly legitimate alternatives. (ibid.: 35)

The sources of environmental uncertainty for corporations identified by Box included competitors (price structures, evolving technology, mergers and so on); governments (expansion of regulatory structures); employees (trade union activity); consumers (elasticity of demand) and public (growing environmental awareness and so on). Although a number of organisational characteristics could be viewed as 'promoting' corporate deviance, Box did not believe that all corporate actors would behave in a similar way. Thus corporate structures are crime facilitative rather than coercive in two respects. First, corporate officers may impair their career by allowing considerations other than profit to cloud their judgement. Second, those who advance their careers and ultimately the goals set by the corporation are duly rewarded. Hence, at the apex of the corporate structure one will find individuals whose personal goals coincide with that of the corporation in a mutually rewarding relationship. These observations are comparable with those of Needleman and Needleman (1979), who consider the facilitative aspects of the market structures in which corporations operate.

The rewards system which co-opts corporate actors into the tireless pursuit of profit to the detriment of other considerations deserves closer attention. For Passas (1990) this system co-opts not only those within the hierarchy of the organisation but also middle-ranking actors who aspire to greater things. Thus, the pressure to conform to corporate goals is felt far further down the organisational chain of command. According to Passas (ibid.: 165) these pressures lead to a multitude of 'rationalisations and systematised beliefs about the business like way of dealing with things'. Eventually, these 'rationalisations and systematised beliefs' lead to 'deviant subcultures' where rule-breaking becomes the norm guided by attitudes such as 'business is business' and 'we

are not in business for our health' (ibid.: 165). Gross (1978) has identified the distinctive characteristics of those who attain top positions. In one sense, Gross's findings were fairly unremarkable: those who held top positions were ambitious, competitive, shrewd and so on. However, Gross's observation that these actors are 'possessed of a non demanding moral code' (p. 71) is particularly useful. It would appear that these actors are able to remove themselves from the confines of extra-organisational moral codes in order to pursue organisational goals. This point will be further considered below.

The use of anomie in this way has certainly informed our understanding of corporate offending, however its focus has failed to locate the production of corporate harm within wider social relations. An idea first espoused in the work of Marx ([1867] 1990) and Engels ([1892] 1987) which recognised that the harms visited upon workers should be attributed to the organisation of capitalist society. This is illustrated by Marx's commentary on the Factory Acts:

[T]his part of the Act strikingly demonstrates that the capitalist mode of production, by its very nature, excludes all rational improvement beyond a certain point. It has been repeatedly noted that the English doctors are unanimous in declaring that where the work is continuous 500 cubic feet is the very smallest space that should be allowed for each person . . . Factory legislation is therefore brought to a dead halt before these 500 cubic feet of breathing space. The health officers, the industrial inquiry commissioners, the factory inspectors, all repeat, over and over again, that it is both necessary for the workers to have these 500 cubic feet, and impossible to impose this rule on capital. They are, in reality, declaring that consumption and the other pulmonary diseases of the workers are conditions necessary to the existence of capital. (Marx [1867] 1990: 612)

Thus, if we are to fully understand the reality of these harms our analysis must refer to the social organisation of production. Slapper and Tombs (1999) identify two features of capitalist society which are fundamental to such an explanation. The first relates to profit maximisation. The capitalist mode of production is based upon extracting the greatest surplus value from labour. Similarly, other social relations are reduced to economic calculus. Consequently, 'business' decisions have a 'rational economic' rather than moral basis. One of the best-known examples of this amoral calculus to decision-making involved the Pinto car made by Ford introduced in 1970 to the American small car market. During production a design fault was identified, namely that the fuel tank was prone to rupture in the event of low-speed impacts. Ford decided it would cost the company less to pay compensation for injury and loss of life than to recall the vehicle and correct the fault (Swigert and Farrell, 1980–81; Box, 1983). It is estimated that between 500 and 900 people lost their lives because of this decision (Box, 1983). As Swigert and Farrell (1980–81: 166) note, 'the use of human life in calculations of corporate profits is by no means unique to Ford Motor Company'. Such calculations are

deeply ingrained within capitalist society, promoted by legal structures that produce compensation figures for human life and used by corporations in their cost–benefit analyses. The second relates to the commodification of human relations. Within this social system values are determined not by intrinsic worth but by exchange (Snider, 1993). Slapper and Tombs (1999: 144) recognise that a society in which the social production of goods is governed by profit considerations makes human sacrifice inevitable: ‘The problematic force, then, is social – it originates systemically – and the decisions, made by individuals, which endanger life are results of the underlying hypostatic grammar of economic reasoning which under lies capitalism’. To support this assertion one may point to Slapper’s (1999) empirical research which found that 60 per cent of deaths at work are directly attributable to the pressures of profit maximisation.

An analysis which focuses exclusively upon the organisation fails to recognise the coercive economic forces that commodify human relationships and reduce business decisions into amoral calculations. However, micro-level analyses improve our knowledge of safe working conditions. Although this author would argue that fundamental changes are required to the mode of production for deaths at work and disasters to be seriously reduced, this does not prevent critical scholars from proposing changes to the present structures of capitalist society. Pearce and Tombs (1998: 135) point out:

[T]here is an ultimate and inevitable truth to the argument that profit maximisation within capitalist economies is the most fundamental cause of industrial accidents . . . there is a need to move beyond this and also develop an appreciation of its articulation within a complexus of second order causes of accidents and thereby an understanding of whether, and how these may be prevented.

Those corporations that promote long-term profit over short-term gain will ensure that safety considerations figure more highly in commercial operations. Consequently, the criminal law should promote practices which lead to safer conditions for workers, passengers and consumers, just as it would seek to safeguard physical integrity from common assault, rape and so on. While the criminal law may fail to prevent harm from occurring it must be recognised that ‘social ideas generated by and reactive to the political economy can fructify into new law and policy’ and in turn ‘change the way companies and executives behave’ (Slapper, 1999: 5). If this is to be achieved then the causes of corporate manslaughter must be fully understood and subsequently reflected in law and policy.

### **The production of ‘moral indifference’ in corporate actors to human suffering**

This section introduces the notion of moral indifference and demonstrates its utility to understanding the production of harm by corporations. It will be

argued that because of the preoccupation of criminal law with harm caused by intent rather than indifference, or, direct acts rather than indirect acts, the criminal law has proved a blunt instrument in safeguarding human life against capitalist excesses.

Although never using the term ‘moral indifference’, Reiman’s (1979) analysis has drawn attention to the ambiguities in legal reasoning relating to harmful acts. For Reiman, jurisprudence is constructed upon an erroneous premise: that one-on-one harmful acts are ‘more evil’ than the harm caused by indirect acts. On the contrary, he contends:

Two lovers or neighbours caught in a heated argument – one kills the other. Such a person is a murderer and rightly subject to treatment by the Criminal Justice System. I make no bones about this. But is this person more evil than our executive who chooses not to pay for safety equipment? I think a perfectly good case can be made that starts without ordinary moral notions and ends up with the opposite conclusion. (Ibid.: 60).

The executive who serves to jeopardise the lives of unspecified others for the sake of increased profit demonstrates a ‘general disdain for all his fellow human beings’ (ibid.: 60). Hence, ‘it is surely absurd to hold that he is less evil than the passion killer’. He urges us to ‘free our imagination from the irrational shackle of the one-on-one model of crime’ (ibid.: 60). Box (1983) reiterated much of Reiman’s analysis but exchanged the couplet ‘direct/indirect’ harm for ‘intention/indifference’ (ibid.: 60). The latter is an important distinction and aids our understanding of corporate manslaughter. Both writers demonstrate that the indirect harms caused by corporations far exceed those caused by one-to-one violence and accordingly warrant the full attention of criminal law. The source of this harm results from management indifference to human safety because of a preoccupation with profit.

The contributions of Reiman and Box are relatively brief in nature and leave theoretical and empirical gaps to be filled. Zygmunt Bauman’s work on morality offers further insights into the ‘moral indifference’ of corporate actors. In *Modernity and the Holocaust* (1989), he demonstrated the facets of modernity which made the holocaust possible and specified a number of processes resulting in the moral manipulation of actors. These are of considerable utility to the analysis of both bystanders and perpetrators of corporate harm. Bauman was particularly concerned with explaining how ‘ordinary’ people in the bureaucracy of the German state took part in the holocaust. The starting point for the manipulation of an actor’s moral responsibility to others begins with the physical and spiritual separation of society. Both of these levels are clearly applicable to corporations. Physical separation applies to medium and large corporations where directors and senior managers are far removed from their victims (workers, passengers and customers). The spiritual

separation of society refers to the commodification of social relations considered above where decisions affecting the safety and lives of others are reduced to economic considerations (Slapper and Tombs, 1999). For those in corporate hierarchies human beings are only units of labour, the source of surplus value and so on.

This separation process is integral to what Bauman (1989: 188) terms 'the social suppression of moral responsibility'. Directors remove those individuals whose physical integrity is compromised by their decision-making from their realm of moral duty. Instead, directors' decision-making occurs in a moral realm where the primary moral obligation (and principal legal duty in the UK) of a director is to the corporation's balance sheet and to shareholders for increasing dividend returns. Those making the decision that endangers human life are not required to implement it. Individuals on the 'factory floor' implement these decisions as part of their job with little or no capacity to challenge them. Their responsibility is to perform the act at the rate and to the level of performance dictated by their line managers. An inherent danger in capitalist societies characterised by large-scale divisions of labour is the moral indifference of corporate actors to actions falling outside their sphere of experience. Directors and managers in large organisational structures who prioritise profit over safety are not unduly concerned by the actions and potential consequences of their employees (the train driver who travels through a red light and so on) as long as they are performed in accordance with this goal.

The consequence of this division of labour is 'the social production of distance'. For Bauman (1989: 192) the relationship between human proximity and morality 'seems to conform to the law of optical perspective'. Thus, as distance increases, responsibility for the other would appear to be reduced. Moral indifference is inherent in the structures of industrial society because the effects of human action far exceed an actor's moral visual capacity. A number of intermediaries stand between a decision made by directors and its implementation, thereby ensuring that they do not experience the consequences of these actions. For those employed at the bottom of the company their obligation to the 'mini-moral community' of the production line is to perform their predetermined task, whereas the 'mini-moral community' for those in the boardroom is governed by profit maximisation (*ibid.*: 196). The latter 'mini-moral community' certainly rejects extra-organisational moral codes for the other. It was noted above that Gross describes these individuals as being 'possessed of a non demanding moral code'. This is not purely an ideological phenomena. The moral silence of those at the top is guaranteed by the rewards offered by the corporation. As Passas (1990) observed, the corporation's goals more often than not coincide with the self-interest of its directors, as well as serving to co-opt those in the corporation who aspire to these

rewards. Hence, the ‘mini-moral community’ of the boardroom and senior management are underpinned by a series of lucrative material incentives.

Kermit Vandivier’s (1996) account of the A7D brake fraud conducted in the name of B.F. Goodrich Co provides an illustration for some of these assertions. Vandivier was an employee of B.F. Goodrich Co, then one of three major engineering companies in the United States during the 1960s making aircraft brakes and wheels. The fraud centres around purchase order P-23718, placed by LTV Aerospace Corporation in June 1967, for 202 brakes dedicated towards a US Air Force plane. Previous dealings between the two companies had been acrimonious and until 1967, B.F. Goodrich Co had failed to secure any orders from LTV. In 1967 B.F. Goodrich Co submitted a bid which Vandivier (1996: 119) described as ‘absurdly low, to LTV to supply the A7D’. B.F. Goodrich Co was willing to assume a short-term loss on the original production of the brake in the expectation that the Air Force would have to buy parts from the company for the lifetime of the aircraft.

Once the order was placed, work began on producing the brake. An engineer, Searle Lawson, who was responsible for the final production design, ran a series of tests on the brake and found that it was overheating. Lawson concluded that the surface area of the brake was too small and a five disc brake was required. This would involve scrapping the original plans, starting again and possibly losing the order. Lawson reported this to his line manager, John Warren (the brake designer) and then Warren’s manager Robert Sink. Both told Lawson to continue to make the brake work. Fans were deployed to cool the brake in order to ‘mislead’ LTV about the brake’s performance. At this stage, Vandivier was required to produce a qualification report to meet the safety standards stipulated by the Air Force. Vandivier, like Lawson, was unsatisfied by the performance of the brake, so he challenged Russell Line, a senior manager in his section. Again the company message was reiterated. Vandivier further questioned Line, asking whether he was not concerned by the fate of the test pilots who would have to land with faulty brakes. Line responded: ‘I just told you I have no control over this thing. Why should my conscience bother me?’ (Vandivier, 1996: 129). Vandivier chose to present a report which falsified the performance of the brake rather than resign over the matter:

At forty-two, with seven children, I had decided that the Goodrich Company would probably be my ‘home’ for the rest of my working life. The job paid well, it was pleasant and challenging, and the future looked reasonably bright. My wife and I had bought a home and we were ready to settle down into a comfortable, middle-age, middle-class rut. If I refused to take part in the A7D fraud, I would have to either resign or be fired. The report would be written by someone anyway, but I would have the satisfaction of knowing I had had no part in the matter. But bills aren’t paid with personal satisfaction, nor house payments with ethical decisions. (Ibid.: 129–30)

Fortunately, no one was seriously injured during the testing of the plane and B.F. Goodrich Co eventually replaced the brakes with a more heat-resistant model. Vandivier (ibid.: 119) notes that the message that emanated from the corporate hierarchy was that ‘we can’t bungle it this time’. The importance of time, efficiency and profit came to be embedded within the individual decision-making of Sink, Line and many others in the B.F. Goodrich Co hierarchy. Clearly Line and Sink’s moral responsibility conformed to the ‘law of optical perspective’: their loyalty was to the task in hand. Line felt no responsibility for the substandard nature of the brake since he had ‘no control over this thing’. Line and Sink’s ‘non demanding moral codes’ ensured their inertia and indeed the company rewarded their silence: Line and Sink were both later promoted. While this may seem absurd, Line and Sink had demonstrated their business acumen because neither allowed any consideration for the safety of others to enter their decision-making – they remained ‘rational’ economic actors. Although Lawson and Vandivier initially expressed their concerns they were co-opted by the corporation because their own material interests coincided with corporate goals. A culture pervaded B.F. Goodrich Co which promoted profit over safety. One may consider a number of individuals within the organisation as responsible. However, our attention should be directed to those who created these cultures where reward systems underpin moral silence and inactivity. The directors of B.F. Goodrich Co were indifferent to the harm their profit-seeking agenda may have caused and were also responsible for upholding systems that promoted the indifference of others to safety.

### **Corporate manslaughter: the legal position in England and Wales**

This section considers the current state of the criminal law in relation to corporate manslaughter. It will seek to demonstrate that the criminal law has failed to address the causes of corporate harm outlined above because of its inability to address the issue of moral indifference.

Under English criminal law, deaths caused by the activities of a corporation may fall under the rubric of involuntary manslaughter caused by gross negligence. This offence is governed by the ‘identification’ doctrine, which specifies that the culpability of a company may be determined by the actions of one of its ‘controlling officers’. The doctrine establishes criminal liability for acts done in the name of the company by employees who think and act on its behalf. Viscount Dilhorne (*Tesco Supermarkets Ltd v Natrass* [1972] AC 153: 187) stated that a criminally responsible individual would have to be someone ‘in actual control of the operations of a company or of part of them and who is not responsible to another person in the sense of being under his orders’.

Viscount Dilhorne confirmed the analogy used by Lord Justice Denning in *H.L. Bolton (Engineering) Co. Ltd v T.J. Graham & Sons* [1957] 1 QB 159:

A company may in many ways be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with direction from the centre. Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.

These rulings were again affirmed in *R v P&O European Ferries* (1991) 93 Cr App R 72 by Turner J, when he argued ‘where a corporation, through the controlling mind of its agents, does an act which fulfils the prerequisites of the crime of manslaughter it is properly indictable for the crime of manslaughter’ (at 84).

The *mens rea* of involuntary manslaughter is governed by the notion of objective culpability. An individual is guilty of corporate manslaughter if s/he did not appreciate a risk which would have been evident to an ordinarily prudent person in the defendant’s position. The prosecution must demonstrate that an individual has committed a breach of duty and this amounts to gross negligence. Several cases involving breach of professional duty of care during the 1990s clarified the nature of involuntary manslaughter. The Court of Appeal in *Prentice and Others* (1994) 98 Cr App R 262 sought to clear up the confusion which had arisen as a result of the *Lawrence* and *Caldwell* cases which had introduced the test of recklessness (*R v Lawrence* (1981) 73 Cr App R 1; *R v Caldwell* (1981) 73 Cr App R 13). In *Prentice and Others* the Court of Appeal confirmed that gross negligence is the proper test in manslaughter cases based on breach of duty. Lord Taylor in that case argued that:

[E]xcept in motor manslaughter cases, the ingredients of involuntary manslaughter by breach of duty which need to be proved are:

- i) The existence of the duty;
- ii) A breach of the duty causing death;
- iii) Gross negligence which the jury consider justifies a criminal conviction.

Furthermore, the states of mind which if proven would lead to a finding of gross negligence included:

- (i) Indifference to an obvious risk of injury to health;
- (ii) Actual foresight of the risk coupled with the determination nevertheless to run it;
- (iii) An appreciation of the risk coupled with an intention to avoid it but also coupled with such a high degree of negligence in the attempted avoidance as the jury consider justifies conviction;
- (iv) Inattention or failure to advert to a serious risk which goes beyond mere inadvertence in respect of an obvious and important matter which the defendant’s



duty demanded he should address. (*Prentice and Others* (1994) 98 Cr App R 269)

The House of Lords in *R v Adomako* [1994] 3 All ER 79 subsequently confirmed the Court of Appeal's decision in *Prentice*.

The identification doctrine appears straightforward: a prosecutor must demonstrate that an individual within the company hierarchy has satisfied the prerequisites for manslaughter. However, Tombs and Whyte (2003) argue that the current manslaughter law as stated in *Adomako*, has made prosecutions against directors difficult for two reasons. First, in law, companies not directors have a duty of care towards those affected by its activities. The larger the company the less likely it is that the prosecution will be able to argue that a director owed such a duty – because of the distance from the victim. Second, as most manslaughter charges relate to directors' failures to act, the absence of a legal duty upon a director to act in relation to the safety of his/her company's operations has proven to be a considerable obstacle to these prosecutions.

Unsurprisingly to date, there have been only nine company directors/managers convicted on these charges. These cases have common features.<sup>3</sup> They are demonstrated by the successful prosecution in *R v Kite and Others* [1994] NLJ 1714, which came in the wake of the Lyme Bay canoe incident which claimed the lives of four teenagers. Legal commentators have noted the unique nature of this case (Slapper, 1994, 1999; Lacey et al., 2003). As Slapper (1994: 1735) argues:

The company OLL Ltd was small, so it was relatively easy to find the 'controlling minds'; the risks to which the students were exposed were serious and obvious and also, critically, they were not technical or esoteric in any way . . . [F]or the prosecution there was also the serendipitous evidence of a letter (from a former employee) which indisputably made the managing director aware of the risks.

The prosecution brought against P&O in the wake of the Zeebrugge ferry disaster highlights the difficulties in bringing manslaughter charges against large companies. A total of 192 people died due to the sinking of the P&O ferry, *Herald of Free Enterprise*, which left port with its bow doors open. The prosecution collapsed due to insufficient evidence against the five employees. The judge concluded that there was no senior member of the company who could be identified as sufficiently reckless. The trial judge followed the ruling in *R v H.M. Coroner for East Kent* (1989) 88 Cr App R 10 which stipulated that the acts of individual defendants could not be aggregated to prove manslaughter. Bergman (1990: 1496) notes a number of evidential weaknesses with the Crown's case, making its collapse wholly inevitable: first, the inability to contest the defence's claim that the system in operation had 'worked without mishap over seven years'; second, current and former

employees of P&O who testified that there was no obvious risk in sailing with the bow doors open; third, four of the five previous 'open door' incidents were unknown to any of the defendants; finally, installing warning lights was not seen as necessary by either the Department of Transport or Lloyds Insurers.

The P&O case demonstrates the inherent difficulties in prosecuting a large corporation for manslaughter. Connecting an individual within the corporate hierarchy to the act of the ferry setting sail with her bow doors open was almost impossible given the size and levels of organisation within the company. However, as the Sheen inquiry (cited in Boyd, 1992: 504) stated: 'a full investigation into the circumstances of the disaster leads inexorably to the conclusion that the underlying or cardinal faults lay higher up in the Company'. The Sheen inquiry went further: 'The Board of Directors did not appreciate their responsibility for the safe management of their ships. They did not apply their minds to the question: What orders should be given for the safety of our ships?' (cited in *ibid.*: 504). From the testimonies to the inquiry, it is apparent that the motivation for profit lay behind the director's indifference to safety (Boyd, 1992; Crainer, 1993).

During the mid-1980s the competition in the cross-channel ferry market was acute. The British government's decision to privatise Sealink UK Ltd. unleashed market forces into an economy previously dominated by state-owned operators (Boyd, 1992). The situation was further exacerbated by the imminent opening of the Channel tunnel. Crainer (1993: 22) points out that the fears of the ferry operators over the competition anticipated from the tunnel soon turned into 'bullishness as they recognised that the tunnel was unlikely to eliminate completely the need for cross-channel ferries'. One Townsend-Thoresen representative suggested that it was possible to 'build a fleet of ships to equal the capacity of the tunnel and at half the price' (*ibid.*: 21). One outcome was an emphasis on achieving the optimum number of crossings. An internal Townsend-Thoresen memorandum stated that 'sailing late out of Zeebrugge isn't on' (Boyd, 1992: 503) and all masters and officers were required to explain to the Townsend hierarchy why delays of as little as ten minutes had occurred (Crainer, 1993). The pressure for a 'quick turnaround' at port and 'to sail at the earliest moment' was identified in the Sheen inquiry as one of the underlying reasons for the ferry's departure with the bow doors still open (*ibid.*). The turnaround had been conducted without all the water from the bow ballast tanks being pumped out, causing the boat to be 3 feet down as it left Zeebrugge port. As the ship left the port and picked up speed, water came through the open doors at a rate of 200 tons per minute.

Several employees had challenged aspects of the company's operations prior to the disaster. More often than not, management disregarded their safety concerns. For example, seven different masters had reported their ships to be carrying passengers which exceeded the capacity of their lifeboats. When one

captain urged the fitting of an indicator light on the bridge to monitor the bow and stern doors, management's response was '[n]ice but don't we already pay someone!' (cited in Boyd, 1992: 507). Days after the Zeebrugge disaster the lights were fitted in all of the company's ships. Finally, the installation of a high capacity ballast pump upon the Zeebrugge service was rejected in light of its cost: as the Sheen inquiry (cited in *ibid.*: 510) noted, £25,000 'was regarded by the company as prohibitive'.

The indifference to the safe operation of the P&O fleet was initiated by the company's hierarchy and is evidenced in the actions and thoughts of directors. It ran from the top of the company to the bottom and was ingrained in operations. Employee concerns were typically dismissed by management because they ran contrary to efficiency and profit. Clearly, those raising these issues did so out of a sense of moral responsibility to the safety of others. However, only action from the directors could have guaranteed the safe operation of the fleet. As the CCA (2000: para. 3.13) has argued in relation to the Zeebrugge disaster:

Even if every employee within the company had, on the day of the disaster had taken place, done everything they should have done, the company would still have been operating a dangerous system, which could only have been corrected by action on the part of the company directors.

The criminal law proves to be a blunt instrument in protecting human life against such operations. Indeed, one may argue that the criminal law has facilitated this behaviour: directors who distance themselves from issues of safety are unlikely to be connected in the eyes of the law to the harm they cause. In this instance, the directors and management were unaware that on four separate occasions ships in their fleet had gone to sea with their bow doors open. As Bergman puts it, '[t]he simple truth is that the larger and more disorganised a company, the less the criminal justice system can do to touch it' (Bergman, 1997: 1652).

### **Policy reform in England and Wales: creating a new corporate manslaughter law**

In 1996, the Law Commission took the opportunity during its review of involuntary manslaughter to propose a new offence of corporate killing. Since then, New Labour have made two election pledges to adopt the Law Commission's offence. Although these pledges remain unfulfilled, proposals for legal reform have been in circulation since May 2000. In fact, the Home Office has already consulted those members of the private sector most likely to be prosecuted under the bill upon the potential impacts of the act for them.<sup>4</sup> In spite of the existence of these proposals, a number of pledges,

and considerable consultation, the government have been seemingly reluctant to place these proposals in a bill before parliament. Ironically, this reluctance has occurred at a time when New Labour has seemed to be, in terms of other legislation, 'hyper-active', creating 661 new criminal offences over a seven-year period (*The Observer*, 2003). Unsurprisingly, the Home Office's (2005) recent publication of a draft corporate manslaughter bill has been greeted with some scepticism.

Putting to one side the issue of the bill's parliamentary schedule, the remainder of this section will focus upon the suggested reforms. The government proposes to create a new offence of corporate manslaughter pursuant to which the corporation assumes criminal responsibility. A corporation will be liable if a loss of life is connected with a management failure that represents a gross breach of the duty of care owed to their employees or customer. A breach of care, is a gross breach, if management failures fall far below what could reasonably be expected of the organisation in the circumstances. In addition to these provisions, the government are considering making amendments to the existing manslaughter law with the creation of new individual homicide offences and these will impact upon the possibility of directors being prosecuted.

I would like to make three points in response to the suggested reforms. First, these proposals do not remedy the legal inadequacies identified thus far, however there appear to be some positive aspects to these reforms. As Tombs and Whyte (2003: 20) note, the introduction of the new individual homicide offences 'are a step forward', because it would not be a requirement to demonstrate that a 'duty of care' existed between the accused and the victim. Yet, the Home Office failed to address how a director's duty to act may be established – one possible solution to this problem being the imposition of a safety duty upon directors (*ibid.*). Furthermore, there is little to suggest that these reforms remedy the problems that currently exist with the identification doctrine in relation to the prosecution of directors (*ibid.*). The new offences of reckless killing and killing by gross carelessness require that 'the risk be obvious' and the defendant was 'capable of appreciating the risk'. Tombs and Whyte correctly argue that if these reforms were implemented, there is little to suggest that identifying individuals within a company would become any easier. However, under the proposals the corporate manslaughter offence offers an alternative path to prosecutors in these cases, where a gross carelessness prosecution fails against directors, the company could itself be brought to account for the actions conducted in its name. This is a progressive move, to some extent, because it offers an avenue, even though it is not perhaps the desired one, for redress in these cases.

The second point specifically relates to the proposed corporate manslaughter offence and the requirement that management failures must 'fall far below what could reasonably be expected of the organisation'. Will courts use a

‘universal standard’ of health and safety or judge a corporation by the standard set by industry? If the latter, those who have campaigned for increased health and safety at work must wonder how low a company’s standards have to fall before a prosecution is brought under the proposed law.

The third and concluding point asserts the case for legal mechanisms which address the question of director’s safety responsibilities and remedy the current inadequacies of the criminal law and its proposed reform. These reforms are particularly unsatisfactory because, as Bergman (1997: 1665) argues, they perpetuate ‘a system of justice where guilty directors can hide behind their companies’. By criminalising corporations for ‘serious management failures’ which lead to the loss of human life, New Labour has successfully removed the issue of directors’ responsibility for those ‘serious management failures’. Corporations operate as a result of human interaction. Absolving directors of their social and moral responsibility for the way in which they have organised their profit-seeking structures is clearly problematic. There is substantial empirical evidence which suggests that legally enforceable safety duties placed upon directors can bring about significant improvements in the health and safety practices of companies (Davis, 2004). Moreover, this discourse is contradictory in nature: directors are richly rewarded for their persistent (and in many cases unsuccessful) pursuit of profit whereas their responsibility for adverse human impacts is denied. For example, Gerard Corbett received a £440,000 payoff for leaving Railtrack shortly after the Hatfield train disaster (*The Guardian*, 2002). Those who reap the benefits of their company stewardship should take responsibility for the consequences of their decision-making. Corporate manslaughter could be seriously addressed by legislation placing statutory safety duties upon directors. Any director who acts in a grossly negligent manner leading to death would have a prima facie case to answer. The Confederation of British Industry (CBI) (*The Guardian*, 2003) have long argued that such duties would have a deleterious impact; as ‘a director who faced the possibility of prison would be very reluctant to take decisions’. On the contrary, legal reforms that effect changes in business decision-making should be viewed as a positive development. If assigning safety duties to directors deters decision-making which puts profit before human safety, then this legislation will have served its purpose: reducing the unnecessary loss of human life caused by corporate greed. Furthermore, we would have a legal system which challenges rather than accommodates the moral indifference to human safety responsible for these deaths.

## Notes

1. I would like to thank Steve Tombs and David Roberts for their insights and comments on this chapter. I am also grateful for Stephen Tully’s rigorous edits of various drafts of the chapter. Finally, I would like to acknowledge the ESRC for the Post Doctoral Fellowship Award PTA-026-27-0250, which allowed me the time to research and write this chapter.
2. Based upon a point made by Slapper (1999).

3. Details of these cases can be found at [www.corporateaccountability.org/manslaughter/cases/convictions.htm](http://www.corporateaccountability.org/manslaughter/cases/convictions.htm).
4. A version of this letter may be viewed at [www.corporateaccountability.org/dl/HOLEt.doc](http://www.corporateaccountability.org/dl/HOLEt.doc).

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# 11 Reforming the doctrine of attribution: a Canadian solution to British concerns?

*Darcy L. MacPherson*<sup>1</sup>

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## **Introduction**

Public scandal and tragedy have often served as the backdrop for law reform. Nowhere is this more evident than in the law governing corporations. It is virtually certain that media scrutiny of the inner workings of Enron and others contributed to the adoption of the *Sarbanes–Oxley Act of 2002*<sup>2</sup> in the United States. Some commentators have even suggested that a fundamental reassertion of governmental authority over corporations is needed (Bakan, 2004: Ch. 6). Similarly, media coverage of tragedies in both Canada and the United Kingdom has led to calls for reform with respect to how corporations are held criminally liable for the actions of individuals acting on their behalf. This chapter begins by examining the historical roots of corporate criminal liability. The subsequent two sections review the current state of the law in each of the United Kingdom and Canada. Although the two nations have much in common, they also diverge on certain key points in this area. Attention will then turn to reforms enacted by the Canadian government in response to corporate scandal. We shall examine whether such a change would be appropriate for the United Kingdom. The chapter concludes that while the reforms are a positive development, they are not without flaws, and should therefore be viewed with caution.

## **History**

The amenability of corporations to the criminal law has been in a state of evolution for some time. Early in the twentieth century, the English courts were generally unwilling to hold corporations liable for crimes.<sup>3</sup> In a line credited to Lord Thurlow, it is said that this was because corporations have ‘no soul to be damned; no body to be kicked’ (Williams, 1961: 856). Underlying this quotation is an assertion about the moral qualities which the criminal law seeks to enforce. It generally concerns itself with acts that are morally reprehensible (Hailsham, 1990, **11** (1): 16). A corporation has no guilty mind with which to form the *mens rea* for the offence. Therefore, it is unfair to judge its actions from a moral perspective. Moral suasion has no impact on a corporation, as a corporation is ‘nothing more than an abstraction’ (*Lennard’s*



*Carrying Company, Limited v Asiatic Petroleum Company, Limited*, 1915: 713 per Viscount Haldane LC). The corporation is thus, on this level at least, incompatible with the fundamental morality on which the criminal law is focused; therefore, the courts were initially reticent to hold corporations criminally liable in most circumstances.

Briefly in the 1940s, English jurisprudence took a rather abrupt turn. In *Director of Public Prosecutions v Kent and Sussex Contractors Limited* (1944), the court held that a corporation could be convicted of any offence except: (i) crimes where imprisonment or death are the only possible punishments (ibid.: 149, per Viscount Caldecote, LCJ); (ii) felonies; and (iii) crimes involving personal violence, such as assault (ibid.: 150). Second, it was indicated that a corporation could be held criminally liable using agency principles (ibid.: 150). In *R. v ICR Haulage Ltd.* (1944, hereinafter *ICR Haulage*), it was held that the corporation could be liable for the actions of agents of the corporation.<sup>4</sup> Therefore, by the middle of the century, the courts had moved from a general rule of corporate immunity from prosecution, to a general concept of corporate amenability to criminal law, based at least in part on agency principles. Each of these general rules had certain exceptions. As will be expanded upon below, neither of these approaches is still the law in the United Kingdom or Canada. The courts in both jurisdictions have decided that, whatever the rationale,<sup>5</sup> corporations can be held criminally liable.<sup>6</sup> The next two sections consider the question of *how* the courts in each country have explained the doctrine under which this is accomplished, referred to as the ‘identification doctrine’. As we shall see, even before the Canadian reform attempt, referred to as Bill C-45, there were some differences between the two jurisdictions. With the passage of Bill C-45, those differences grew more pronounced.

## The British position

### *The common law*

While this section is concerned with UK jurisprudence, the Canadian law is based, in large part, on British precedents. Therefore, to the extent that the principles of UK law are replicated in Canadian cases, we shall cover both in this section. To the extent that the two countries do not share a common viewpoint, the UK law will be dealt with in this section; the Canadian jurisprudence will be considered in the following section.

In *Tesco Supermarkets Ltd. v Natrass* (1972, hereinafter *Tesco*) the House of Lords made it clear that the acts of any corporate agent were not necessarily sufficient to hold the corporation criminally liable. Instead, the human being who performed the *actus reus* with the requisite mental fault<sup>7</sup> had to be a ‘directing mind’ of the corporation. A directing mind is described as someone

who is delegated control over a sphere of functions within the corporation. This definition draws a distinction between those who set corporate policy, on the one hand, and those whose purpose is to put that policy into practice, on the other (*Tesco*, 1972: 180–81, per Lord Morris of Borth-y-Gest). In the parlance of the cases, the former are the ‘minds’ of the corporation; the latter are merely its ‘hands’ (*Tesco*, 1972: 171, per Lord Reid, and at 187, per Viscount Dilhorne, each quoting Lord Justice Denning (as he then was) in *H.L. Bolton (Engineering) Co. Ltd. v T.J. Graham & Sons Ltd.*, 1957: 172). Each ‘directing mind’ – a corporation can have more than one (*Tesco*, 1972: 171; *Canadian Dredge & Dock Co. v The Queen*, 1985: 693) – acts as the corporation within his or her respective sphere of authority; other agents can only act for the corporation, but cannot become the ‘embodiment’ of the corporation (*Tesco*, 1972: 170, per Lord Reid). The law seeks a human being who can be ‘identified’ as the corporation, thereby explaining the moniker of the ‘identification theory’. Once that human being is ‘identified’ as the corporation, the *actus reus* and mental fault of a crime committed by the human being are also that of the corporation.

This means that only the actions of corporate officials at the highest level (where policy decisions tend to be made) can render the corporation liable for crimes requiring proof of mental fault. The same was true under Canadian common law. In *Canadian Dredge & Dock Co. v The Queen* (1985: 682), the concept of a ‘directing mind’ was adopted. On another occasion, the Supreme Court of Canada said that a directing mind must have: ‘authority to design and supervise the implementation of corporate policy rather than simply to carry out such policy. In other words, the courts must consider who has been left with the decision-making power in a relevant sphere of corporate activity’ (*The Rhône v The Peter A.B. Widener*, 1993: 521, per Justice Iacobucci, hereinafter *The Rhône*).

The second element to consider is also mentioned in the above quote. Its final words (‘a relevant sphere of corporate activity’) show that the designation of ‘directing mind’ depends on the nature of the activity undertaken by the individual alleged to be a directing mind. If the person is performing an activity in an area where he or she has the power to make policy, the person is a directing mind; if the activity does *not* fall into such an area, the person is not a directing mind (*Tesco*, 1972: 170 and 174–5, per Lord Reid).

The third element of the identification theory is that generally, if the corporation is liable for a crime requiring proof of mental fault, the directing mind will *also* be liable for the offence (*Canadian Dredge & Dock Co. v The Queen*, 1985: 685). This follows naturally from the first element above; if an individual becomes the ‘embodiment’ of the corporation (*Tesco*, 1972: 170, per Lord Reid), and society convicts the corporation of an offence, then that individual – who is still a human being, responsible for his or her own actions, even if the

actions are taken in a corporate capacity – can be convicted as well. A related point must also be made here. Under the common law of each jurisdiction, knowledge of and failure to prevent a crime of another is not in itself enough to convict a person of a criminal offence. Non-interference to prevent a crime is not itself, without more, a crime.<sup>8</sup> This rule of the criminal law is not specific to corporate wrongdoing. However, as will become evident below, in certain cases Bill C-45 specifically changes these two results – that is, (i) the ability to convict the directing mind of the crime of which the corporation has been found guilty and (ii) the knowledge of the crime of someone else is not an offence – with respect to corporations.

The fourth element of the identification theory concerns defences. The UK and Canada have gone in different directions on this point. In the UK, this area of the law has been the subject of controversy. In *Moore v I. Bresler Ltd.* (1944, hereinafter *Moore*) a corporation was charged with knowingly making a false return under a taxing statute. The corporation alleged that the director who had filed the return had acted in fraud of the corporation, and thus, the corporation should not be liable (*ibid.*: 516, per Viscount Caldecote, LCJ). The King's Bench Division held:

those sales of the company's goods were made by those persons as agents of and with the authority of the respondents, and the sale is not less made with the authority of the master because the employee means to put into his own pocket the proceeds of the sale when he receives them.<sup>9</sup>

In other words, as long as the individual who committed the offence is a corporate agent acting within the scope of his or her authority, the corporation is liable. Thus, the case leaves very little room for the concept of defences. Up to 1985, it appears that this was the law in England.<sup>10</sup>

Scholarly authors have criticised this decision. They claim that there are times when, even though an individual is a policy-maker for the corporation, and is acting within the scope of his or her authority, it is none the less inappropriate to consider that the individual is acting *as* the corporation (Waddams, 1966: 148–9; Fien, 1972: 427; Williams, 1983: 973). More recent English case-law seems to suggest that there may be a defence for the corporation if it was defrauded.<sup>11</sup> However, none of these cases specifically overrule *Moore*. Therefore, given the current state of uncertainty in the UK, we shall consider the defence of fraud on the corporation when we consider the Canadian law, where the defence is firmly established.

In *A.-G.'s Reference (No. 2 of 1999)* (2000, hereinafter *A.-G.'s Reference*) the English Court of Appeal (Criminal Division) was asked to consider whether a non-human defendant could be convicted of a negligence-based offence without proof of guilt of an identified individual. The court said that a single individual had to be guilty of the underlying offence before the corporation could

be liable (ibid.: 191). The common law was to the same effect in Canada. While the corporation and the directing mind 'become one' (*Canadian Dredge & Dock Co. v The Queen*, 1985: 699), no one suggests that it is possible to aggregate the actions and/or mental states of all the directing minds of a given corporation. As will be seen below, Bill C-45 changes this with respect to crimes of negligence.

To sum up thus far, the identification theory is the manner in which a corporation can be liable for a crime requiring proof of mental fault. The court identifies an individual who committed the offence. Then, the court determines whether the individual has the authority to set corporate policies in the area in which the offence occurred. If so, then the individual is a directing mind; his or her actions and mental states are attributed to the corporation. If the corporation is liable, generally, the directing mind will also be guilty of the offence. It is *possible* that if a corporation is the victim of the crime, the corporation may avoid having the actions of the directing mind attributed to it. However, there is some uncertainty surrounding this defence in the UK. Finally, a corporation may have more than one directing mind. However, the prosecution *cannot* aggregate the actions and/or mental states of two or more directing minds, to establish the guilt of the corporation. The prosecution must 'lay the crime at the feet' of a single directing mind.

There is a minor caveat to the identification theory as described. In *Meridian Global Funds Management Asia Ltd. v Securities Commission* (1995, hereinafter *Meridian*) the Privy Council held that, if the purposes of the legislation so require, a special attribution rule may be formulated. In *Meridian*, a corporation stood accused of failing to give notice when it acquired a substantial interest in a second corporation, whose shares were publicly traded. Relying on *Tesco*, lawyers for the corporation argued that the corporation's chief investment officer was not a directing mind, and therefore, the corporation was not liable. The Privy Council recognised that a mechanical application of the identification theory could potentially allow the corporation to escape liability.<sup>12</sup> Their Lordships held as follows:

The policy of [the notice section] is to compel, in fast-moving markets, the immediate disclosure of the identity of persons who become substantial security holders in public issuers. Notice must be given as soon as that person knows that he has become a substantial security holder. In the case of a corporate security holder, what rule should be implied as to the person whose knowledge for this purpose is to count as the knowledge of the company? Surely [it is] the person who, with the authority of the company, acquired the relevant interest. Otherwise the policy of the Act would be defeated. Companies would be able to allow employees to acquire interests on their behalf which made them substantial security holders but would not have to report them until the board or someone else in senior management got to know about it. This would put a premium on the board paying as little attention as possible to what its investment managers were doing. (Ibid.: 511)

This gloss, however does not overwhelm the identification theory. By its very terms, the gloss generally applies only where the ‘policy of the Act would be defeated’ to do otherwise. As will be discussed below, while the *Meridian* gloss has been used with respect to certain enactments, it has been used only once with respect to what could be called the ‘core’ of criminal law.<sup>13</sup> The English Court of Appeal (Criminal Division) has even gone so far as to say that the *Meridian* gloss, rather than questioning the relevance of the identification theory, actually confirms its importance (*A.-G.’s Reference*, 2000: 192). So, even though the *Meridian* gloss exists in UK law, and could be used in criminal law, the identification theory remains the primary touchstone for corporate criminal liability.

### *The call for change*

In September, 1997, a passenger train operated by Great Western Trains smashed into a freight train. Seven passengers died as a result of the collision (*A.-G.’s Reference*, 2000: 184) with an additional 160 injured, in what was referred to as the Southall tragedy. Safety measures designed to protect against such an occurrence had been turned off. The driver was charged with manslaughter. The trial of the corporation, however, was made more difficult by rulings upheld in the *A.-G.’s Reference* case, discussed above. Less than a month after the disaster, the home secretary announced that the government was considering the creation of an offence called ‘corporate killing’. This offence would make it easier to prosecute both corporations and their directors for deaths caused by negligence.<sup>14</sup> Despite this avowed commitment to make it easier to convict corporate criminals, the government was slow to put this commitment into action before Parliament.<sup>15</sup> Only in May 2000 did the government generate proposals for discussion purposes.<sup>16</sup> In March 2005, the government revamped its proposals, and issued a draft bill for further discussion among interested parties.<sup>17</sup> As of the date of writing – April 29, 2005 – this process has not moved beyond the discussion stage.<sup>18</sup>

### **The Canadian position**<sup>19</sup>

#### *Prior to Bill C-45*

Despite the many similarities and common jurisprudential history between Canada and the United Kingdom, the two countries do not necessarily walk in tandem with respect to corporate criminal liability. For our purposes, there are three differences of note. The first is that Canada has not adopted the *Meridian* gloss. However, this difference may be more apparent than real. Most of the cases in which the *Meridian* gloss has been invoked by the British courts<sup>20</sup> have revolved around what the Canadian courts would call ‘regulatory’ offences, as opposed to ‘true’ crimes.<sup>21</sup> The UK courts do not have as strong

a distinction in this respect as do their Canadian counterparts.<sup>22</sup> This is not surprising, given the unitary structure of the British government. In the Canadian federal system, however, legislative jurisdiction is split: the federal government maintains power over criminal law, while the provinces maintain broad regulatory jurisdiction within their borders.<sup>23</sup> As such, few provincial offences explicitly require proof of *mens rea*, thereby reducing the need for the identification theory or any gloss thereon for these offences. Since this leaves only offences passed under the federal criminal-law power, which are generally fairly serious offences, the *Meridian* gloss on the identification theory is less relevant in the Canadian context.<sup>24</sup>

The second difference lies in the application of the test for a ‘directing mind’ to particular facts. In *Tesco* itself, the House of Lords decided unanimously that a store manager was not a directing mind of the appellant store chain (*Tesco*, 1972: 200 per Lord Diplock). Notwithstanding the unanimous result in the United Kingdom, the Supreme Court of Canada was not necessarily convinced. Citing the need for subdivision of delegation, particularly over large geographic areas, Justice Estey wrote: ‘The application of the identification rule in *Tesco*, *supra*, may not accord with the realities of life in our country, however appropriate we may find to be the enunciation of the abstract principles of law there made’ (*Canadian Dredge & Dock Co. v The Queen*, 1985: 693). A second example of the differences in application between the two countries can be found in *The Rhône* (1993). After acknowledging that there is significant discretion in a master of the flotilla, Justice Iacobucci, for the majority, held:

A master’s discretion in navigational matters does not derive from delegation of central authority but from tradition and necessity. The very nature of the shipping business makes it impractical for a ship’s master to call in for instructions to deal with routine navigational concerns. (Ibid.: 525)

The UK case law draws no distinction between a delegation of authority made in organising the corporation’s business, on the one hand, and authority derived from tradition and necessity, on the other.<sup>25</sup> Therefore, while it is clear that both countries began with the same test at the level of theory, it is equally clear that the application of this test has led to significant divergence between the jurisdictions (Stuart, 1995: 579–80).

The third difference between the two countries is perhaps the most important. It concerns defences. As mentioned above, the UK position with respect to defences is somewhat muddled and uncertain. This is not the case in Canada. As Justice Estey put it:

[T]he identification doctrine only operates where the Crown demonstrates that the action taken by the directing mind (a) was within the field of operation assigned to

him; (b) was not totally in fraud of the corporation; and (c) was by design or result partly for the benefit of the company. (*Canadian Dredge & Dock Co. v The Queen*, 1985: 713–14)

First, there is the matter of terminology. Technically, as this quotation makes clear, these are not defences at all. They are elements that the Crown must prove in order to convict the corporation. For example, point (a) is a necessary element of being a directing mind of the corporation in the first place. As mentioned earlier, the designation of ‘directing mind’ is activity specific. Point (a) reinforces this. However, I shall refer to points (b) and (c) as ‘defences’ because they have their impact after the Crown has already proven that the human being who committed the *actus reus* with the requisite mental fault was sufficiently high up in the corporate hierarchy to be a directing mind.

Point (b) (‘was not totally in fraud of the corporation’) seems to recognise the fact that, logically, one person cannot be both perpetrator and victim of the crime. Even though the corporation is in law a person separate from those who act on its behalf<sup>26</sup> it is important to remember that once the identification theory applies, the directing mind becomes the embodiment of the corporation (*Tesco*, 1972: 170 per Lord Reid). For these purposes, the corporation and the directing mind become one (*Canadian Dredge & Dock Co. v The Queen*, 1985: 699). It would seem to require ‘Olympic-calibre mental gymnastics’<sup>27</sup> to suggest that when reporting a crime committed by one of its high-ranking officials against it, the corporation is simultaneously making itself an accused. Therefore, the Canadian courts have said that when there is fraud against the corporation, the person who would otherwise be a directing mind is no longer so, because the outer boundary of the identification theory has been exceeded (*ibid.*: 712–13).

The third point is two-pronged. In order to use the defence, the directing mind must have *neither* (i) intended to confer some benefit on the corporation; *nor* (ii) conferred actual benefit, intended or not, on the corporation. While this could, in some cases, overlap with the ‘totally in fraud of the corporation’ defence, the two are not necessarily co-extensive. For example, even if the corporation is not a victim – and thus the ‘totally in fraud of the corporation’ defence would not apply – it is possible that the directing mind could be lining his or her own pockets, and simply using the corporation as a means to that end, without intending to confer, or actually conferring, a benefit on the corporation. In such a case, the Canadian courts have decided that corporation should not be held criminally liable.

### *The call for change*

As will be discussed below, Bill C-45 attempts to make it easier to hold corporations criminally liable. The common law position, as exemplified by *Tesco*

and *Canadian Dredge & Dock Co. v The Queen* had been in place for a considerable period time in each jurisdiction. Each had remained largely unchallenged. What social forces, then, brought Bill C-45 into being? Just as in the United Kingdom, a Canadian tragedy where many lost their lives was, at least from the government's perspective, one impetus for legislative change. On 9 May 1992, 26 coal miners were killed by an underground methane explosion at the Westray mine near Stellarton, Nova Scotia. A public inquiry placed blame in many quarters, including for safety- and training-related failures by, among others, two mid-level mine managers and the corporate parent of the mine, Curragh Resources Inc. (Richard, 1997: Vol. One, 140–44). However, no one was ever successfully prosecuted for the 26 deaths. The public inquiry into the tragedy specifically recommended changes to the criminal law to make it easier to convict corporate agents in similar cases (ibid.: Vol. Two, Recommendation 74 at 601). When statutory reform<sup>28</sup> was introduced in the Canadian House of Commons, the accompanying press release specifically mentioned the Westray disaster,<sup>29</sup> and the bill was known colloquially as the 'Westray Bill'.<sup>30</sup>

#### *After Bill C-45*

Bill C-45 alters the Canadian law on corporate criminal responsibility in at least five major ways.<sup>31</sup> First, it changes the triggering event for corporate liability from the actions of a directing mind to requiring the involvement of a 'senior officer'. A senior officer is defined as follows:

a representative who plays an important role in the establishment of the organization's<sup>32</sup> policies or is responsible for managing an important aspect of the organization's activities and, in the case of a body corporate, includes a director, its chief executive officer and its chief financial officer.<sup>33</sup>

The first part of the definition clearly replicates the common-law concept of a directing mind. The second part – 'is responsible for managing an important aspect of the organization's activities' – clearly lowers the threshold for corporate liability. The Crown can now hold corporations liable for the actions of mid-level managers who, while not responsible for setting corporate policy, are empowered to operationalise it. This recognises that although, legally, the power in a corporation generally rests with the board of directors,<sup>34</sup> the genuine day-to-day control of corporate decision-making rests with officers who set policy, *and* those employees who interpret and give operational effect to it.

The second change that Bill C-45 makes is to eliminate the activity-specific nature of the 'directing mind' – or, in this case, the 'senior officer' – inquiry. Section 22.2 of the Criminal Code<sup>35</sup> (a section added by Bill C-45) provides for liability of the corporation where a senior officer:



- (a) acting within the scope of their authority, is a party to the offence;
- (b) having the mental state required to be a party to the offence and acting within the scope of their authority, directs the work of other representatives of the organization so that they do the act or make the omission specified in the offence; or
- (c) knowing that a representative of the organization is or is about to be a party to the offence, does not take all reasonable measures to stop them from being a party to the offence.<sup>36</sup>

In other words, paragraph (c) applies if:

1. a representative undertakes criminal wrongdoing;
2. a senior officer has knowledge of criminal wrongdoing by any representative of the corporation; and
3. the senior officer does not take 'all reasonable measures' to prevent the offence.

If these conditions are met, it does not matter that the senior officer with the requisite knowledge had no responsibility for the area of the corporation in which the crime occurred, and no authority to prevent the wrongdoing. If the senior officer does not have the power to prevent the behaviour, he or she must, through due diligence, ensure that those who *are* in a position to prevent the behaviour receive the necessary information so that they can stop it.

The third change made by Bill C-45 is related to the second. Under the statute, it is possible to convict the corporation without the underlying facts justifying the conviction of the individual whose actions are the conduit to the corporation. In Canadian law, having knowledge of wrongdoing being committed by another is not enough to be convicted of the crime committed by that other. But under Bill C-45, it is simple knowledge (coupled with the status of being a senior officer) that allows the corporation to be convicted. The government may be able to convict a corporation under paragraph 22.2(c) where a senior officer had knowledge of criminal behaviour of a corporate representative and did not take 'all reasonable measures to prevent it'. Of course, it is possible to convict the representative who, as an individual, committed the offence. But, the fact that a representative, who is not a senior officer, commits an offence is, *without more*, insufficient to convict the corporation. One needs a senior officer. But, under paragraph 22.2(c), the government may be able to convict both the non-senior-officer representative, and the corporation, but may *not* be able to convict the senior officer, even though the senior officer is the conduit through which the wrongdoing of the other representative is attributed to the corporation.

The fourth change concerns defences. The opening words of section 22.2 (the operative paragraphs of which are discussed immediately above) read as

follows: ‘In respect of an offence that requires the prosecution to prove fault – other than negligence – an organization is a party to the offence if, *with the intent at least in part to benefit the organization*, one of its senior officers’.<sup>37</sup> This language eliminates the two-pronged test set out by Justice Estey in *Canadian Dredge & Dock Co. v The Queen*. Under Bill C-45, even if there is an actual, but unintended, benefit conferred on the corporation by the actions of the individual committing the offence, the corporation cannot be convicted. In such a case, the Crown cannot prove ‘the intent [of a senior officer of the corporation was] at least in part to benefit the organization’. As mentioned above, under the Canadian common-law approach, if there was a benefit conferred on the organization by the actions of a directing mind acting within the scope of his or her authority, and such were not totally in fraud of the corporation, the corporation could not argue that intent was necessary, nor did the prosecution necessarily have to prove intention to benefit the corporation. Under Bill C-45, proof of this intention is a key component of the prosecution’s case. In my opinion, this restricts, rather than expands, corporate criminal liability.

The fifth change involves crimes of negligence. When dealing with this category of offence, Bill C-45 provides as follows:

In respect of an offence that requires the prosecution to prove negligence, an organization is a party to the offence if:

- (a) acting within the scope of their authority:
  - (i) one of its representatives is a party to the offence, or
  - (ii) two or more of its representatives engage in conduct, whether by act or omission, such that, if it had been the conduct of only one representative, that representative would have been a party to the offence; and
- (b) the senior officer who is responsible for the aspect of the organization’s activities that is relevant to the offence departs – or the senior officers, collectively, depart – markedly from the standard of care that, in the circumstances, could reasonably be expected to prevent a representative of the organization from being a party to the offence.<sup>38</sup>

This section allows the court to examine the actions of both representatives who commit negligence-based offences, and the senior officers of a corporation, on a collective, rather than on an individual, basis. The section insists that the criminal law view the corporation, not as one cohesive whole, but rather as a tapestry, with many sources of input, the contribution of each of which cannot be viewed in isolation, but can only be appreciated in the context, and against the backdrop, of the contributions of others. Therefore, if two or more representatives make errors that are negligent, the effect of those actions is viewed cumulatively. Similarly, the mistakes made by managers are equally viewed in the context of the corporation as a whole, rather than being separated from the actions of others in management.

The changes described in this section are the major changes to the identification theory brought about by the passage of Bill C-45. Two questions remain to be answered in the next section. First, do these changes serve their avowed goal of expanding corporate criminal liability? Second, if these changes do serve to expand liability, will the expansion be positive in today's business environment?

### **Law reform: does Bill C-45 bring positive change?**

The question posed in the title of this section cannot be answered with a simple 'yes' or 'no'. The first change is, in my view, a positive one and it does expand liability. The distinction between making policy decisions oneself and implementing the policy decisions of others potentially has less relevance today than previously. Many of the world's largest corporations are conglomerates with diffuse decision-making authority. But perhaps even more important is the fact that operational authority is often more important than policy-making authority. In fact, the leading Canadian case-law in this branch of the law has recognised this, even while maintaining the primacy of policy-setters as directing minds. In *Canadian Dredge & Dock Co. v The Queen*, the corporate defendants argued that it should be a defence to the actions of the directing mind if he or she violated corporate instructions by undertaking the criminal activity. The court held:

If the law recognized such a defence, a corporation might absolve itself from criminal consequence by the simple device of adopting and communicating to its staff a general instruction prohibiting illegal conduct and directing conformity at all times with the law . . . Where . . . the court is concerned with those *mens rea* offences which can in law be committed by a corporation, the presence of general or specific instructions prohibiting the conduct in question is irrelevant.<sup>39</sup>

One could take this to mean that the setting of corporate policy is important, but if those charged with ensuring compliance (that is, turning the policy into concrete actions) do nothing to enforce the standards set by policy, one should question the importance of the policy. In other words, general statements of policy (including a policy of obedience of the law) are good, but it is in the execution of policy where 'the rubber meets the road', as it were. Therefore, by moving the identification theory from the level of policy to that of managerial or operational control of corporate affairs, the Canadian Parliament may have taken to heart Justice Estey's words, the consequences and natural outgrowth of which the learned justice himself had managed to ignore.

The definition of 'senior officer', however, is not without its problems. There will undoubtedly be litigation around the issue of what constitutes an 'important aspect of the corporation's activities', such that a person will be a

senior officer. However, given the wide variety of circumstances in which the statutory language could potentially be applied, any more specificity could mean that the statute could be too easily avoided. Therefore, notwithstanding that certain things are left to be resolved by the courts, the elasticity of the definition is necessary for the statute to complete its purpose.

The second and third changes are interrelated, in that they both stem from paragraph 22.2(c), reproduced above. The second change – eliminating the activity-specific nature of the designation of ‘senior officer’ – indicates that if a person is a management-level employee, this carries with it a level of respect and autonomy within the corporation. As was recognised in *Canadian Dredge & Dock Co. v The Queen*, it is the decision and ability to implement, or have others implement, policy-level directives that is crucial. Hence, if a vice-president has enough autonomy to have his or her operational directives acted upon by others, in my view, it should not matter that the policy-setting authority for the sphere of corporate activity lies elsewhere. In other words, by removing the activity-specific nature of the concept of a directing mind, Bill C-45 recognises that the operational autonomy of high-ranking corporate officials is at least not *necessarily* restricted to the area in which the officials have policy-setting power. Therefore, I view the second change as a positive one. None the less, a question remains. Should the government eliminate the activity-specific nature of the senior officer designation in paragraphs 22.2(a) and (b), by eliminating the words ‘acting within the scope of his or her authority’ in those paragraphs? The brief answer is that I believe that it should, for the reasons given above. However, the elimination of the activity-specific language in paragraph 22.2(c) is certainly a positive beginning, and the failure to do the same in the other paragraphs of the section can easily be rectified later on, if the government decides that the two paragraphs are too narrow.

The third change – making the corporation liable when any senior officer fails to take all reasonable measures to prevent criminal wrongdoing by corporate representatives of which the senior officer becomes aware – emphasises the expectation that the management-level employees of a corporation must communicate with one another. It is said that no one is an island. Yet, until now, this is exactly what the common law assumed in terms of corporate decision-making. A person who was a directing mind made all the decisions with respect to a particular area, and was not privy to the decisions made outside of this area.

But, corporate activity is replete with examples where people in one part of the management team learn information which might be relevant to other members of management. If a member of management ‘shuts his or her eyes’ to the criminal wrongdoing of any employee, this is wilful blindness to the employee’s actions. It is this wilful blindness which is then identified as that of the corporation (even if there is no specific power in the member of

management to stop the criminal employee), and thus the corporation is guilty of the offence committed by the employee.<sup>40</sup> Therefore, in principle, I support the idea of requiring communication between senior officers in order to prevent criminal wrongdoing by corporate representatives.

The fourth change – which makes it easier for corporations to avoid liability through loosening of defences – seems fundamentally misguided. It is one thing to require proof that the corporation was not the intended victim of the crime. It is another matter to make the prosecution prove an intention to benefit the corporation. If the senior officer did *not* intend to benefit the corporation, then the corporation is *not* liable. If the senior officer creates an unintentional benefit for the corporation, under Bill C-45 the corporation can accept the benefit without criminal liability. If a corporation accepts gains that result from criminal activity of which a senior officer is aware (or in which the senior officer is involved), then it seems to be a just result that the corporation be held criminally liable. After all, the thoughts of the senior officer are, for these purposes, the thoughts of the corporation. The intent to commit a crime is thus shared. This is true even if the senior officer did not specifically intend to benefit the corporation. This is particularly important if the government intends to make it easier (not more difficult) to prosecute corporate criminals.<sup>41</sup> Requiring the prosecution to prove an intention to benefit the corporation makes it easier for corporations to *avoid* criminal liability. Therefore, it seems to me that Justice Estey's view of defences is superior to that offered by Bill C-45.

The final change recognises the fragmented nature of decision-making in the modern corporation. In my view, this expands liability, and it is a positive change, for a number of reasons. First, the section recognises that, as a corporation gets larger and the number of people involved in corporate decision-making increases, the area of decision-making of any one person gets smaller. In other words, authority to make decisions in the modern corporation is becoming increasingly fragmented. This fragmentation makes criminal negligence harder to prove. Assume that I am a senior officer who has decision-making control over a small area of corporate affairs. I make one decision that is negligent, but which does not meet the standard for criminal liability – described as 'gross negligence' in the United Kingdom (*A.-G.'s Reference*, 2000: 185) and, in Canada, as a 'marked departure from the standard of care'.<sup>42</sup> Then, another senior officer makes a separate decision which, likewise, is negligent without meeting the higher standard. Finally, assume also that the course of decision-making that led to certain actions by representatives of the corporation is such that it meets the higher standard. Even though there may be no single decision – or more importantly for current purposes, no single *decision-maker* – that meets the higher standard, it is possible that the totality of the decisions made meets that higher standard. A good example of

this can be found in the Westray tragedy, discussed earlier. In the introduction to his report, the Commissioner wrote:

The *Westray Story* is a complex mosaic of actions, omissions, mistakes, incompetence, apathy, cynicism, stupidity, and neglect. Some well-intentioned but misguided blunders were also added to the mix. It was clear from the outset that the [tragedy] was not the result of a single definable event or misstep. (Richard, 1997: Vol. One, viii)

It is clear that in today's complex business environment, finding a single cause for dangerous and often lethal negligence committed by corporate officials acting as or on behalf of the corporation can be a difficult task.

As discussed above, in both the United Kingdom and Canada, prior to Bill C-45, there was no mandate to assess the actions of corporate officials collectively. Section 22.1 clearly provides this opportunity, not only with respect to senior officers ('or the senior officers, collectively', in para. 22.1(b)), but also with respect to the actions of representatives of the corporations (see sub-para. 22.1(a)(ii)). This idea of focusing on collective action, as opposed to finding a single individual, is driven by concern over what one might term 'corporate sloppiness'.<sup>43</sup> If a corporation develops a culture of cutting corners in the name of profit, bad things tend to happen. A culture of cutting corners which results in someone's death (that is, manslaughter by criminal negligence) or injury is unacceptable. Therefore, in general, I support the idea that the corporation may be liable for criminal negligence even though no single corporate official may have *individually* done anything that would meet the criminal negligence standard.

A corporation relies on individual decisions, but those decisions must fit into a collective plan for the corporation. The actions of one senior officer often only make sense against the backdrop of all the decisions made by others. Yet, the identification theory demands that the decisions of one directing mind be assessed without reference to the decisions of others. Bill C-45 rectifies this, by recognising the collective nature of corporate decision-making.

This section performs a second related function as well. UK commentators have observed that only small corporations have ever been convicted of manslaughter by criminal negligence under the *Tesco* standard.<sup>44</sup> Small, private corporations generally have relatively few decision-makers. This makes it easier to place the criminally negligent behaviour 'at the feet' of a single directing mind. On the other hand, large, publicly traded corporations are generally much harder to convict because the larger the corporation, the more decision-makers there are, which fragments the corporation's decision-making. Therefore, this section of Bill C-45, if adopted in the UK, would level the playing field, as it were, ensuring equal treatment for all corporations,

regardless of their size. To conclude this section, I believe that Bill C-45 makes positive changes with respect to corporate criminal liability. However, Bill C-45 also makes it easier for corporations to avoid conviction. The public outcry following the Southall and Westray disasters demanded that corporations be held more accountable for their actions. So, to the extent that it makes conviction more difficult, Bill C-45 does not serve its avowed purpose. This, among other points, indicates that Bill C-45 has certain flaws.<sup>45</sup> Therefore, any other jurisdiction wishing to change its rule(s) on corporate criminal liability could look to Canada for inspiration. However, any such jurisdiction should exercise care in deciding whether or not to adopt the model offered by Bill C-45.

### **The future**

Let us briefly consider the future. Assume that there were sufficient desire in the United Kingdom to implement changes similar to those in Bill C-45. How would one go about doing this? There is no legislative enactment in UK that covers this area. Therefore, two options present themselves. The first is a judicial change to the common law; the second is legislative. In one sense, the first seems unlikely. *Tesco* has remained undisturbed for more than 30 years as the major authority on the identification theory. While the House of Lords has recognised its right to overrule its own decisions (*Practice Note*, 1966) it has generally been hesitant to expressly say that it is doing so, even when this is the effect of one of its rulings.<sup>46</sup>

However, at another level, the House of Lords has produced jurisprudence that might allow it to suggest that a change is a refinement of earlier case law, rather than its wholesale rejection. The *Meridian* gloss, although it is currently not generally applied to ‘true crimes’, indicates that *Tesco* may not be the final word on the identification theory. By making the application of the identification theory context-dependent, it would be easier for the courts to modify corporate criminal liability without having to abandon *Tesco*. However, judges are unlikely to rewrite the common law when to do so would pre-empt a stated desire by elected officials to do so by legislation. Therefore, what remains is a legislative alteration of the common law. If British parliamentarians are looking for a template to stimulate the discussion on this issue, Bill C-45 could serve in this capacity. Therefore, I think that legislation in the UK could be modelled on the Canadian example, subject to important adjustments, as discussed earlier in this chapter.

As for Canada, the acid test for the future will be when Bill C-45 is applied by the courts. Until this happens, any predictions as to the future can be little more than pure speculation. The question will soon be answered: will the courts fully embrace the parliamentary directive to hold corporations more accountable using the criminal law? I suspect that the answer will be in the affirmative, but only time will tell.

## Conclusion

The law regarding corporate criminal liability had been changing until late in the twentieth century. Until 2003, Canada had borrowed extensively from the United Kingdom with respect to this branch of the law. However, the common law in each of the two jurisdictions has gone in different directions on certain points. Each jurisdiction has endured very public disasters with which the criminal law was unable to cope, leading to calls for change. The Canadian Parliament has now stepped in and changed the law in this area significantly. Some of these changes have expanded liability; others have made it more difficult to convict corporations. These changes have both positive and negative aspects. Therefore, Bill C-45 should not be imported into any other jurisdiction without critically examining the changes made. As for the question asked in the title of this chapter, Bill C-45 has some answers, but they may not *all* be the right ones. None the less, given the long period of time since the UK government promised change (since 1997), perhaps the passage of Bill C-45 in Canada will generate legislative momentum for change in the United Kingdom.

## Notes

1. Generous financial support for this project was received from the Legal Research Institute, University of Manitoba. The research assistance of Ryan Brolund is also gratefully acknowledged.
2. The Public Company Accounting Reform and Investor Protection Act, 18 USC §§ 1514A(a) (2002).
3. There were four notable exceptions to this general rule: (a) criminal contempt; (b) nuisance; (c) criminal libel; and (d) statutory offences of absolute liability: see Hailsham (1933: 8, 111–12, 178; 9, 14, 5).
4. *ICR Haulage* (1944: 695) per Justice Stabile, for the Court. For indications that these cases go too far, see *Tesco* (1972: 173) per Lord Reid. Notwithstanding that the terminology of agency was used, the results of these cases on their particular facts have been held to be consistent with the identification theory: see *Canadian Dredge & Dock Co. v The Queen* (1985: 680).
5. One rationale for corporate criminal liability grows out of the idea of the fact that a corporation is a person: Canada Business Corporations Act, Revised Statutes of Canada (RSC) 1985, c. C-44, s-s. 15(1) (hereafter CBCA) and *A. Salomon Co. Ltd. v Salomon* (1897; hereafter *Salomon*). Another is pragmatic: since corporations occupy and/or affect a large portion of society, leaving corporate commercial activity outside the net of the criminal law is simply unacceptable as a matter of policy: see further *Canadian Dredge & Dock Co. v The Queen* (1985: 692) and MacPherson (2004: 256–8).
6. For Canada, see *Canadian Dredge & Dock Ltd.*, (1985) per Justice Estey for the Court, and for the United Kingdom, see *Tesco* (1972).
7. ‘Mental fault’ is a phrase that is meant to encompass both subjective *mens rea* (intention, recklessness and so on) as well as objective tests for liability (for example, gross or criminal negligence).
8. With respect to the UK, see Smith (1999: 130). With respect to Canada, see *R. v Dunlop and Sylvester* (1979: 898) per Justice Dickson (as then was), for the majority of the Court.
9. *Moore* (1944: 517) per Justice Humphries. For holdings to the same effect, see 516, per Viscount Caldecote, LCJ, and see 518, per Justice Birkett (as he then was).
10. I am supported in this conclusion by Justice Estey in *Canadian Dredge & Dock Co. v The Queen* (1985: 704–5).



11. See further on this point *McNicholas Construction Co Ltd v Commissioners of Customs and Excise* (12 January 1999), UK (Transcript) (VAT and Duties Tribunals) (Lexis); *R. v Rozeik* [1996] 3 All ER 281: 286 (Court of Appeal (Criminal Division)), per Lord Justice Leggatt, for the Court. Contra, and reaffirming the correctness of *Moore*, see *Reynolds v Welch; Growth and Secured Life Assurance Society Ltd. et al. v Welch* (26 January 1981), UK No. 97/80, 98/80 QB (Div Ct) (Lexis), per Justice Forbes.
12. *Meridian* (1995: 508–9) citing Lord Templeman in *Re: Supply of Ready Mixed Concrete (No. 2)* (1995: 465 hereinafter *Re: Supply*). However, I would argue that the legal issues raised in the earlier case with respect to the making of agreements designed to implement restrictive practices and contempt of court do not invoke the identification theory at all.
13. *R. v Rozeik* (1996). The court held that there was a distinction made between attribution for the purpose of holding the corporation criminally liable, on the one hand, and for the purpose of allowing third parties to avoid liability for victimising the corporation, on the other (at 287).
14. L. Halligan and R. Rice (1997), ‘New offence of “corporate killing” considered: company responsibility – disasters prompt proposals to convict directors if negligence causes a death’, *The Financial Times* (London) (3 October), 8.
15. J. Eaglesham (2004), ‘Corporate killing legislation faces new delays’, *The Financial Times* (London) (31 March), 6.
16. Home Office (2000) ‘Reforming the Law on Involuntary Manslaughter: the Government’s Proposals online’: <<http://www.homeoffice.gov.uk/doc/invmans.html>> date accessed: 27 April 2005.
17. Home Office (2005) ‘Corporate Manslaughter: the Government’s Draft Bill for Reform’. The Stationery Office CM. 6497.
18. *Ibid.* There are at least two reasons why this chapter is not the appropriate forum to discuss these proposed changes. First, the proposed changes have not yet been introduced in Parliament. Thus, currently, they are nothing more than the government’s thinking on the issue, and the government is seeking input from others (*ibid.* at para. 31). Therefore, given the fact that the government has already changed its proposals once, until the proposals are put forward to Parliament, it is difficult to predict with any certainty how the proposals might amend the common law. Second, the current proposals are limited to manslaughter only (*ibid.* at para. 13). This chapter is meant as a review of the broad area of criminal liability, and is not limited to the offence of manslaughter. The law as discussed will remain relevant to all other criminal offences, even if the government’s proposals as currently drafted are subsequently enacted by Parliament.
19. For a detailed discussion of the impact of Bill C-45 on Canadian law only, see MacPherson (2004).
20. See, for example, *Shanks and McEwan (Teesside) Ltd. v The Environmental Agency* [1997] 2 All ER 332 (Div Ct), per Justice Mance, for the Court (environmental protection); *Morris et al. v Bank of India* [2004] EWHC 528 (Ch), per Justice Patten (fraudulent trading in the context of insolvency legislation); *R. v British Steel plc*, [1995] 1 WLR 1356 (CA): 1362, per Lord Justice Steyn (as he then was), for the Court (occupational health and safety legislation).
21. See further *R. v Wholesale Travel Group Inc.* [1991] 3 SCR 154: 205 (per Chief Justice Lamer, Justice Sopinka, concurring), at 216–19 (per Justice Cory, Justice L’Heureux-Dubé, concurring) and at 209 (per Justice LaForest, concurring with Justice Cory).
22. See *Tesco* (1972) itself. The case involved an offence for what could be referred to misleading advertising. Essentially, a store advertised that an article was available for sale at a price lower than provided for in the store. Since this was described as an ‘offence’, Lords Reid (at 170), Morris of Borth-y-Gest (at 179), Viscount Dilhorne (at 185), Lords Pearson (at 188) and Diplock (at 193) clearly deal with this as a criminal matter. However, Lord Diplock also makes clear that this statute is focused on consumer protection. Consumer protection is largely (though not exclusively) covered by provincial legislation in Canada.
23. See Constitution Act 1867 (UK), 30 & 31 Vict. c. 3, s-s. 91(27) and s-s. 92(13) respectively, reprinted RSC 1985, App. II, No. 5.
24. Lord Reid in *Tesco* (1972: 173) was opposed to the idea of altering the test for corporate attribution depending on the nature of the offence.

25. In fact, the giving of discretion appears to have to be virtually unfettered in order to effect the designation of a 'directing mind' in the United Kingdom: see *Tesco* (1972: 171, per Lord Reid).
26. For the United Kingdom, see *Salomon* (1897: 51, per Lord MacNaughten); for Canada, see CBCA: s-s. 15(1).
27. This turn of phrase was used by the court, albeit in a completely different context, in *R. v Calder*, (1994) 19 OR (3d) 643 (CA): 665, per Justice Doherty, dissenting.
28. Bill C-45. An Act to Amend the Criminal Code (criminal liability of organizations), 2d Sess., 37th Parl., 2003 (Royal Assent, 7 November 2003), SC 2003, c. 21.
29. Canada, Minister of Justice, Press Release, Bill C-45 online: Department of Justice <[http://canada.justice.gc.ca/en/news/nr/2003/doc\\_30922.html](http://canada.justice.gc.ca/en/news/nr/2003/doc_30922.html)> accessed: 12 May 2004.
30. See, *inter alia*, Parliament of Canada, House of Commons Debates, 144 (27 October 2003) at 8797 (Mr Inky Mark); House of Commons Debates, 144 (27 October 2003) at 8798 (Ms Alexa McDonough).
31. Aspects of Bill C-45 which I shall not be considering here include the creation of a legal duty on all persons with the authority to direct work undertaken by others, and sentencing provisions specific to organisations.
32. An organisation is defined in s-s. 1(2) of Bill C-45 as follows: '(a) a public body, body corporate, society, company, firm, partnership, trade union or municipality, or (b) an association of persons that (i) is created for a common purpose, (ii) has an operational structure, and (iii) holds itself out to the public as an association of persons'.
33. Bill C-45, s-s. 1(2). In the same subsection, the term 'representative' is, in turn, defined to include any director, partner, employee, member, agent or contractor of an organisation.
34. CBCA: s-s. 102(1); Companies (Tables A to F) Regulations 1985 (UK), SI 1985/805, Table A, art. 88.
35. RSC 1985, c. C-46.
36. Bill C-45, s. 2. Paras (a) and (b) of section 22.2 largely codify the common-law position: see further MacPherson (2004: 259–62).
37. Bill C-45, s. 2 (emphasis added).
38. Bill C-45, *ibid.*; also *Criminal Code*, RSC 1985, c. C-46 s. 22.1.
39. *Canadian Dredge & Dock Co. v The Queen* (1985: 699). In essence, the same defence was rejected by the House of Lords in *Re: Supply* (1995: 464–5 per Lord Templeman).
40. With respect to wilful blindness, see *R. v Sansregret* [1985] 1 SCR 570: 585–6, per Justice McIntyre, for the Court.
41. With respect to the United Kingdom, see Halligan and Rice, *supra* note 14. With respect to Canada, see Canada, Minister of Justice, Press Release, Bill C-45 online: Department of Justice <[http://canada.justice.gc.ca/en/news/nr/2003/doc\\_30922.html](http://canada.justice.gc.ca/en/news/nr/2003/doc_30922.html)>, date accessed: 12 July 2003.
42. See further *R. v Morrissey* [2000] 2 SCR 90: 105, per Justice Gonthier, for the Court on this point.
43. J. Smerin (2000), 'Law: bringing the bosses to book – as the Ladbroke Grove rail inquiry opens, pressure is mounting for changes in the law that would make it easier to prosecute the companies involved in disasters', *The Independent* (foreign edn) (9 May), Features, 11.
44. R. Verkaik (2003), 'Big companies escape conviction under weak law corporate killing law', *The Independent* (foreign edn) (10 July), News, 2.
45. In certain cases, Bill C-45 may also place certain corporate officials in an untenable position, especially when decisions must be made quickly. See further, MacPherson (2004: 264–5) discussing the role of internal auditors in the corporation.
46. See further *I.R.C. v Moodie* [1993] 2 All ER 49 (HL): 55 per Lord Templeman, for the House of Lords.

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## 12 Sustainable waste management: the challenge for businesses in Wales

*Lorraine B. Frater*

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### **Introduction**

Many businesses find the term ‘sustainable development’ (SD) abstract, a concept too complex to allow any connection. Yet it is one of the primary drivers behind a substantial number of current environmental laws and policies. Current English and Welsh waste strategies identify sustainability as a spur to innovation and an increasingly important factor in business competitiveness. These strategies and other government policies aim to achieve improved waste management practices from commercial and industrial organisations by linking sustainable waste management with production and operational efficiency. The Welsh Assembly Government (WAG), under its devolved powers, is constitutionally bound to pursue sustainable development. Section 121 of the Government of Wales Act 1998 makes Wales unique within Europe, the section requires that economic and environmental improvement must fulfil the criteria of sustainable development. This extends to the application of its waste strategy.

Current waste management practices in Wales, however, do not comply with this unique statutory duty. Due to the majority of Welsh companies disposing large quantities of waste to landfill, Wales is near the bottom of the European league in waste management. To alter this position, WAG, in compliance with European and UK legislation has published *Wise About Waste: The National Waste Strategy for Wales* (Parts One and Two) (WAG, 2002a, b), which covers wastes outlined in Section 75 of the Environmental Protection Act, 1990 (EPA). The strategy meets the requirements for a National Waste Strategy for Wales as laid down in Schedule 2 of the EPA. The document sets stricter waste targets than those contained in the *Waste Strategy for England and Wales* (DEFRA, 2000) (which now applies only to England). The targets set for commercial and industrial organisation are classed as secondary targets, that is those over which WAG recognise they have no direct influence. To meet the targets, WAG are relying on how companies will respond to the pressures not only from current European waste directives, but also from a package of incentives and assistance to encourage Welsh businesses to adopt sustainable waste management practices.

A recent (2003) survey<sup>1</sup> conducted in Wales by the Economic and Social Research Council (ESRC) Centre for Business Relationships, Accountability, Sustainability and Society (BRASS) in partnership with the Environment Agency Wales (EAW) visited over 2000 commercial and industrial companies throughout Wales to gather data on waste arisings. The data collected from the survey will assist WAG in assessing: the success of the strategy to date; whether targets are being met; what may need to be done to reach the targets for waste minimisation; and reducing waste to landfill and increasing reuse and recycling within Welsh businesses. The survey constitutes a unique opportunity to gain an understanding of how Welsh businesses in particular but UK businesses in general, from small to large, are tackling current waste issues and what factors influence sustainable waste management.

From the data gathered during the survey, it is clear that there were a number of factors influencing the way a business would manage its waste. Some of these include legal and financial obligations, size, location, personal values, culture and corporate commitment from parent companies. In most instances there were a myriad of interconnections and interdependencies between these factors, the influences of one or more determining the main driving influence. In recognition that no one single factor determines how a company manages its waste, policy makers and legislators have developed an integrated approach to encourage and drive businesses to undertake sustainable waste management. The Welsh waste strategy identifies sustainability as a central goal of the strategy: '[i]t is a strategy designed to move Wales from an overreliance on landfill to a position where it will be a model for sustainable waste management' (WAG, 2002a: 1)

### **Applying the sustainable development concept to waste**

Sustainable development means different things to different people. The most regularly quoted definition is that found in *Our Common Future* (WCED, 1987: 43) (the Brundtland Report): '[s]ustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs'. As different nations and different organisations have used the term over the last 15 years, its interpretation has reflected the central concerns of the interpreter. Brundtland emphasised ecology at the core of the concept and to stress this focus, Australia now advances the concept of ecological sustainable development (ESD), which highlights that the emphasis of SD should be on conserving and enhancing resources so that ecological processes are maintained. It therefore, looks beyond economic progress to achieve sustainable societies.

A different approach is highlighted in the foreword to the *Consultation on the Sustainable Development Action Plan of the Welsh Assembly Government 2004–2007* (WAG, 2004), which states:

Sustainable development is often seen as an environmental issue but it is just as much about wealth creation and tackling poverty and injustice. For me [Rhodri Morgan AM] sustainable development means rethinking our economy towards sustainable production and consumption and relieving poverty and injustice for people now.

This emphasis may be influenced by the fact that Wales is one of the poorer regions within the UK. The greater emphasis on economic issues in the interpretation of sustainable development is reflected in the Welsh waste strategy, which identifies the creation of recycling markets as a means of creating economic and employment opportunities.

At the core of SD is the need to integrate economic, social and environmental policies, which will ensure a better quality of life for everyone, now and for future generations (DEFRA, 2004: 7). Sustainable development has a number of core characteristics. First, it requires thinking beyond the here and now, with each generation looking after the next (Jacobs, 1991: 73). Second, it promotes a sense of equity and justice by acknowledging that if we ignore our effects on others in an interdependent world, we do so at our peril. Third, that there should be an understanding of how the environment, economy and society interconnect. Resources are finite and they should not be removed at a rate faster than they can be replenished or disposed of more quickly than the environment can absorb them.

These are some of the issues inherent in current waste management practices. The need to develop sustainable integrated practices requires a move away from an overreliance on landfill, a reduction of the impact of waste on the environment, the maximisation of resource utilisation, economically and environmentally efficient production and more socially and environmentally conscious consumption. At the heart of policies is the need for businesses to recognise that resource efficiency lies at the heart of the sustainability challenge. The impetus is to enhance competitiveness through the better use of physical, human and financial resources, thereby creating value with less impact. Sustainable waste management is about breaking the connection between economic growth and waste production. This view is echoed in the European Union's (EU's) Sixth Environment Action Programme, which identifies waste prevention and management as one of its four top priorities.

In the introduction to *Waste Strategy*, WAG acknowledges that 'waste is Wales' biggest environmental problem' (WAG, 2002a: vii). One of the primary reasons for this is the excessive quantity of waste sent to landfill every year. In the 1998/99 National Waste Production Survey (1998 Survey) conducted by the Environment Agency, Welsh commercial and industrial companies produced over six million tonnes of waste annually<sup>2</sup> and the collection and management of commercial and industrial waste was estimated to be between £73 and £178 million per annum. Historically, Wales has a poor record

of waste management. It produces high quantities of waste, and landfill is the preferred method of disposal. The results of the 1998 Survey revealed a good recycling rate of 62 per cent within the Welsh industrial sector. The reality was that these figures were the result of an 81 per cent recycling rate within the metal refining sector, which accounted for about 53 per cent of industrial waste. In contrast, the remaining industrial sectors were not engaged in such a high level of recycling.

Nearly 70 per cent of all commercial waste was sent to landfill, with just under 18 per cent being recovered or recycled. This was a much more alarming finding as commercial sector waste like that in the municipal sector is increasing at 3 per cent annually.

The landfilling of waste has been recognised by the EU as unsustainable and is the destination of last resort in the waste hierarchy. This hierarchy prioritises waste management techniques in order of their environmental impact. At the top of the hierarchy is prevention of waste production. Landfilling waste is unsustainable because it uses up valuable land space, potential resources are lost and increases the depletion of virgin materials. In addition, it causes air, water and soil pollution, discharges methane into the atmosphere and risks chemicals and pesticides being released into the earth and groundwater. This in turn is not only harmful to plants and animals but also to human health. In real terms in certain parts of the UK, void landfill space is dwindling; the strategic waste management assessments for Wales published in 2000 by the Environment Agency suggest that the maximum life expectancy of remaining landfill capacity is approximately six years. To combat the growing problem of waste production and reduce the impacts of unsustainable disposal options, the EU established a package of waste directives that require member states to identify waste as a major policy issue. The legal requirements impact not only on multinational organisations, but also on small and medium-sized enterprises (SMEs) and even public sector organisations.

### **The legislative framework**

The main driving force behind current UK waste legislation is Europe. The EU has established a three-tier framework for tackling the growing problem of waste production and disposal throughout the European Union. The first level establishes the basic framework concentrating on the definition of waste and the permitting and planning of waste disposal. The Waste Framework Directive (75/442/EEC as last amended by Directive 91/692/EEC) requires member states to take all necessary steps to prevent waste generation, not only to encourage reuse but also to ensure safe disposal, as well as establishing an integrated and adequate network of disposal installations. It also highlights the need for solutions to be based on the principles of self-sufficiency and proximity.<sup>3</sup>



The second level is the introduction of legislation that concentrates on reducing the impacts of waste by setting common technical standards, as demonstrated in the Directive on Integrated Pollution Prevention and Control (IPPC) (1996/61/EC), the Waste Incineration Directive (2000/76/EC)<sup>4</sup> and the Landfill Directive (1991/31/EC). For the purposes of discussing sustainability of waste management within businesses, the last is of the most importance. The Landfill Directive marked the end of co-disposal at landfill sites, that is hazardous and non-hazardous waste could no longer be disposed in the same landfill site. The directive also introduced a disposal ban on certain wastes at landfill; it required treatment of waste to landfill and a reduction of biodegradable municipal waste disposed to landfill so that by 2020 it amounts to no more than 35 per cent of that produced in 1995. The potential impact of the IPPC Directive should not be overlooked. It directly influences how some large industrial installations operate by requiring them to possess the relevant permit, which must be based on the concept of best available techniques (BAT) under Article 2(11). It therefore requires installations which fall under Annex 1 of the directive to consider the applications of waste minimisation techniques to prevent or reduce to a minimum all types of waste and emissions wherever possible.

The third and final level is the identification of specific waste streams. Legislation highlights those waste streams considered at present by the EU to be particularly problematic. These include the Batteries Directive (1991/157/EEC), the Directive on Waste Electrical and Electronic Equipment (2000/96/EC) and the Packaging Directive (94/62/EC).

The outcome of all of these directives is that attitudes and practices to waste have to change. Disposing of wastes to landfill can no longer be the preferred option and more fundamentally producers would need to take responsibility for the wastes that they generate. In transposing these directives into UK legislation, the UK government has developed a strategy of proposals that will influence how businesses respond to waste production and disposal. None of the legislation passed in the UK imposes any direct targets on business to reduce or recycle waste. The intention of the legislation is to lead businesses to the conclusion that waste minimisation and reuse and recycling are not only better operational options but also more economically efficient. The legislation that exists focuses on the disposal of waste, while the creation of it is left to non-legal instruments. For example, the principle of innovative approach to design proposes that businesses should seek competitive advantage by aiming to make products that are more durable, more easily reusable or recyclable and less disposable.

The primary provisions covering waste management in Wales are the Environment Protection Act 1990 (as amended) and the Environment Act 1995. WAG has general powers under the Government of Wales Act 1998 and

the Transfer of Ministerial Functions Order to introduce new or amend existing secondary legislation. It only has this power if this has been recognised under primary Acts. WAG must be designated under the European Communities Act 1972 (1972 Act) or have powers devolved to it under primary acts before it can make or amend regulations implementing European directives in Wales. Under the 1972 Act, WAG has been designated powers in relation to the 'controlled management of hazardous waste' and therefore it can and is introducing secondary legislation to implement hazardous waste regulations.

The UK government has enacted much secondary legislation for both England and Wales to implement some of the aforementioned European directives into UK law. Those of direct importance are the Landfill (England and Wales) Regulations 2002, the Landfill Tax Regulations 1996, as amended in 1998, the proposed Hazardous Waste Regulations (amending the Special Waste Regulations, which will be introduced in Wales by WAG) and Waste Acceptance Criteria. Each of these will directly effect how businesses will treat their waste in the future.

Landfill tax, as an economic instrument, has two main aims. The first is to ensure that the cost of landfill properly reflects the impact it has on the environment, thereby internalising the externality. Until recently, current pricing policy has been the reverse of the waste hierarchy with landfill providing the cheapest option. Companies did not face the true cost of the production process and the economic impact it had on the environment and it did not comply with the principle of 'polluter pays'. The second aim is to help achieve more sustainable waste management by providing a financial incentive to reduce waste production, dispose of less waste to landfill and recover more value from the waste that is produced. These aims are to be achieved by increasing the landfill tax from £7 in 1996 to £15 per tonne in 2004 and increasing it incrementally by £3 per tonne per year until it reaches £35 per tonne. Even at £35 per tonne, it will still be less than the tax in a number of other European countries. The House of Commons Environment, Food and Rural Affairs Committee (2003: para. 46) has commented that not until the tax reaches £35 per tonne will it have any effective influence. The reason for this is that landfill may still be a cheaper option than recycling or incineration. For example one company during the 2003 Survey said they sent waste to landfill because the cost of incineration was ten times more expensive. However a number of the multinational companies surveyed during the 2003 Survey had already identified the future effects of the landfill tax and were acting accordingly.

While the Landfill Tax Regulations directly effect the financial interests of a company, they indirectly affect the costs of waste disposal. The impacts on waste producers are that as well as complying with all aspects of the Duty of

Care regulations, producers are also responsible for making sure that the landfill site receiving their waste has an appropriate licence or permit for that type of waste. Landfill sites have to be classified as hazardous, non-hazardous or inert.

From July 2004 these regulations prohibit the practice of co-disposal of waste: only a site classified, as 'hazardous' will be allowed to accept hazardous waste. Hazardous waste applies to those wastes classified as hazardous in the consolidated European Waste Catalogue (EWC). The regulations also introduce certain types of waste that have been banned from landfill. The list includes liquids (excluding sludge), whole used tyres (and from July 2006 shredded used tyres), hospital and other clinical wastes and wastes that may be explosive, corrosive, oxidising, flammable or highly flammable under landfill conditions. The effect of all of these restrictions will be to reduce disposal options for waste producers and collectors, and the waste management industry believes this will potentially add cost to difficult wastes. In addition, all wastes have to be treated prior to landfilling to reduce their environmental impact to the lowest level that is achievable.<sup>5</sup> The impacts of the regulation are that businesses will need to find alternatives to landfill, primarily because landfill capacity will fall. Costs will increase due to the requirement of pre-treatment.

Wales will be seriously affected by the regulations because there are no registered hazardous landfill sites in Wales. Businesses will either have to find alternative means of disposing of hazardous wastes or face higher disposal costs. For example, one of the 2003 Survey companies stated that one impact of the regulations was that the transportation of their waste has increased from 50 to 200 kilometres. Due to the increased number of identified hazardous wastes introduced in the EWC, more businesses will be classed as producers of hazardous waste. They may then be affected by the new Hazardous Waste Regulations,<sup>6</sup> which introduce amendments to the Special Waste Regulations. While the Landfill Regulations deal with the disposal of hazardous wastes, the Hazardous Waste Regulations deal with consignment. The proposed new regime in England will include some of the following. It will be the responsibility of waste producers to determine whether their waste is hazardous or not by reference to the EWC. In addition they must cease any practice of mixing hazardous wastes. One intent behind these new regulations is to shift the emphasis of responsibility for hazardous waste from waste managers to waste producers. Sites producing hazardous waste must notify their site to the Environment Agency, submit periodic returns to it and face agency inspections. The disposal site must report back to the producer confirming disposal. Wales, although not Scotland and Northern Ireland, is likely to implement similar controls. The anticipated result is an increased administrative burden on those who produce hazardous waste. However, the Department for the Environment, Food and Rural Affairs (DEFRA), in reaction to scepticism from the waste

management industry, believes that in the long term the changes to the system will result in reduced costs and an improved audit trail.

Producers will have to demonstrate compliance with all waste acceptance/treatment criteria as provided in the 2002/2004 Landfill Regulations and the three-point test. The latter requires that any potential treatment must be a physical/thermal/chemical or biological process (including sorting); that it must change the characteristics of the waste; and finally it must reduce its volume or hazardous nature and facilitate handling or recovery.

There are various anticipated outcomes of these legislative changes but primarily producers are being forced to come to terms with the realities of their activities. During the 2003 Survey, it was evident that many waste producers dissociated the production processes from waste production and lacked any attitude of responsibility or environmental duty. Moreover, the necessary connection between their activities and impacts on society, environment or human health did not exist.

The legislation seeks to make landfill a less attractive option. Once businesses begin to realise the true cost of waste they will introduce more effective and efficient operational activities to reduce its production. Alternatively, they will demand market alternatives to landfill.

### **Sustainable waste management in Wales**

To assume that businesses will immediately alter production processes and operate more efficiently due to novel regulation would be naive. In Wales, WAG has recognised that there are a number of economic and social barriers to change and, as a result, have introduced a wide range of policies to meet both EU and UK regulations. WAG has also introduced reduction and reuse/recycling targets for businesses based in Wales, which constitute desirable rather than mandatory goals. The commercial and industrial waste targets encourage businesses to aggregately achieve the following reductions:

- *Waste minimisation target for public sector and business* By 2005, achieve a reduction in waste produced equivalent to at least 5 per cent of the 1998 arisings figure, doubling by 2010.
- *Diversion of commercial and industrial waste from landfill* By 2005 to reduce the amount of waste sent to landfill by 85 per cent of that landfilled in 1998 and to 80 per cent by 2010.
- *Diverting commercial and industrial biodegradable waste from landfill* By 2005 to reduce biodegradable waste sent to landfill to 85 per cent of that landfilled in 1998 and to 80 per cent by 2010.

From July 2004 there are no hazardous waste landfill sites and commercial and municipal waste is expected to increase by 3 per cent per year for the next

ten years. Wales is an economy dependent upon micro companies (93 per cent of businesses have fewer than 25 employees) and research and development is not prevalent. WAG has identified as the keys to success the following factors: resource productivity; innovative product design; development of recycling markets; best practicable environmental option (BPEO);<sup>7</sup> BAT; public sector procurement and the sharing of good practice. WAG has released substantial funding to a variety of organisations from local authorities to business support groups in order to assist companies in improving their waste management. For the period 2001/02 until 2004/05, £79 million will be given to local authorities and other organisations to meet targets for minimisation, recycling, composting and diverting waste from landfill. Funding awarded to business support organisations such as Arena Network, Waste Resources and Action Programme, Envirowise and Groundwork is intended to enable waste audits and provide information on current waste legislation. The 2003 Survey also seeks to remedy the fact that improving waste management requires the collection and analysis of sufficient data.

### **The commercial and industrial waste arising survey: Wales 2003**

During the 2003 Survey,<sup>8</sup> BRASS visited over 2000 commercial and industrial organisations across Wales, representing 2.5 per cent of the business population. The sample represented key industrial sectors within Wales and were randomly selected. The information collected included type, quantity and form of waste, waste management option, contractor and destination.

The survey provided BRASS with considerable soft data, particularly commercial attitudes to waste and their knowledge in relation to the impact of current waste legislation. The results highlighted the challenges facing governments, regulators and stakeholders in achieving sustainable waste management within businesses in Wales. A significant percentage of companies would be unable to alter their operational practices or their waste management system without external assistance. Significantly, although Wales has a large manufacturing sector it also has a large and growing leisure, tourism and services sector. Many of these organisations are located in rural areas and face the hurdles of cultural attitudes and the lack of an effective recycling infrastructure.

The 2003 Survey identified three classifications of companies: those who exceeded minimum legal standards, those who met minimum legal standards and those who fell below minimum legal standards.

Several questions were addressed: is sustainable waste management an achievable goal? What factors drive a company to implement sustainable waste management systems? How much impact does regulation and policy have on a company's waste management decisions? Integrated policies and strategies look not only to the law to alter corporate behaviour but also self-regulation,

economic instruments, voluntary agreements and business practices. They utilise the tools of corporate social responsibility, corporate governance, SD and environmental protection to achieve compliance. This reflects a tendency of legislators and policy-makers to shift environmental protection from being solely an external legal framework to an internal process of how companies manage themselves (Ong, 2001: 686).

Three companies from the survey have been chosen as examples of implementing effective waste management systems. While two are multinationals, one is a Welsh company. They all operate very different waste management systems but also had a number of common factors.

*Case study 1: Panasonic* Panasonic Communications Company in Wales is a subsidiary of the Japanese Matsushita Electric Industrial Company Limited. Since 1995 it has published a policy on social responsibility and since 1996 an environmental policy. The current waste management strategy is based on reduction and reuse: they recycle 88 per cent of their waste and send only 10 per cent to landfill. In 1990 the company was spending £75,000 on landfill disposal and in 2004 that cost has been reduced to £9000. The main reason for the company's waste strategy is derived from the global organisational attitude. Panasonic have also undertaken product evaluation methodology and life-cycle assessment, design products with deconstruction in mind and apply a green procurement policy to their suppliers. Key factors in the waste management practices of Panasonic are as follows:

- corporate commitment and support
- regular waste audits and corrective follow up
- member of voluntary environmental management scheme
- published environmental policy
- applied supply chain pressure
- waste initiatives developed by senior management and employees
- individual company champion
- product live-cycle analysis
- creative solutions to waste management problems
- ongoing waste minimisation activities
- waste training for employees
- actively involved with business support organisations

*Case study 2: Dolgarrog Aluminium* This Welsh-owned company manufactures aluminium cold rolled products. In 1989 it published its first environmental policy. Since the company's principal waste management policy was to reduce cost, the preferred waste management option was reuse or recycling. A prime factor in achieving waste reduction was segregation of wastes and encouraging suppliers towards recycling. Currently, the company sends only four waste streams to landfill for which they are actively seeking alternative sources. To improve operational efficiency and product quality the company replaced mineral oils with higher performance synthetic ones and mill-rolling coolant with one that had a longer life. This also reduced maintenance costs and entailed less production disruption. Key factors in the waste management practices of Dolgarrog Aluminium are as follows:

- conducting waste audits
- published environmental policy
- ongoing practice of waste minimisation
- member of voluntary environmental management scheme
- clear identification that waste is a loss of profit
- everyone is accountable to each other
- waste champion
- as all employees are potential shareholders, a direct connection with production efficiency

*Case study 3: Bosch Limited* Based in southeast Wales this is a subsidiary of the German Company, Robert Bosch GmbH. The company has policies on social responsibility and the environment, which were devised by the parent company. The company operates a policy of recycling by hiring only one waste contractor. Current legislation should have little impact on Bosch as they stated that they are ahead of targets and current legislation. The waste minimisation initiatives undertaken by Bosch include repairing rather than disposing of pallets; operating a returnable packaging scheme; and reorganising logistic control systems which reduce stock keeping and allow for more accurate supply ordering. Key factors in the waste management practices of Bosch are:

- published environmental policy
- conduct regular waste audits and followup
- member of voluntary environmental management system
- practice ongoing waste minimisation
- corporate commitment
- green product design
- waste training for employees
- are ahead of minimum legal standards
- waste management initiatives are part of a long-term logistic strategy
- encourage suppliers to follow their example
- relationship with waste contractor
- involved with business support organisations

These companies are in the main exceptions to the rule. In general businesses in Wales have been slow to realise that there are cost savings as well as environmental gains to be made through improving their environmental performance. One characteristic common to many of the SMEs in the 2003 Survey was poor accounting of waste management costs and the value of materials being discarded. This was coupled with a perception that environmental improvements are too expensive to undertake. There was generally a lack of environmentally qualified staff and management commitment due to time and financial constraints. Many companies possessed little if no knowledge of current legislation and policies. One company stated that '[s]mall companies like ourselves have no time or manpower to investigate policies or strategies, it's too expensive. There are so many regulations already, now all this comes on top of that. We simply can't keep up with it'.

A number of SMEs did not believe that they created any large-scale industrial waste. The quantities produced were nominal and therefore perceived as being of no impact or importance. A common comment was 'this is the amount of waste we produce, it cannot be changed'. Although some companies did monitor their waste expenditure, they had not undertaken any waste reduction and did not associate waste minimisation with waste expenditure. The problems highlighted by the survey included an ingrained waste producing mentality, a lack of responsibility for one's own waste and a lack of awareness in relation to improving waste management systems.

The same obstacles emerged repeatedly. Cost was a major issue, with insolvency the likely consequence of any additional costs. Lack of information was also identified, with several companies having no knowledge of ready alternatives. There were also infrastructure problems in terms of insufficient or unavailable recycling facilities or collectors. Quantity was also an issue: although companies wanted to recycle, they did not produce sufficient quantities to make collection economically viable.

By way of exception to the norm, Dolgarrog Aluminium identified waste as a cost to the company and acted accordingly. The true cost of waste is not just disposal but also materials, energy, resources and personnel. Waste can also be an opportunity having far-reaching environmental and financial benefits including the reuse of refurbished or rescued components in the manufacture, transportation and use of products. For example, Bosch's recycling policy is a source of income rather than a form of expenditure.

Commercial attitudes and practices differed according to sector, size and location. Industrial organisations have higher rates of recycling than commercial ones because many have eliminated sending their process wastes to landfill. Larger organisations are generally better at waste management than SMEs. However in Wales, the location of alternative waste management sources is also a vital factor. Poor road and rail infrastructure, particularly in rural areas hinders the availability of alternatives to landfill.

A failure to implement an efficient sustainable waste management system (that is, one based on appropriate technologies, strategies and procedures) could be a breach of a director's fiduciary duty to shareholders. The traditional view first espoused by Milton Friedman is that 'the social function of a business is to make profits for investors' (Friedman, 1970: 33). A number of factors have recently altered this perspective including the emergence of corporate social responsibility (CSR). In particular, increased public participation in decision-making requires corporations to be more transparent and accountable to a wider section of society. Public participation has been improved due to access to environmental information and community right to know legislation. These in turn increase demand for corporate self-regulation and voluntary reporting through environmental management systems and the



Eco-Management and Audit Scheme. The greater role of non-governmental organisations (NGOs) in highlighting commercial activities and the role of the media affects the perception of corporations in society. Businesses operate in a more visible society where they are expected to be receptive to stakeholders such as shareholders, employees, consumers, suppliers, NGOs and local communities.

Panasonic and Bosch acknowledge these trends and their environmental policies identify corporations as citizens with responsibilities. Panasonic's environmental policy, for example, states that 'Panasonic is a company that takes its responsibilities as a European and Global Citizen very seriously and foremost amongst these is a duty to protect the environment'. This is a clear identification and acceptance of the company as a citizen and not merely as a corporate entity with duties and responsibilities to the wider community rather than shareholders exclusively. The language used is that of CSR: actions that go beyond legal or regulatory standards and having social objectives rather than simply profit maximisation.

CSR combined with corporate legal responsibility requires that companies not only obey the law but that they alter their self-perceived role within their immediate community and wider society. Only through this means will the external legal framework become part of the everyday management of a company. How successfully a company manages waste reflects its organisational effectiveness. Companies can choose to operate waste management options, which cause it very little financial burden. In contrast, on-site burning of waste is illegal under section 33(1)(b) of the EPA (1990) and may result in a financial penalty of up to £20,000.

Such commercial behaviour suggests a company's attitude to its social responsibilities. The offender does not associate (or ignores) the potential damage from on-site burning to society, community and environment at large. The 2003 Survey indicated a strong connection among those companies who exceeded minimum legal standards with an acknowledgement of social and environmental responsibilities. This connection was missing among those companies who fell below minimum legal standards.

### **Key factors for managing waste sustainably**

Corporations irrespective of size are not homogeneous. Differences arise in corporate philosophy or industrial sector classification on account of size, location or individual employees so that no single sustainable waste management solution will be universally applicable. WAG has identified several influential factors. The first is accepting the cost. This is dependent upon the level of knowledge of the company, and to date most Welsh companies have not identified the 'real' cost of waste management. The second factor is technological standards and practices including integrated and innovative product

design, resource productivity, BPEO and BAT. Once again this requires knowledge, time and resources. WAG encourages businesses to reduce waste by process change, cleaner technology, improving operational practices, raw material substitution and continuous monitoring and reporting.

These factors were present in the three case studies considered above. However, it was the presence of additional common practices that resulted in these companies exceeding their corporate legal responsibility. All three companies had a published environmental policy, which they embedded into business practices through the adoption of voluntary environmental management systems. Furthermore, all three conducted waste audits and acted on the results. All three companies undertook ongoing waste minimisation initiatives and provided employees with waste training (two at the induction stage and one throughout). Two companies on account of their multinational status also undertook life-cycle analysis of their products at head office to evaluate the long-term impacts of waste. The companies also practised some form of supply chain pressure: whereas Bosch encouraged suppliers to follow their example, Panasonic implemented a green procurement policy and encouraged suppliers to obtain ISO14001 accreditation. If suppliers are unable to alter their practices to comply then Panasonic may choose to find others. Supply chain pressure would appear not to work in the reverse since one SME in the survey tried unsuccessfully to encourage a multinational supplier to provide goods in biodegradable packaging.

Significantly, parent company commitment was a driver for both Panasonic and Bosch, which in turn supported the initiatives of local employees. Corporate governance therefore encouraged waste initiatives through the identification of waste champions: local individuals within subsidiaries who were committed, perhaps for personal reasons, to undertake waste minimisation initiatives. This was evidenced in Panasonic by the practice of walk-about management techniques on the factory floor, talking to employees and listening to suggestions. There was also evidence of philanthropic responsibility within the company carried out by employees (Carroll, 1979). When asked who was responsible for waste within the organisation, Panasonic uniquely replied 'everyone in the company'.

Dolgarrog were perhaps motivated by different factors such as the cost of waste disposal but since all employees are potential shareholders there is an economic interest in inefficient operational activities. In short, their motives may have been less altruistic but no less effective.

The fundamental elements to internal sustainable waste management are a corporate commitment and individuals who accept responsibility. The corporate commitment requires integrating an environmental policy into the working practices of the organisation and into company culture. Waste considerations need to be included into management decision-making from

the very beginning of the production process. Companies also need to have a clear understanding of the types and quantities of waste they produce and to undertake ongoing monitoring and reporting.

The funding allocated by WAG to business support organisations is a step towards achieving many of these factors, particularly in relation to publishing policies, conducting audits and obtaining accredited Environmental Management System (EMS) status. Unfortunately, during the 2003 Survey only about 6 per cent of the companies surveyed had any knowledge of or involvement with business support organisations. Those who were involved commented that the relationship had generally been very positive and influential. However, the lack of waste infrastructure remains the single major obstacle to achieving sustainable waste management within Wales. Current legislation directs wastes away from landfill but as indicated by the Welsh Waste Strategy it is also an opportunity for Wales to achieve economic growth through the creation of recycling markets. Although many companies surveyed during the 2003 Survey were frustrated by the lack of recycling facilities at present any improvements are only negligible.

### **Conclusion**

Achieving sustainable waste management within business will not be accomplished through legislation alone. Resolving waste issues require a mix of economic, legislative and social solutions. The Environment Agency expects an increase in illegal dumping and fly tipping as a result of the end of co-disposal by July 2004. There were numerous violations of the duty of care regulations throughout the 2003 Survey, whether intentional or not. Some waste producers disposed of their waste in another company's waste container or passed it on to persons unknown, destination unknown. Although these acts are already covered by legislation they have not prevented such infringements from occurring.

The majority of companies will seek to comply with their corporate legal responsibility but will only ensure minimum compliance. A number of SMEs, particularly the very small ones, are struggling to keep abreast of the huge amount of environmental legislation. In 2004, the Confederation of British Industry reported that environmental regulations were the greatest concern for companies second only to employment rules. The poor implementation of environmental legislation caused further uncertainty among companies.

Furthermore, legislation will not alter cultural attitudes. WAG has observed that altering a company's self-perception that it is responsible for the waste it produces requires education and marketing. Waste is a feature of the external legal framework and is not yet part of the internal regulation of the company. The three case studies demonstrate that waste can transcend the external framework and become an integrated aspect of corporate governance. A key

challenge for government is to find the right mix of regulatory, economic and other instruments, including voluntary initiatives. The mix presently implemented in Wales does exist but is flawed. First, an extensive recycling infrastructure including road and rail transport does not yet exist within Wales. Second, business support organisations have not achieved wide recognition even though they can assist companies to obtain some of the core factors for exceeding minimum legal standards. These include an environmental policy, auditing and achieving EMS status. Third, Wales unlike Scotland does not have primary lawmaking powers. If Wales considered that the landfill tax was too low, it could raise it only with the support of the UK government.

Although sustainable waste management is achievable, most SMEs cannot achieve it acting alone. It requires partnership with local authorities, WAG, the Environment Agency, the UK government, business support organisations and numerous other actors. Furthermore, many of the barriers in Wales will not be overcome in the short term: cultural attitudes and poor infrastructure require long-term investment. Since improved information is currently required, business support organisations have to become more visible. Providing the necessary information is the first step to ensuring that companies understand the cost of waste, not only to their business but also to society and the environment.

### Notes

1. The Commercial and Industrial Waste Arisings Survey was funded by the Landfill Tax Credit Scheme via Biffaward and also in part by Environment Agency Wales.
2. During this survey only about 2.5 per cent of Welsh companies were surveyed. The results from this survey formed the basis of the targets for waste reduction by businesses in the Welsh waste strategy.
3. For definitions of these terms, see WAG (2002a: 13).
4. 2000/76/EC amalgamating 94/67/EC (hazardous wastes), 89/369/EEC and 89/429/EEC (non-hazardous wastes).
5. The exceptions to this rule are: (1) waste that is inert and for which treatment is not technically feasible and (2) waste other than inert waste for which treatment would not reduce its quantity or its hazard to human health and environment.
6. The proposed Hazardous Waste Regulations are due to be enacted in July 2005.
7. BPEO is defined as: 'The outcome of a systematic and consultative decision-making procedure which emphasises the protection and conservation of the environment across land, air and water. The BPEO procedure establishes, for a given set of objectives, the option that provides the most benefits or the least damage to the environment as a whole, at acceptable cost, in the long term as well as in the short term' (RCEP, 1988).
8. Aggregated data from the survey will be released at the end of 2004, when the Welsh data are amalgamated with the English Commercial and Industrial Waste Survey, and will be available on the Environment Agency website.

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# PART III

## ALTERNATIVE ACCOUNTABILITY MECHANISMS





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## 13 In the dark all cats are grey: corporate responsibility and legal responsibility

*John Sabapathy*

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### **Introduction**

In many ways the recent rise of corporate responsibility is in tension with the driving impulse behind the legal structure of public limited companies (plcs). If such companies have a genetic (legal) code, it is not to maximise shareholder returns, contrary to popular ‘anti-globalisation’ convention. More accurately, limited liability companies have evolved from the days of the East India Company as ways of doing precisely that – limiting the risk that owners took on when investing in the company (Micklethwait and Wooldridge, 2003; Bakan, 2004; Robins, forthcoming 2006). But irrespective of the explicit interest of the law in framing corporate responsibility, the two are always and necessarily intertwined, even if the law only provides the frame within which corporate responsibility happens.

The ambiguity of the relationship is in part precisely related to the massive recent rise in voluntary activity that has sought to achieve civil rather than legal regulation. The phenomenon has been variously labelled as ‘corporate responsibility’, ‘corporate accountability’, ‘corporate social responsibility’ (CSR), ‘corporate citizenship’ or ‘corporate sustainability’. This proliferation in jargon can be happily distilled to a core issue: companies’ consideration and integration of social, economic and environmental impacts into their strategising, processes products and services. It is this that ‘corporate responsibility’ denotes in this chapter. Today thousands of non-financial reports are produced annually (see [www.globalreporting.org](http://www.globalreporting.org)) addressing companies’ legal compliance with health, safety and environmental regulations as well as other issues that drive economists such as Martin Wolf to despair (Wolf, 2002).

This chapter provides an inevitably partial overview in three main sections. First, it considers to whom companies are thought responsible. It then asks for what they are responsible. The main analysis closes by asking what mechanisms the ‘corporate responsibility movement’ has mobilised to enforce its aims – whether mandatory, voluntary or some other arrangement. Its starting point is British and European, although it tries to site these developments in their wider global framework.

While the use of one or other of the above terms can signify a particular user's (political) emphasis or perspective, they unhelpfully continue to be used more or less interchangeably. Terminological consensus can mask complete disagreement but equally, the use of different terms need not imply a political difference about what constitutes corporate responsibility. In continental Europe, the discourse and practice of government, labour and civil society 'social partnerships' creates a significantly modified starting point when compared to the UK (Nelson and Zadek, 2000, *passim*). In Denmark for instance, the debate is far more likely to take as read corporate involvement in delivering public goods. In the UK the development of the CSR movement (as it is generally and unattractively described) emerged out of the twin starting points of 1980s' corporate philanthropy and inner-city regeneration before moving towards attempts to define the so-called 'business case' for corporate responsibility. This strategy has partly arisen from corporate and governmental resistance and scepticism about the likely effectiveness of any legislation on this subject: any strategy which bypasses the need for regulation by appealing to self-interested action is consequently attractive. In the USA, the concept of corporate (philanthropic) citizenship has dominated, reflecting American companies' historic definition of their social role and anxiety about open-ended accountability. To allow such definitions, it seems, is *not* to limit liability.

If this reason for American corporate resistance is true, the irony is that it means that the USA has been one of the few cultures to take the language of corporate responsibility seriously (Muirhead et al., 2002). This arises in part out of American corporate culture's notorious sensitivity to potential sources of litigation: sources that are necessarily enhanced by assenting to the accountability of the company to other groups or individuals. But this is precisely the implication of using the language of corporate responsibility. It signifies duties owed by companies to society, not gifts given. Yet the most visible use of the phrase 'corporate responsibility' by the current US administration was as a backdrop for George Bush's announcement of the process that led to the Sarbanes–Oxley Act following the Enron and WorldCom scandals. The point here of course is that these were corporate scandals that hit shareholders and employees – not scandals that raised wider questions about companies' responsibility to society. 'Corporate responsibility' was being used in a narrow and technically accurate way. This is at worst, a sign of the relatively poor progress made by advocates of corporate responsibility elsewhere in turning their language and their principle concept – the stakeholder – into a device that has sufficient traction to hold companies to account for their wider social, environmental and economic impacts.

## **Responsible to?**

### *The stakeholder: soft and hard definitions*

The idea of ‘stakeholders’ to whom corporations owe some duty of care is perhaps the key conceptual principle driving recent attempts to define and institutionalise corporate responsibility. Indeed for a time the idea of ‘stakeholding’ seemed to provide a possible basis for broader political debate, although here at least the language has fallen into disuse (Blair, 1996; Wheeler and Sillanpaa, 1997). It remains critical nevertheless in discussions of corporate responsibility and has passed untranslated into French, Spanish and German. The basic definition is that stakeholders are persons who affect or are affected by the actions and activities of organisations. This way of defining stakeholders was explicitly used in the mid-1990s as a way of giving traditionally excluded groups the ability (if not the notional right) to call more powerful interests to account for their impacts (Raynard et al., 1996). The development of this language was then used by non-governmental organisations (NGOs) such as the New Economics Foundation to underpin ‘social audits’: evaluations of companies’ social and environmental performance. Initially the preserve of mostly ‘niche’ companies with strong ethical aspirations (for example, Ben & Jerry’s, The Body Shop), these audits and their resulting reports are now undertaken by increasing numbers of large companies. In turn they have fostered an international industry of NGOs, consultants, analysts, academics and in-house corporate specialists. The idea and principle of stakeholder consultation remains key in all this activity (much of variable quality). Whether it is traditional consumer group surveys or sophisticated engagement with Vietnamese garment workers inside Adidas’s supply chain, the underlying proposition is that stakeholders’ views must be sought if we are to gauge corporate responsibility.

Underneath this are deeper debates about the nature of organisational rights and responsibilities that the language of stakeholders entails. To simplify, if we use the language of stakeholding it means that corporate responsibility expresses one of two different forms of behaviour:

1. Either corporate responsibility comprises duties that are owed by corporations to stakeholders and which are therefore inalienable. To have stakeholders is therefore to have ‘really’ and literally extended the boundaries of organisational responsibility. This would then carry structural implications for how and for whom the company is run.
2. Or corporate responsibility comprises voluntary efforts whose assumption nevertheless falls short of implying a real duty of care towards stakeholders. Such efforts are therefore rather extensions of philanthropy, and the language of the stakeholder is more metaphorical than literal. This would not carry the same implications for how and for whom the company is run.

This debate often feels relatively muted outside of academic or campaigning NGO circles. In part this is due to the political sensitivity of gradualist organisations who seek to encourage rather than criticise corporate engagement with stakeholders and consequently avoid drawing categorical lines in public debate. In part it is also due to the political pragmatism of those inside and outside of companies who are working to integrate corporate responsibility deeper into businesses' core activities and who do not wish to jeopardise their work by appearing too extreme. And finally it is in part due to real ambiguity about what is actually happening to corporations' responsibilities and which definition of stakeholding is 'winning'.

Unsurprisingly then, advocates within companies have different public and private views about what their corporate responsibility activities actually mean. The obvious corollary from this is that, up to a point, from outside a company the same activity conducted within different companies can imply different political positions about that company's 'acceptance' of corporate responsibility. It is logically true that there will be different groups applying different interpretations inside any given company. The corporate responsibility manager may have a different perspective on the company's duties from the chief financial officer. And this creates the daily conundrum faced by civil society advocates when looking at companies, particularly where a company produces and releases a report on its sustainability. Company X may be 'more' accountable, and responsive to its stakeholders than Company Y. They may be reporting using the same reporting template (say, the Global Reporting Initiative guidelines – see further [www.globalreporting.org](http://www.globalreporting.org)). Their reports may look similar but belie completely different struggles for corporate responsibility inside each organisation. 'Justification by reports alone' proves insufficient as a guiding principle, to date.

*British company law and stakeholders* The recent discussion about the revision of the Companies Act convened by the Department of Trade and Industry has exemplified both the desire to retain and eliminate the 'productive ambiguity' encouraged by such open-ended approaches to stakeholders. The independent Company Law Review, which produced in July 2002 the Modernising Company Law White Paper, appeared to end the hard-fought battle about who company directors have to report to and about what. The debate was framed in apparently arcane terms around two principle concepts: 'users' and 'materiality'. The first concept and debate concerned whether the category of report users should go beyond shareholders to encompass some definition of stakeholders. The second debate occurred largely after the issuing of the White Paper and was held in relation to the 'operating and financial review' (OFR) – the paper's newly proposed, reporting vehicle designed to address corporate performance issues (DTI, 2004). This second debate

concerned the OFR's coverage of 'material' information, and how far a definition of materiality would stipulate the inclusion of corporate reporting on social, environmental and economic impacts and performance. This second debate is dealt with in the next section.

Campaigning groups largely saw the debate as an opportunity to achieve a binding definition of corporate responsibility. Most business groups, unconvinced of the value of what they saw as restrictive definitions did not wish to see this. The debate on users eventually favoured a predominantly shareholder-driven perspective – that is, the White Paper defines the principal users and audiences of reports to be shareholders. While others (creditors, potential investors together with 'other stakeholders and the wider public') are cited as relevant, the NGO-led campaign to structure the OFRs' terms around a stakeholder-based definition of 'users' failed in its broader objective. The opportunity to debate the issues provided by the Company Law Review has led in Britain to the creation of the Corporate Responsibility Coalition ('CORE'). Convened by Friends of the Earth, CORE continues to lobby for a mandatory Corporate Responsibility Bill that would require companies to report on a wide range of corporate responsibility issues ([www.corporate-responsibility.org/](http://www.corporate-responsibility.org/)).

### *Corporate reporting and corporate responsibility*

This chapter has already made numerous references to reporting and corporate responsibility, sometimes risking the elision of both terms. It is worth pausing and asking what is going on here, because such reporting has become both a valuable focus and a limiting fetish. The volume of reporting is often used as a proxy for the 'level' of corporate responsibility. The advantages and limitations of such measures are clear: it provides a concrete focus for attention and a reason for working out what a company's social, economic and environmental impacts are. So too can it limit attention by conniving in the assumption that 'reporting = responsibility'. Similarly, as argued above, reporting can hide a multitude of sins or obscure thriving good practice. But more interesting (given their overwhelming importance in the debate) is how the reports themselves discharge accountability functions to stakeholders. The bad news is that when companies have publicly reflected on the value of reporting they have expressed doubts about how they and external stakeholders use their reports (Monaghan et al., 2002). Certainly it is clear that most directly affected stakeholders do not make use of these reports. This is not to generally imply that these reports are produced in bad faith, or that they are a waste of money and effort. It is to imply that models that identify mandatory reporting with the attainment of corporate responsibility are too simplistic. And it is to say that reporting plays a much more complicated and indirect role as a mechanism for achieving accountability.

There are groups who do believe that some companies produce their reports

in bad faith (see further below). This has resulted in ‘anti-reports’ that subvert official corporate reports by offering the ‘real’ information some believe has been deliberately omitted from the latter. British American Tobacco, BP and Shell have all been on the receiving end of such reports, assembled by NGOs and designed to look like their official reports. Critically, given the argument about ‘intermediary accountability’ below, these reports aspire to giving voice back to those groups that are deemed excluded or ill-served by the companies’ official corporate responsibility reports. They are designed as attempts to return to a stronger expression of stakeholder accountability – in which its stakeholders evaluate the company – and which some groups feel has been lost as a side-effect of the ‘CSR industry’s’ rise.

*Intermediary accountability* It is certainly true that in industrialised countries, the responsibility of making good use of companies’ reports and finding ways of making the activities behind the reports more effective falls largely (outside the companies themselves) on intermediary groups. Pragmatically speaking, companies render accountability to those who speak on behalf of individual investors, workers or homeowners affected by a given company’s actions. There are, certainly, many successful groups who consist of these ‘direct’ stakeholders. There are equally, many others who lie one step beyond them and act as intermediaries, their link with directly affected groups acting as their right to speak. The professionalisation of civil society increasingly encourages this when dealing with the media and large multinational corporations, although groups such as the World Social Forum ([www.forumsocialmundial.org.br](http://www.forumsocialmundial.org.br)) emphasise the unmediated authenticity of the voices they provide a platform for. Nevertheless, when it comes to the conceptual and institutional formulation of corporate responsibility as a movement it is industrialised nations and groups based in them that have led the way – for better and worse.

Therefore, legal attempts to define who companies are responsible to are only one part of the conversation. Legal definitions provide a threshold but not the ceiling. The existence of so many corporate responsibility intermediary organisations has naturally fed into critiques of the corporate responsibility ‘movement’ itself – not least from organised labour. Such critiques have accused the movement (comprising NGOs, academics, consultants, labour groups and corporations themselves) of falling prey to corporate capture and adopting an essentially managerial position that eliminates the voice of weaker or less powerful stakeholders in the discussion. Given both the diffuse nature of the corporate obligations under discussion and their ability to explode unpredictably in public there was considerable anxiety on all sides about how a consensus would emerge about what corporate responsibility was. This saw a veritable explosion in the mid-1990s of groups defining indicators, establishing guidelines and seeking to steer this process of consensus building (see

next section). The dust has by no means settled, but it is worth touching on three initiatives whose institutional structure connects directly with the issue of intermediary accountability.

The Global Reporting Initiative, the Ethical Trading Initiative and AccountAbility all grew out of this 1990s process with distinct mandates and sought to firewall their missions through applying hard-wired multi-stakeholder governance frameworks which were intended to prevent the dominance of any one sectoral interest. All have complex procedures for selecting board members or equivalents from their constituencies and importantly all seek to represent a variety of constituencies. Their purpose is to provide a stable space within which groups that have often been historically antagonistic to one another can address shared corporate responsibility problems. Companies, trade unions, NGOs, consultants academics and accounting professionals have all played roles in influencing the activities of each.

*Via shareholders to corporate responsibility?* If, by and large, this generation's attempts to hardwire the concept of stakeholders into (for instance) UK corporate law has failed there are other routes that are being explored. Rather than addressing stakeholder rights, these extend traditional debates about corporate risk. Does the possibility of child labour in Pentland's supply chain pose a risk to the company? What is the potential risk to Orange from mobile phone pornography created by third generation handsets? Such a route to integrating corporate responsibility into companies' strategic considerations does not inherently hinge on the concept of stakeholders. Instead it hinges on a return to a company's self-interest. The views and feelings of stakeholders may be a way of organising or defining the risk, but risk-based approaches to corporate responsibility do not require any bond of trust between company and stakeholder. That may make it a stronger or weaker pathway for encouraging companies to be responsible, and it is a pathway that we can ill afford to ignore. What it certainly provides is a mechanism for defining what companies may be responsible for.

### **Responsible for?**

Defining this is particularly important since, although different issues of 'corporate responsibility' will be found reported in the pages of the *Financial Times*, the reality is often that different issues are handled by different groups inside and outside of the corporation. This section works through three different approaches to defining corporate responsibility which, despite their intertwinement in public politics, are the product of distinct strategies for delineating what companies should be responsible for.

*'Single issue'*

Much lobbying is conducted by 'single-issue' campaigners: groups that take a discrete area of corporate impact and specialise in it. This is partly as a result of the ongoing professionalisation of the corporate responsibility industry. Representatives in business, government and civil society working on, for instance, labour rights issues are perfectly likely to have postgraduate qualifications and/or field experience. The presence or absence of qualifications is of course less important in perhaps the biggest area of single-issue types of campaigning: local neighbourhood campaigns. Here, again, the authenticity of campaigners' experience is what qualifies them to speak, whether the issue is the erection of mobile telephone masts or the building of a new shopping centre. The Ogoni campaign against Nigerian state oppression and alleged corporate involvement is a good example of local campaigners and professional groups combining to increase the leverage of both groups.

Human rights and development issues have for many years been the two largest subjects for social campaigning. Labour rights groups have developed an extraordinarily visible profile over the last ten years and include the Ethical Trading Initiative (UK), Global Exchange (USA), Clean Clothes Campaign (Netherlands/Europe) and the Maquiladora Solidarity Network (Canada). Perhaps most interesting is the rise of the business membership group for businesses who want to engage with the corporate responsibility agenda and necessarily play a role in developing it. Groups such as Business for Social Responsibility (USA), Business in the Community (UK) or CSR Europe (Belgium) are well established. But so too are Instituto Ethos (Brazil) or the Centre for Social Markets (India/London). These business membership groups play a particularly interesting role when issues of legal corporate accountability arise, since government naturally turns to them as a legitimate business voice when discussing social or environmental legislation aimed at business. Often, however, the existence of such voluntary groups is taken as evidence that legal action is not required, which as a blanket principle is nonsensical, and which even in specific cases makes little sense given the very small absolute numbers involved in such initiatives (the Global Reporting Initiative, for example, lists some 600 groups currently reporting using its standard). The Disability Discrimination Act in Britain is a good example of coordinated business involvement in social legislation. Here, businesses that felt they had strong records on equal opportunities, retention and adjustment practices for disabled employees and customers actively involved themselves in the legislative consultation. Business membership groups such as the Employers' Forum on Disability played important roles in expressing members' views on what would in their view be effective legislation. It is too easy to be cynical about such involvement as self-serving. It would be foolish to ignore the insight and experience of companies with experience of voluntarily practising a given



activity. Equally, companies' perspectives and agendas can only be one part of governmental consideration when setting out the public goods it wants.

Businesses with relatively strong records of voluntary activity have, in any case, highly ambivalent attitudes towards legislation. On the one hand they feel that competitors who do nothing have an unfair advantage and therefore want a levelling of the playing field. On the other they remain anxious that legal intervention will eliminate the basis for any market differentiation based on their corporate responsibility practices.

Environmental campaigning is the most established of single-issue campaigning areas, the most quantifiable, and, in that respect, potentially most amenable to legal intervention. But one of the philosophical conundrums given the stakeholder model outlined above is that the environment is 'voiceless' – everyone and no one is a stakeholder. In terms of local environmental disputes (for example, pollution by a factory) this is no different from any other engagement between stakeholders and corporations. But elsewhere the peculiarly deferred effects of environmental problems often appears to leave no one affected, making it very difficult to campaign against vested interests who would be immediately affected by any change. The USA's ongoing failure to ratify the Kyoto Treaty is the outstanding example of this dynamic. More modestly, when at the end of 2004 European Commission proposals for drastic cutbacks on fishing quotas collapsed, the threat to fish stocks could only be 'represented' by specialist biodiversity groups, whereas the immediate interests of fishing groups was far more tangible. The French government has explored this challenge and drafted an Environment Charter which, if passed into law, would give citizens recourse to legal action if they felt that their right to 'live in an environment which is balanced and respects their health' was not being upheld (*The Guardian*, 27 May 2004).

Despite the longevity and experience of groups such as Greenpeace and Friends of the Earth in campaigning on environmental issues, and despite the more readily quantifiable nature of environmental problems, these difficulties in how we experience the environment as a public good make it very hard to effectively bridge corporate responsibility and legal responsibility for it.

### *Encyclopaedic*

As noted above in the wake of multiple single-issue campaigns, from the 1990s various groups have sought to systematise and organise the seemingly disparate ragbag of issues that had been thrown up. The logic of this was to try to achieve a consensus about what corporate responsibility was; to make it easier for companies to see what the whole picture looked like; and to make it easier for civil society advocates to organise around this shared set of issues. Most illustrative is the history of the Global Reporting Initiative (GRI). Initially an outgrowth of the Coalition for Environmentally Responsible

Economies, the GRI was convened as a space within which companies and civil society could reach an international consensus about how and what companies should report on their sustainability. The process has produced two successive iterations of guidelines (most recently in 2002) and is envisaged as necessarily ongoing. The first iteration concentrated on relatively generic indicator sets, divided into environmental, social and economic sets. The first mentioned vastly outweighed the last two in number and specificity. The 2002 guidelines have done much to rebalance this, and there has been increasing recognition of (a) the need for principles to help companies select relevant or material indicators and (b) the need for sector-specific supplements to the core set of guideline indicators. Because of its nature, the GRI is a good index of the current consensus of what should be measured and which measures should be used ([www.globalreporting.org/guidelines/2002.asp](http://www.globalreporting.org/guidelines/2002.asp)).

The production of the 2002 guidelines was preceded by an enormous international round of consultation, working groups and negotiation over what should go into the guidelines. They were seen, rightly, as the principal international forum for defining corporate responsibility enjoying corporate, NGO and labour buy-in. Inevitably the process threw up all sorts of questions which any other attempts to codify (whether normatively or legally) must wrestle with: what are the boundaries of the reporting organisation? Do I report on my supply chain? What are the principles I should use to decide what indicators to report on or do I just report on everything? Is the process principally about the production of a report and if not, what weight should be given to the process of stakeholder engagement that precedes reporting?

The GRI raises important questions for any attempts to codify corporate responsibility in law. The presence of labour groups, NGOs, consultants and companies in the GRI's governance as well as the UN's endorsement of it makes it a very serious political initiative. At the same time, it is clear that a great deal of work remains to be done in working through corporate sustainability reporting. At present only three sector supplements exist (telecommunications, tour operators and financial services). The issue of reporting boundaries remains to be clarified. The assurance of sustainability reports remains a huge challenge (ACCA & AccountAbility, 2004). So too does the relationship between principles of selection – for example, determining what is material or relevant – and reporting on the substantive indicators themselves – for example, description of policy for preserving customer health and safety during the use of products and services (Zadek and Merme, 2003). The implications of this for attempts to legislate on corporate responsibility reporting are set out in the next section. It is sufficient to note here, however, that there is by no means a clear continuum between agreement on how to handle and measure a specific corporate responsibility issue and its codification in law.

*'Principle based'*

Although the GRI has attracted most of its attention because it defines what companies should report on, it also sets out equally (perhaps more) important principles of how companies should approach the process of making themselves responsible. Such 'principle-based' methodologies should indeed be part of the same continuum of corporate responsibility since, as already noted, indicator sets alone beg rather than answer questions. Much of AccountAbility's work has addressed the challenge of defining the processes and principles which would, as one of their effects, lead to the production of the corporate reports that have been discussed here. The AccountAbility 1000 standard (AA1000) was first issued in 1999 as a guideline for organisations wanting to identify their stakeholders, engage with them, determine the organisations areas of impact and, as one output, report on them (AccountAbility, 1999). Partly anticipating the issues that would arise from defining indicator sets as well as seeking to complement initiatives such as the GRI, AA1000 saw the challenge principally in terms of adequate stakeholder engagement. It argued that framing this process was the challenge, particularly when within a voluntary framework sanctions are needed to discourage the avoidance of difficult or 'weak' stakeholders whose views are not politically important to a company. The need to construct some form of binding evaluation of how well this engagement has been managed led AccountAbility to develop an Assurance Standard which sets out the issues that those 'assuring' a corporate responsibility report should apply – and moreover in ways comparable to the assurance of financial reports (AccountAbility, 2003). The principles outlined are intended to be rigorous but responsive to individual organisational idiosyncrasies. Key questions addressed are:

1. Is the information presented material – that is, does it cover the organisation's key areas of impact? Is information omitted which would prevent a reader from reaching a view of its hierarchy of impacts?
2. Does the information presented reflect the responsiveness of the organisation to its stakeholders – is engagement apparent, is inclusion of information resulting from engagement apparent and what are the feedback loops that make the report reflective of a series of 'real' relationships rather than reflective simply of itself?
3. Overall, is a user, on the basis of the information presented, able to form a complete view of the organisation's sustainability? Are there territorial gaps in the report's coverage, is there a clear sense that the organisation has priorities for future work and is there an alignment between resources available and priorities set?

The intention with this last strategy was to provide authoritative guidance, not so much on what subjects should be covered, but rather on how such reports

should be evaluated. The eventual goal was to create a market-based feedback loop within which:

1. companies wished to make their reports credible and therefore sought guidance on what an evaluation would look like;
2. their consultants would want a framework for prioritising issues when working with a company;
3. assurors would require a framework within which to assure; and
4. civil society would want a basis on which to evaluate the inclusion or omission of 'relevant' issues.

As with other initiatives in this area, the eventual impact of such strategies remains to be seen.

#### *Corporate responsibility and globalisation*

The work of both the GRI and AccountAbility are in the nature of 'civil regulation' – attempts by civil society (including companies) to provide agreed mechanisms for addressing corporate responsibility where other legal and social contracts do not. They are therefore defined, by and large, by the absence of participation by international governmental organisations (IGOs). In parallel however, there also exist overlapping, sometimes complementary, sometimes disconnected IGO initiatives. Both the examples of civil regulation cited above and many of the key IGO examples share the aspiration to provide internationally functional tools. This functionality may mean only that the tool is not so context specific that it cannot work elsewhere, or it may mean that the initiative has active aspirations to be used internationally. Good IGO examples would include the Global Compact ([www.globalcompact.org](http://www.globalcompact.org)), the UN-housed initiative which provides a high-level overview of the corporate responsibility values that a range of UN bodies wish to strengthen. The OECD's 'Guidelines for Multinational Enterprises' would be another example, although here the coverage is obviously limited to OECD countries.

While their international mandate make these fora highly attractive to civil society groups who are seeking authoritative platforms on which to define corporate responsibility, this in no way guarantees their success. Thus there has been considerable anxiety within business about what the 2004 UN Business Norms for Human Rights address and how they would be monitored. The Global Compact itself has undergone criticism for allowing companies to be listed as participants on the basis of an annual letter from their chief executive to UN Secretary-General Kofi Annan describing what action the company had taken over the previous 12 months to implement the compact. Similarly, questions have been raised about the effectiveness of the OECD's national contact point scheme as the principal mechanism for tracking and

addressing alleged breaches of its guidelines. Part of the reason for the relative success of civil regulation in this environment is precisely because of the relatively greater speed and ease of negotiating consensus on corporate responsibility. Given their international standing, what can be endorsed coming from a civil society organisation becomes far more difficult to endorse coming from an IGO.

What is more broadly important about both civil and IGO initiatives is that they are increasingly seeking to complement one another and create consensus and coherence rather than confusion. This is a striking contrast given the position at the end of the twentieth century, when the relative novelty of attempts to synthesise corporate responsibility, together with a completely open market for institutions seeking to provide such consensus led to a sandstorm of initiatives.

The desire for intra-initiative consistency can make real differences to what any given institution does or says. Both AccountAbility and the GRI have sought to align their public pronouncements in this way and reinforce one another's messages. Similarly, intra-governmental action can be affected (although needless to say such coordination is by no means the norm). This can be clearly seen within the European Union. In the UK debate on the OFR mentioned above, one of the key terms was materiality. It was widely expected that this was the terminology to use when seeking to define the debate's terms. There was even a 'Materiality Working Group' to which submissions were invited. It came as a surprise therefore when the OFR eventually reported and substituted the terminological concept of materiality for the need to report on non-financial issues 'to the extent necessary'. The last-minute switch had been taken in order to make the UK language consistent with the European Modernisation Directive. Such debates are at one level arcane exercises in word-play. At another level, however, there was a very real ambiguity about whether this language was in some sense 'weaker' than the language of materiality that had been developed in, through and because of the OFR consultation process. As with so many of the questions discussed here, its history remains to be made.

### **Responsible through?**

The previous section has described what different stakeholders think that companies 'should' be responsible for while occasionally touching on how this 'should' is enforced. So, if this is what companies are responsible for, how then are they made responsible for these issues? For advocates of broader concepts of corporate responsibility, this is partly a function of politics, partly a function of strategy and partly a question of legal leverage. Although there are some issues that are dealt with through hard law and legal requirements, most aspects of corporate responsibility seek realisation through other mechanisms as already noted.

*Civil regulation*

The last section addressed a number of exercises in ‘civil regulation’. The normative reference points for almost all such exercises are the treaties and conventions of the UN and its subsidiary bodies. The UN High Commission for Human Rights provides the core international standards on which all work on human rights is based ([www.ohchr.org/english/law/index.htm](http://www.ohchr.org/english/law/index.htm)). The International Labour Organisation’s Core Conventions provide the point of departure for all credible initiatives on labour rights. The UN’s Millennium Development Goals offer a basic consensus for developmental initiatives. The 1992 Rio and Agenda 21 declarations of the UN’s Environment Programme (UNEP) have provided key environmental priorities and goals. Although all are based on state participation, rather than business participation (as with the OECD), it is these norms that the Global Compact seeks to translate for businesses. These norms therefore set the tone, base and stage for other institutions whose direct interest is corporate, rather than state responsibility.

A subset of those groups have already been partially analysed above. The value they play is precisely that of intermediary institutions between immense and generalised international principles such as the UN’s and national business cultures which include binding law.

For a number of reasons, therefore, ‘civil regulation’ seems a far preferable language than that of ‘voluntarism’. The language of voluntarism has generated an unhelpful either/or opposition between ‘voluntary’ and ‘mandatory’ approaches. Inevitably in open democracies where the social contract between business and society is being renegotiated, it is highly unlikely that governments will introduce binding, primary legislation without having experimented with it on a voluntary basis first. The language of civil regulation also makes clear therefore that while not binding, such approaches can offer civil sanctions which give institutions such as the Ethical Trading Initiative (ETI) teeth. Certainly there is no de facto obligation to interact at all with such institutions. But corporate non-members with significant supply chains do want to join. The ETI has declined membership to companies which it has felt it could not admit. Sometimes this has eventually resulted in admission, sometimes not. Likewise, corporate members do not want to be told by the ETI’s secretariat that the ETI annual reports they are required to produce are inadequate, and thereby risk expulsion. Fear of expulsion and desire for inclusion have both acted as drivers for companies to comply with the requirements of voluntary initiatives. Of course the membership requirements of different civil regulators vary widely and wildly.

*Peer-based norms*

This discussion shades into a related but nevertheless discrete mechanism for promoting corporate responsibility: peer-based norms. Again, these norms are

strictly voluntary but set thresholds for companies who wish to establish themselves as either leaders in a particular region or in a particular sector. In the former category, BOVESPA (the Brazilian Stock Exchange) offers enhanced credit ratings for companies with strong governance and corporate responsibility credentials, as does the Johannesburg Stock Exchange which requires reporting against the GRI framework. FTSE4Good has acted as a London-based listing for companies wishing to be evaluated for their corporate responsibility while the Dow Jones Sustainability Group Index offers a European perspective that breaks participants down in a ‘best-of-sector’ approach. These approaches by the financial sector have been a critical development of the last five years. Their importance is not only that they establish an explicit link between financial listing, access to finance and corporate responsibility. More broadly, they reflect the globalisation of non-financial standards for companies operating internationally – demonstrating that sufficient clarity has been gained to make the financial markets’ evaluation of corporate responsibility a part of their assessment of corporate value.

Other sectoral approaches have taken an ‘involuntary’ inclusion approach – that is, companies have been ranked by organisations without the companies necessarily wanting to participate. This was the basic model for AccountAbility’s Gradient Index ([www.gradient-index.net](http://www.gradient-index.net)), a ranking of six UK sectors for their management of supply chain labour rights issues.

Still more sectoral groupings have revolved less around listing and ranking and more around participation in voluntary self-regulation activities. The Kimberley Process Certification Scheme is a good example. Participating companies, from the 51 signatory states, agree to provide warranties to all diamonds they sell which guarantee that these rough diamonds have not been mined in conflict zones as well as providing paper trails back to source. An exercise in government-brokered civil regulation, it is a further example of both its limitations and its achievements. Operating at the high-end of the market, such initiatives create structures for companies and provide points of reference for consumers, governments and the financial industry but have little way of forcing those to play who don’t want to. Thus the AccountAbility Rating (AccountAbility & CSR Network, 2004) took the 100 largest global companies and scored them for their corporate responsibility but found that the average score was a mere 24 out of a maximum of 100. Part of the reason why the financial industry has become so interested in these mechanisms for the evaluation of corporate responsibility is that civil society pressure has made this an aspect of performance. Although there was apparently little impact on Shell’s share price from the crises it faced in Nigeria, it was clear that corporate responsibility was becoming part of its risk register. Front-page stories in the *Financial Times* (22 February 2001) about worker deaths in Indonesia also created a ‘business case’ for Nike to improve its corporate responsibility.

*International agreements and legally binding regulation*

Finally there is of course the law as a means for obtaining corporate responsibility. Much of this chapter has analysed non-legal mechanisms' attempts to create the sorts of outcomes we want from law: corporate participation, agreed terms and conditions for participation and also sanctions for abrogation.

There is of course a huge amount of legislation already on statute books that obliges companies to be responsible in given ways. Corporate governance codes set standards general standards for behaviour, whether it is Sarbanes–Oxley in the USA or the Combined Code in the UK. The US Toxic Release Act regulates corporate pollution. Discrimination legislation of various hues is well-established across most post-industrial countries. Within Europe the Human Rights Act may prove to be an important instrument for corporate responsibility, although in this context it has to date largely been used in resolving cases such as unfair dismissals.

Obviously such laws vary widely internationally, and this has created its own problems when companies relocate to less-stringent legal regimes. At the moment companies and civil society groups are evaluating how to prevent the conclusion on 1 January 2005 of the World Trade Organisation's (WTO's) Agreement on Textiles and Clothing precipitating a collapse in responsible apparel sourcing practices. The ending of the WTO's quota system in this area (which has to date forced multinationals to spread their sourcing beyond the cheapest – and poorest – countries) will create enormous pressure even for those companies committed to labour standards to source from countries with inevitably poorer practices.

In a different context, the concept of foreign direct liability has been used to sue companies listed within stronger legislative regimes for practices committed in weaker regimes and which are moreover only illegal where those corporations are listed and not where the offences are committed (Ward, 2002). Nike found itself at the receiving end of the now famous case brought by the activist Marc Kasky. Another complex legal battle, the centre of the argument concerned the legal status of Nike's public statements concerning its corporate responsibility and whether these statements were protected under the USA's 1st Amendment or whether they could be censured as misleading and therefore qualifying as unfair competition under California state law where the case was first brought (Ward, 2003). The case was fascinating because it promised to test the legal standing of corporate responsibility reports. Some civil society advocates were keen to make these statements legally binding and therefore a means of obtaining accountability. Others feared that to do so would freeze what was ultimately a voluntary activity in any case. The case was eventually settled out of court in September 2003, without the issues at hand having been tested at all (either the truth or falsity of Nike's public pronouncements or the status of these pronouncements at



law). Such cases are complex and difficult to generalise from, but they show both the immense complexity of corporate legal responsibility and the legal acrobatics involved in using the existing law to achieve corporate responsibility.

The final set of alternatives here is the introduction of laws specifically designed to create corporate responsibility. Beyond relatively specific issues such as discrimination legislation and the like there have been a few attempts to introduce such laws to date. In 2001, France introduced its *Nouvelles Régulations Economiques* which require all listed French companies to provide reports which ‘contain information on how the company takes into account the social and environmental consequences of its activities’. To date the devil remains in the detail and while reports should address employees, working hours, wages, health and safety conditions and supplier relations it is unclear how their legal status will improve the quality of reporting or corporate practice. At the other end of the spectrum, at the end of 2004 the British government introduced a draft bill on corporate manslaughter, potentially opening individuals inside companies to such liability (*The Guardian*, 23 November 2004). How this would work and what levels of attenuation it would provide down supply chains for instance remains completely unclear and would not be clarified before the next British election.

### **Conclusions: from soft law to hard law?**

The basic assumption in the minds of many campaigners is that as corporate responsibility becomes more clearly defined, so too will it become easier to make mandatory and so too will companies become more accountable and responsible. Should we therefore expect all forms of corporate responsibility to move towards legal codification once we agree how best to achieve given social or environmental outcomes?

It is not clear that we should. The displacement of economic activity from a more to a less onerous social/environmental regime has already been illustrated. Within a closed economic system it might be theoretically possible to achieve corporate responsibility through such mechanisms, but it becomes practically impossible within a global economy. Nor does it seem immediately apparent that the solution is therefore to construct binding international frameworks, given the immense political challenge of even ratifying the modest environmental goals of the Kyoto Treaty. By its nature, the space which such international fora can create, while valuable, is not politically radical.

One moderate view is that some aspects of corporate responsibility may remain voluntary, while others will prove amenable to legislation. There is a strong line of thought which argues that rendering corporate responsibility mandatory will restrict the creativity and innovation with which corporations voluntarily implement it. This is an argument with strong proponents both in

business and government. Certainly it remains completely unproven that ‘corporate responsibility’ as a coherent concept can be legislated for. The French experiment should be watched with care, as too should the experiments within the financial industry. An essentially technocratic position, this is to argue in general that the world is simply too complicated for us to legislate for corporate responsibility *tout court*. We may be able to introduce this law here and amend that market incentive there, but we must continue to muddle through with a mix of civil and legal regulation as best we can. While this sounds perfectly reasonable and undogmatic in principle, it is worth asking whether such a position essentially fudges the political choice facing us when we ask what corporate responsibility (and corporate legal responsibility) is for.

It is here that the debate about stakeholder- versus risk-based approaches may prove decisive. This debate begs the question: what is the purpose of corporate responsibility – is it to protect stakeholders or is it to help companies manage risk? Our answer to that question will ultimately define the role that law will play in framing corporate behaviour.

Law is what happens when society agrees on how to define and handle a challenge it faces. But will we see legislation on how British companies should handle labour conditions in their supply chains once the ETI has determined the effectiveness of codes of conduct versus other mechanisms? We remain very far from consensus on many corporate responsibility issues and often the longer we look at the problem the more complicated the question seems to get. Frederick William Maitland argued that ‘legal ideas never reach very far beyond practical needs’ (Maitland, 1898, p. 27). From that perspective this need for corporate responsibility remains yet unproven to the law. To that extent advocates of corporate responsibility have yet to state their case effectively, since only once this is done with clarity over a period of decades will the need for stakeholder-driven approaches to organisational responsibility become apparent.

In the dark all cats are grey. We certainly remain in the dark about how the current debate on corporate responsibility will resolve itself – if only because this is history we have still to make. And, with respect to the role that domestic and international law might play, and how effective it will be, it is fair to say there is plenty of grey in the mix.

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## 14 Whistleblowers: the critical link in corporate accountability

*Dana L. Gold*

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### **Introduction**

Focus on corporate wrongdoing has been unyielding since the now-infamous accounting fraud scandals of Enron, WorldCom, Tyco, Adelphia, Global Crossing and others eclipsed the news at the end of 2001. Despite the heightened attention on corporate accountability, scandals continue to emerge, ranging from fraud in the mutual fund industry to the international scandal of Parmalat in Italy to improprieties in the US government's distribution of federal contracts to Boeing and Halliburton. Dramatic responses to corporate fraud in the form of sweeping US legislative reforms (specifically the Sarbanes–Oxley Act of 2002, passed to restore investor and consumer confidence in the corporate sector), aggressive prosecutions of top corporate executives, revisions to stock exchange listing requirements that mandate specific corporate governance reforms by publicly traded companies, and increased activism on the part of shareholders, board directors and stakeholder groups, have all thrown into question deeply held presumptions about market economics, ideal corporate governance structures and the role of corporations in society generally.

Corporate wrongdoing, despite the recent attention, is not new. Egregious examples include the excessive overcharging of materials by defence contractors in the 1980s; the environmental and health disaster in Bhopal, India caused by Union Carbide (now part of Dow Chemical) when its pesticide plant's cooling system failed, causing a gas leak that killed 8000 people in three days and poisoned more than 500,000; the deliberate misrepresentation by tobacco company Brown & Root of the inclusion of deliberately addictive chemicals in cigarettes; rampant fraud in the health-care and pharmaceutical industries (HealthSouth, TAP pharmaceuticals, and HCA, to name a few); and vulnerabilities in America's plutonium stockpiles guarded by private security firm Wackenhut, Inc. Many corporations, either negligently or intentionally, have through unaccountable behaviour harmed or potentially harmed the environment, local communities, the health and safety of the public, and the interests of consumers, stockholders and citizens.

Each of these examples of corporate wrongdoing was averted, could have been averted, or was or could have been at least mitigated, by a whistleblower.

Every year thousands of workers witness wrongdoing on the job, ranging from financial fraud to health and safety dangers to gross mismanagement to illegal and corrupt practices. Few workers, however, actually report the wrongdoing they witness. Those employees who choose to disclose evidence of wrongdoing – most commonly known as ‘whistleblowers’ – are the first line of defence against problems that, unaddressed, could cost millions of dollars to remedy, claim innocent lives, and devastate the environment, public health and safety. Because they work inside the corporate structure, employees have direct, immediate access to information about problems – or potential problems – which corporate board directors, outside regulatory agencies, watchdog organisations, shareholders, consumers and community members may never know about until a crisis occurs.

Rather than receiving praise for raising concerns and possibly preventing crises from occurring, these workers more often suffer reprisal, becoming victims of retaliatory investigations, harassment, intimidation, demotion, dismissal and blacklisting in their fields. Corporate managers and executives compelled to meet production deadlines, reduce costs, protect stock value, avert negative publicity and avoid government investigations generally find it difficult to view messages about problems as opportunities to further, rather than obstacles to achieving, all of these same interests in the long term. Instead they often view the message, and the messenger, as the problem.

An increasingly large patchwork of whistleblower protection laws has grown out of recognition that employees who work within a company are in the best position to promote legal compliance, and that retaliation against employees who report violations of law has a profound chilling effect that prevents disclosure of information needed to avert problems. These laws also reflect an understanding, consciously or not, that the ‘corporation’ – a legal construct which, with its quality of limited liability and large concentrations of capital, has an incredible ability to wreak large-scale havoc on important public interests – is made up of individual, human actors who ultimately make the decisions that create corporate behaviour. Whistleblower protection laws recognise that humans have as much potential to act out of self-interest and fear as out of moral courage and honesty, and that only by protecting the ethical actions of employees can we truly protect not only the public interest, but also the corporate institution itself.

With a primary focus on the trends in the United States, this chapter will offer an overview of the cultural and legal development of the role and protection of whistleblowers up to the present time. It will then discuss some of the relevant public policy implications for current approaches to whistleblower disclosures and protection, including an examination of the problems with the patchwork of legal protections currently provided to whistleblowers and the absence of blanket protection for corporate whistleblowers, as well as the

increasing focus on internal corporate controls in the form of anonymous hotlines for employee disclosures and ethics codes. Finally the chapter will discuss the corporate governance implications of the current state of whistleblower protection law and its crucially needed improvements, while also suggesting opportunities for improved corporate responsibility through greater alignment of the interests of the corporation and those of ethical employees who disclose instances of legal non-compliance.

### **The cultural evolution of whistleblowers and whistleblower protection**

The term ‘whistleblower’ originally derives from the concept of the English policeman who would blow his whistle to alert local bystanders and authorities about crimes or danger. In the United States, the term ‘whistleblower’ is used commonly in the myriad statutory and common laws that protect from retaliation employees who disclose information they reasonably believe is evidence of illegality, gross waste or mismanagement, abuse of power, or substantial and specific danger to public health or safety.

Although the word has been integrated into the legal lexicon, it remains a charged term in the cultural lexicon of the workplace. While employees who report serious problems witnessed at work may be lauded as ethically courageous or as heroes willing to stand up against the status quo for the greater good, these same employees, before the problems they report are addressed or confirmed, are more frequently characterised as ‘snitches’ who are ‘disloyal’ to the company and unable or unwilling to be ‘team players’. This stigma against employees who speak out against their employers can be a powerful deterrent against raising concerns about workplace problems, and, accompanied by the likelihood of reprisal in many corporate cultures, can chill disclosures about danger and illegality completely.

While there are many workers who blow the whistle on corporate wrongdoing even in the face of potential stigmatisation and retaliation, the wave of corporate fraud scandals in 2002 seems to have influenced the perception of whistleblowing employees, if slightly. In 2002, *Time* Magazine’s annual ‘Person of the Year’ issue was dedicated, unusually, to three people – ‘whistleblowers’ Sherron Watkins of Enron, Cynthia Cooper of WorldCom, and Colleen Rowley of the Federal Bureau of Investigation (FBI). These employees warned their superiors of serious problems that, if heeded, could have mitigated or even prevented the two largest bankruptcies in US history or the worst terrorist attack on US soil on September 11, 2001.

*Time*’s mainstream characterisation of employees who reported fraud and mismanagement as heroes was perhaps less a statement of a cultural shift in valuing whistleblowers than a statement about how the consequences of employers’ refusal to listen to – and act on – employees’ warnings can be catastrophic, and thus a change in how institutions deal with evidence of problems

is essential. Nevertheless, the article and the flurry of similar coverage about employees' disclosures in the wake of the corporate fraud scandals (all coming on the heels of the box office hit 'The Insider' about tobacco industry whistleblower Jeffrey Wigand) did contribute to one among many shifts in how whistleblowers are perceived and portrayed in the cultural milieu of the corporate workplace.

The increasing trend of supporting rather than demonising whistleblowers has been matched by more expansive legal protection for employees in the corporate sector. Although the new Sarbanes–Oxley Act offers whistleblower protection only to employees of publicly traded corporations who raise concerns related to fraud, this expansive legislative scheme, with its strict penalties against employers who retaliate against whistleblowers and its mandates to facilitate disclosure of problems to all levels of the corporation, is setting a tone across the entire business world that promotes a fundamental shift in how corporate cultures deal with employees who identify problems. Managers, officers and corporate board directors, who prior to the passage of Sarbanes–Oxley may have viewed the issue of an employee who raises a concern only as a personnel or human resources issue stemming from a grievance or law suit, must now focus on the message as well as the messenger. This is a significant sea change in the corporate environment.

### **The current legal landscape of whistleblower protection**

The Sarbanes–Oxley Act was signed into law on 30 July 2002 as a swift reaction to the Enron and other corporate fraud scandals that began cascading at the end of 2001. This legislation, which applies only to publicly traded companies, contains several mechanisms to prevent similar accounting schemes from devastating shareholders, employees and consumers in the future, including such requirements as greater board director independence, CEO certification of financial statements, tougher criminal penalties, and development of reliable internal controls to prevent fraud.

The act also contains some of the most expansive whistleblower protection provisions ever contained in federal legislation to date, providing for jury trials and criminal penalties against those who retaliate against employees who report evidence of fraud (for comprehensive analysis of the whistleblower provisions of the Sarbanes–Oxley Act, see Kohn et al., 2004). Perhaps even more significant, however, is that the act requires corporations to set up anonymous reporting mechanisms so that employees can safely identify financial malfeasance without fear of retaliation, with the additional requirement that substantive problems are conveyed to the board of directors. While it may be too soon to measure the effectiveness of these measures, the act of legislating support of employees in their role as corporate watchdogs as essential to identifying and fixing problems *before* they rise to the level of either whistleblower retaliation

or corporate catastrophe is not only revolutionary, but also reflective of the substantial harm caused by corporate cultures that, for the most part, have neither supported whistleblowers nor heeded their concerns.

Despite the confluence of more favourable attitudes towards whistleblowers in the media and Sarbanes–Oxley’s more proactive legal scheme to support whistleblowing, the legal landscape for whistleblower protection is inadequately structured to establish a serious and consistent mechanism to promote corporate accountability in the private sector. The employee protection provisions contained in Sarbanes–Oxley, though an important advance in some respects, reflect the very problem of how the United States, and indeed most countries, approach corporate accountability and the role of employees in promoting accountable corporate behaviour.

In the United States, there is no comprehensive whistleblower protection law that offers a remedy to all private sector whistleblowers who suffer retaliation for reporting wrongdoing. Rather, whistleblower protection is a patchwork of state and federal statutory and common law that may or may not offer a legal remedy depending on the substance of the disclosure and the nature of the reprisal against the employee (see Kohn, 2001, where whistleblower remedies are elaborated more fully).

Most states, for instance, have developed a common-law tort remedy known as a ‘wrongful discharge’ claim, or otherwise referred to as a ‘public policy exception’ to the employment-at-will doctrine. This exception essentially prohibits an employer who, under the employment-at-will doctrine would normally have discretion to fire an employee for ‘good reason, bad reason, or no reason at all’, from discharging an employee who reports employer conduct that contravenes the letter or policy of the law, which is found in constitutional, regulatory or statutory schemes as well as in prior judicial opinions.

Like most tort claims, wrongful discharge claims have two- or three-year statutes of limitations, provide for a jury trial, and offer some degree of damages for both lost wages as well as emotional distress. However, although the substance of what an employee may blow the whistle on is obviously quite broad under the public policy exception, this remedy applies in most states only if an employee is actually fired. Only in one state is a common-law wrongful *retaliation* claim recognized; thus the majority of whistleblowers who suffer harassment, demotions, withheld bonuses, poor performance appraisals, or other forms of reprisal short of discharge are frequently left without a civil claim (and some states still do not even recognise the tort of wrongful discharge for whistleblowing at all). Furthermore, for those states that have limitations on recoverable damage awards, it is often difficult for employees to find legal representation for these claims that are frequently complex and expensive to litigate.



Other legal remedies do exist for whistleblowers who suffer retaliation other than termination. The majority of the federal environmental statutes contain employee protection provisions to facilitate enforcement of the underlying purpose of the legislation. Thus, the Clean Air Act, the Toxic Substances Control Act, the Solid Waste Disposal Act and most other federal environmental statutes all provide employees who suffer retaliation for raising a concern that their employer is violating the policy of the act (known as ‘protected activity’) with an administrative remedy through the Department of Labor. Similar employee protection provisions are increasingly being added to new legislation aimed at protecting the public interest, such as airline safety regulations and the Sarbanes–Oxley Act. However, for an employee to have a viable legal claim, he or she must suffer retaliation for blowing the whistle on a problem regulated by statutory scheme that contains employee protection provisions within it.

There are benefits and limitations to these administrative remedies. Most have attorney fee provisions if an employee substantially prevails in the case, which may increase the likelihood of a whistleblower being able to secure legal representation. However, damages are limited to ‘make whole’ remedies – those that put employees in the position they would have been in in the absence of retaliation with typically small allowances for emotional distress awards. In addition, employees have no right to a jury trial (after an initial investigation, an employee can seek a hearing before an administrative law judge with appeal rights to a politically appointed review board). Finally, for cases that can take years to resolve, the average statute of limitations is only *thirty days* from the time the employee becomes aware of the retaliation to file a claim. While some statutes provide for longer times to file a complaint, the longest timeframe allowed is just 180 days (notably in sharp contrast to the two- or three-year statutes of limitations typical for state law wrongful discharge claims). These short timeframes can make it very difficult for an average employee who may not be aware of his or her legal rights to file for protection, let alone to find an attorney to assist with filing a claim.

Some federal statutes have whistleblower protection provisions that provide greater protections, and greater incentives, to employees who disclose serious problems. For instance, the False Claims Act, which covers fraud against the government by corporate contractors, is a vehicle which both actively addresses the wrongdoing itself while also affording the whistleblower protection from retaliation. Under the False Claims Act, a whistleblower who independently discovers fraud (known under this scheme as a ‘relator’) can make a disclosure to the US Department of Justice who can choose to prosecute the corporation committing fraud. If the suit is successful, the whistleblower is entitled to recover up to a third of the total amount of the fraud, which usually runs in the millions of dollars for those cases the

Department of Justice ultimately pursues. Moreover, if the Department of Justice chooses not to pursue the suit, the whistleblower can choose to bring the suit on behalf of the government independently.

Finally, in addition to providing a vehicle to address the fraud itself, the whistleblower protection provisions of the False Claims Act allow for a jury trial, a six-year statute of limitations, and double damages for recovery. This legislation – which combines monetary incentives for whistleblowers to disclose wrongdoing, a vehicle to enforce the law and stop fraud, and significantly improved remedies for any retaliation suffered by an employee for blowing the whistle – has been one of the most effectively utilised statutes in the country, with whistleblowers helping the government stop theft of taxpayers' monies and recover literally billions of dollars from fraud. Notably, however, the number of whistleblowers who either have cases adopted by the Department of Justice or who otherwise file whistleblower claims under the False Claims Act is quite small, simply because the kinds of corporate wrongdoing that are witnessed by employees on the job stretch far beyond the bounds of fraud against the government.

The new whistleblower protection provisions of the Sarbanes–Oxley Act, though they do not provide financial incentives for employees to disclose accounting improprieties, are a significant advance on the counterparts against which they are modelled (primarily the employee protection provisions contained in the federal environmental statutes). As mentioned earlier, they provide an avenue for a jury trial after starting the initial process in the Department of Labor. Other claims that may provide for punitive damages are not pre-empted by Sarbanes–Oxley, the statute of limitations is 90 days to file a claim, and the burden of proof for demonstrating that an employer retaliated against an employee because he or she engaged in protected activity is highly favourable to the whistleblower.

Perhaps most significant are the criminal penalties provided against employers and their agents who retaliate against an employee who provides information to or otherwise assists law enforcement in investigations related to a wide range of federal offences. Individual liability for reprisal, though probably an effective deterrent for harassing a whistleblower for raising a concern (Sarbanes–Oxley provides for fines and/or imprisonment for up to 10 years), is extremely rare, since most whistleblowers only have remedies against the corporate employer itself. Notably again, however, the only employees who would be protected from unlawful retaliation under the Sarbanes–Oxley Act are those who work for publicly held companies and who blow the whistle on problems regulated by the act.

Finally, the Sarbanes–Oxley Act requires that the audit committee of the corporation's board establish procedures for confidential reporting of concerns about accounting issues by employees (as well as individuals outside the

company). These provisions seek to encourage the identification of problems rather than merely discourage whistleblower reprisal and are the most significant institutional advancement of the recognition of the value of whistleblowers yet. Companies are still in the process of implementing systems that use third-party hotlines, allow for employees to make anonymous reports, and that get critical information to board audit committees without overwhelming them with immaterial details. Whether compliance with these provisions becomes merely window-dressing or eventually prompts a fundamental shift in corporate cultures to those that actively encourage employees to identify problems remains to be seen.

Despite the myriad of statutes or common-law claims that make it unlawful to retaliate against whistleblowers, the patchwork of laws that make protection dependent on the nature of the problem disclosed, the reprisal suffered, or even the statute of limitations for filing a complaint means that many whistleblowers are left without protection against retaliation. For instance, if an employee blows the whistle on fraud within a non-publicly held company and suffers harassment but not discharge, depending on that employee's state of residence, the whistleblower may be left completely without a remedy and be forced to endure a terrible work environment.

Similarly, if a health-care worker in a private hospital is fired for reporting staff failures to follow health and safety protocols for patient care, he/she may be left without a remedy because there is no federal statute that covers the provision of medical services with an employee protection provision in it, and any state claims for wrongful discharge may be barred because professional protocols, even those that can risk lives if not followed, are not rooted in law, statute or judicial opinion that establishes a 'clear public policy'. Moreover, besides the purgatory of retaliation-without-a-remedy in which the whistleblower may find him/herself in these scenarios, the further tragedy is that the lack of meaningful remedies can create a tremendous chilling effect on other employees that deters disclosure – and thus prevention – of serious problems.

The patchwork of legal protections that depends, in part, on the nature of the problem disclosed is mirrored in the lack of one formal, institutional 'watchdog' organisation that receives, investigates and resolves complaints about all forms of corporate wrongdoing. There is no set path for whistleblowers to report potential legal violations or threats to the public interest – it is up to them to navigate how best to raise a concern, whether through internal disclosure to management, to a government agency with jurisdiction over the substance of the concern, to an independent non-profit watchdog organisation or to the media.

Thus, the dominant legal structures related to whistleblowing do not focus on addressing the substantive problem raised by an employee, but rather only come in to play after an employee suffers retaliation by his or her employer for

blowing the whistle. The False Claims Act and the anonymous reporting provisions of the Sarbanes–Oxley Act (both of which deal only with issues related to fraud) are the only legal provisions that offer a mechanism to address evidence of wrongdoing directly while at the same time offering some degree of protection to whistleblowers to prevent retaliation.

### **Advantages and disadvantages of current approaches to whistleblowers and their disclosures**

As outlined above, the predominant legal model for dealing with whistleblowers and their concerns has been to address the messenger rather than the message. While the various laws that protect whistleblowers from reprisal are arguably intended to encourage employers to listen and respond to problems raised by employees, there is no legal requirement for an employer to investigate or address an employee's concerns. The burden of identifying critical problems falls squarely on the employee who has neither a mechanism for ensuring that the problem will be adequately addressed, nor confidence, given the patchwork nature of whistleblower protection laws, that s/he will have a remedy if her/his employer responds with hostility and adverse job actions rather than gratitude and correction of the problem.

While the burden of promoting corporate accountability rests on the shoulders of the whistleblower concerned enough about a problem to risk jeopardising his or her job, the potential corporate wrongdoer, in contrast, is relatively sheltered from addressing the wrongdoing promptly and seriously. First, the patchwork of whistleblower protection laws creates a corollary patchwork of liability; in the absence of blanket, national protection for all whistleblowers, the likelihood of a whistleblower being able to find a law that covers the subject of concern, the type of retaliation and a meaningful remedy worth pursuing is low, and thus the likelihood of an employer suffering legal exposure for retaliation is also low. In addition to this inconsistent and unlikely liability, the imbalance of resources between a corporate employer and an individual employee in litigating extended civil employment disputes, coupled with the short-term financial and public relations interest that a corporation may have in ensuring that a problem is hidden rather than exposed, creates a dynamic that may encourage employers to target the whistleblower rather than address the underlying problem raised. Finally, the absence of a requirement to address the substance of whistleblower disclosures creates an opportunity for the corporation to make the issue about the 'disgruntled employee' rather than about the impropriety itself. These factors combined only serve to perpetuate the cultural stigma of the whistleblower as a modern Don Quixote: arguably noble, but probably also disruptive or even crazy for fighting a losing battle against corporate wrongdoing difficult to both prove and fix.

The weakness of legal protections for whistleblowers due to a lack of comprehensive national legislation that covers all corporate employees, the insubstantial remedies that can take years to secure, and the absence of mandatory systems for employers to investigate and remedy whistleblower concerns all contribute to a general deterrence against whistleblowing. Even if the cultural stigma against the practice eroded to the point where the presumptive perception of whistleblowers becomes one of heroism rather disloyalty, the challenge of litigating a long and expensive case against a corporate defendant with unlimited resources with the promise of only limited remedies – and no assurance that the underlying reasons for blowing the whistle will be addressed – would necessarily lead most people to conclude that taking such action is simply not worth the professional and personal risk. Thus, in the absence of a blanket whistleblower law that promises real protections and remedies as well as a mechanism for addressing the underlying disclosures, we are left wondering what problems could have been averted – or could be averted in the future – if only our system was set up to better support ethical employees.

### **Alternative mechanisms to identify problems and prevent retaliation**

Until recently, efforts to address whistleblowers and their disclosures proactively – in other words, efforts to seriously address and remedy problems raised by employees without subjecting them to retaliation – have been minimal and even at times destructive.

For instance, some companies in the past instituted internal ‘anonymous hotlines’ for employees to report concerns, but management co-opted the hotline process in order to discover the identity of the whistleblower to set him or her up for reprisal. Some companies have created an ‘ombudsman’ position to hear employee concerns, where that person was purportedly given the authority to act independently from management and maintain confidentiality. While some of these programmes have been successful, many have been flawed by the ombudsman being either beholden to management or subjected to retaliation himself for attempting to resolve the underlying concern.

One extremely successful, though relatively short-lived, model for resolving underlying problems was established at the Hanford Nuclear Site in Washington State, one of the most contaminated sites in North America with a long history of whistleblowing activity and consequent employer retaliation. An innovative alternative dispute resolution forum called the Hanford Joint Council for Resolving Employee Concerns was established in 1994 following a long period of costly and well-publicised whistleblower cases brought by the Government Accountability Project (GAP), a national whistleblower protection law and advocacy group, against the site’s corporate contractor Westinghouse Hanford Company (Brock, 1999). The early Joint Council

involved representatives from the Department of Energy (the regulating body of the corporate-operated nuclear sites), the State of Washington, the senior managers of the corporate contractors, and nuclear safety public interest advocates (including a representative from GAP), all of whom worked together to resolve, through consensus, the most significant and complex whistleblower concerns at Hanford. The council addressed not only the retaliation issues of the cases, often restoring workers to their former job status if they suffered termination or demotion, but also the underlying health and safety issues raised, frequently causing changes in practices at the site to prevent future problems.

The council resolved cases in approximately six months using mediation techniques to address the complex personnel and safety issues involved in the claims; cases that were litigated took years to resolve and thousands of dollars to litigate, and did not ultimately address the underlying safety concerns at issue. It also provided training to managers regarding how to constructively handle whistleblowers and their concerns, and was widely acknowledged to have improved the culture of safety at the dangerous site.

When Fluor Hanford took over the Department of Energy contract from Westinghouse in 1996, it was obligated by contract to work with the council, and many of the subcontractors participated as well, resolving 24 of 26 cases with consensus recommendations. However, as a new contractor unfamiliar with, or arguably unconcerned about, the legacy of expensive, time-consuming, media-attractive litigation suffered by its predecessor Westinghouse, in 2003 Fluor withdrew from its participation in the council, deciding instead to utilise self-defined ‘internal processes’ and resources to address whistleblower concerns. Litigation and adverse media coverage have since ballooned at Hanford because of the serious problems and culture of whistleblower reprisal that plague the site.<sup>1</sup> The marked difference in the culture of employee reprisal and poor health and safety practices that has been resurfacing at Hanford since Fluor’s resistance to and ultimate withdrawal from the council reveals the effectiveness and value of this innovative dispute resolution model that involved all stakeholders – employees, employers, regulators and issue advocates – relevant to resolving both the personnel and substantive issues involved.<sup>2</sup>

The corporate fraud scandals that exploded in 2002 graphically exposed the problem with the corporate sector’s long history of dealing begrudgingly at best with employees who reveal violations of law or public policy, let alone the violations themselves. The sweeping legislative response to the Enron and other accounting débâcles highlighted whistleblower disclosures and whistleblower protection as two of the most critical elements in preventing future financial disasters. Rather than allow each corporation to determine for itself how it would address problems raised by employees, the Sarbanes–Oxley Act

*mandates* that public companies establish internal reporting processes that facilitate employee disclosures of fraud, ensure investigation of serious problems, and require reporting of those problems to the audit committee of the board. Although the new law does not offer specific instructions for companies about how to comply with the new internal reporting obligations, its emphasis on the creation of overt mechanisms for employee reporting, criminal penalties for those who retaliated against whistleblowers, and mandatory communication of concerns to those ultimately responsible for the health of the corporation (the board of directors), makes clear that any voluntarily created ‘internal processes’ for handling whistleblower concerns were on the whole simply inadequate to prevent disasters like Enron from occurring.

To comply with the anonymous reporting procedures required by the Sarbanes–Oxley Act, many businesses have employed the services of independent, third-party hotline companies, dozens of which have sprung up since the act was implemented (among other new cottage industries offering various services relating to Sarbanes–Oxley compliance). Unlike some other problematic hotlines connected too closely to management, the majority of these services are independent vehicles for receiving employee reports of potential problems. The success of these hotlines has yet to be determined at these early stages, with ‘best practices’ barely in their infancy given that compliance procedures are still being developed. Ultimately, whether the new requirements actually further the twin goals of encouraging employee disclosures and identifying problems will depend on such things as the quality and extent of employee and manager training on the reason for implementing and how to use the hotline systems, and the quantity, quality and frequency of information passed along to the board’s audit committee for evaluation of concerns and review of possible patterns of concerns raised by employees.

The new hotline requirements of Sarbanes–Oxley on balance reflect a significant improvement on the more traditional model of focusing on the whistleblower instead of the underlying issues. Congress recognised that the value of whistleblowing lies in the power of inside information to prevent problems from starting or escalating. Employees who are able to remain truly anonymous will be more likely to disclose problems because they are safer from retaliation.

Nevertheless, an anonymous reporting system does have some problems. For instance, those on the receiving end of the report may not be able to extract more information about the problem, if needed, from an anonymous source. Likewise, employees who are not putting their reputations on the line by raising a serious concern directly to a manager may be more likely to disclose superficial problems that involve office politics or grudges than significant evidence of fraud or other violations. Finally, if management is able to determine who the employee is through back channels but there is no way to prove

that an employee who used the hotline suffered significant job consequences because of his/her disclosures, it will be difficult to satisfy the important elements of a whistleblower claim which requires that the employee prove that the employer knew he or she blew the whistle and that any retaliation occurred because of the whistleblowing. Public disclosure can actually offer would-be whistleblowers a greater degree of legal protection, while anonymity can actually make legal resolution of concerns and personnel issues more difficult.

One other area that Congress focused on in passing Sarbanes–Oxley in its effort to promote ethical conduct in the workplace is the use of corporate codes of conduct or ethics codes. If corporations fail to implement a company code of ethics, they need to affirmatively explain in their securities filings *why* they have made such a choice. While the emphasis on ethics codes is positive in that it requires companies to be intentional as they think about whether to have a corporate code of conduct that governs employee conduct, whether those ethics codes are truly effective or are just window-dressing for the appearance of compliance is something that can only be measured company by company and case by case. Meaningful ethics training, enforceable consequences for violating codes of conduct, and perhaps most importantly, the proverbial ‘tone from the top’ set by senior management and the board of directors, has far more to do with whether an employee will truly be empowered to report problems in the workplace without fear of reprisal and believing the problems will be seriously addressed.

Of course, the most glaring deficiency in all of these provisions of the Sarbanes–Oxley Act that seek to actively encourage whistleblowing is that they apply only to disclosures about financial fraud. Employees who have information about environmental disasters, consumer threats, or even national security risks are not afforded the some kind of protection as employees who have information about securities violations. Left dangling by this limitation that divides protection for whistleblowing and the opportunity to remedy problems into discrete issue areas, protection from anything but financial misconduct continues to substantially elude not only employees, but also board directors, managers, shareholders and the public at large, all of whom will also pay the price for corporate misconduct.

### **Law and policy implications: a new vision of the corporate paradigm**

There is no real debate about the importance of whistleblower disclosures in preventing serious problems in the corporate arena. Nor is there real debate about the importance of protecting employees who report violations of law from reprisal. The legal landscape currently in place, however, belies, and indeed largely undermines, the creation of workplace norms that reflect these priorities.

In the light of numerous and graphic examples of preventable harm had



whistleblowers been heeded and protected, the lack of comprehensive legislation that meaningfully protects all corporate employees who blow the whistle demonstrates a failure of vision and a recipe for catastrophe. The current patchwork of legal protections is driven by individual issue areas, and with little exception does nothing to mandate corporate attention on problems disclosed by employees. A comprehensive legal scheme that protects all private employees who blow the whistle on any violation of law or public policy and that requires employers to investigate and resolve the concerns raised by whistleblowers would radically alter the troubling status quo. Responsibility for corporate legal compliance would shift, both culturally and legally, from the backs of vulnerable employees with literally everything to lose to the corporations themselves.

With the current state of insufficient legal protections for whistleblowers posing such a glaring problem in need of a remedy, it is easy to overlook some of the more subtle policy implications related to the current paradigm of the employee/employer relationship in the corporate sector. Put simply, shifts in how the dominant corporate model is understood as it relates to employees could ultimately be even more transformative than new comprehensive whistleblower protection legislation in creating a culture that supports rather than resists identification of workplace problems. The dominant corporate model includes three primary actors: the board of directors, management and shareholders. Employees are not part of the corporate governance triangle. Although employee stock ownership programmes have given some employees the status of stockholders in the corporation, it is their interest as financial investors in the company, and not as workers, that gives them any decision-making influence in the corporation.

Traditionally, US law has interpreted the fiduciary duty of the corporation's directors and officers to protect the best interests of the company as something that is measured by maximising shareholder profit. There may, however, be closer alignment between the interests of shareholders and the interests of employees, even those without stock ownership, than has been widely recognised.

If we think of shareholders as true 'owners' of the corporation, not just in the financial sense but as those who extend a sense of care and interest in the long-term health and performance of a company, then employees certainly share a similar degree of commitment. Employees, who generally seek job security in the form of extended employment, living wages and a safe workplace characterised by integrity and respectful treatment, are directly 'invested' in fostering a workplace that performs well and grows over time. Thus, protecting the interests of employees can correlate with protecting the interests of shareholders.

The mandate to protect the interests of the corporation by maximising

shareholder profit is being shaped by dramatic shifts in recent years of the character of the typical stockholder. Institutional investors in the form of mutual and pension funds have taken on an increasingly powerful and active role in monitoring and influencing corporate activity. In contrast to the typical 'day trader', institutional investors represent thousands of individuals typically interested in holding corporate stock for the long term. In the light of corporate fraud scandals, increased attention on corporate accountability, and emphasis on effective corporate governance to prevent future disasters, institutional investors are progressively exercising their significant financial clout and voting rights to promote good governance, transparency, information disclosure for investors, and ethics. The interests of institutional investors that are more inclined to take a long-term view of corporate health and performance increasingly mirrors the corporate employees' interests in the long-term success of a company.

Further, the 'shareholder primacy' model of corporate governance itself is increasingly allowing more discretion on the part of directors in exercising their fiduciary duty of care of the corporation (O'Connor, 1993). In response to the takeover era when corporations were beholden to shareholder profit at the direct expense of other constituencies – such as employees – who had significant interests in preventing changes in the control of their corporate employer, courts have allowed directors greater latitude in considering non-shareholder interests in strategic decisions. The progressive recognition in legal decisions, academic scholarship and the business community itself of the distinctive role employees play as a non-shareholder constituent none the less deserving of consideration in the exercise of directors' fiduciary duties, reflects a shift in both thought and practice of traditional corporate norms that fixated predominantly on short-term profit as the important measure of corporate success (Greenfield, 1998).

The increasing alignment between the interests of shareholders and employees and trends that value consideration of employee interests may set the stage for heightened attention and commitment to the importance of employee whistleblowers. Whistleblowers, viewed as the early warning systems against corporate wrongdoing and legal non-compliance, expensive litigation and adverse media exposure, all of which can devastate the financial performance of a company over time, serve as the greatest protectors of the shareholders' investment in the corporation and its performance beyond the quarterly earnings. Companies that deter employees from raising concerns create a laboratory for unethical, illegal and potentially dangerous behaviour that over time will jeopardise the health of the company and ultimately the health of shareholder returns.

Shifting the dominant paradigm from one that views employees as a group of stakeholders that falls outside of the corporate governance model, with

interests that are sometimes viewed in conflict with shareholder interests (for example, high employee wages may reduce short-term shareholder profits, even if those wages translate into unmeasured savings in the form of employee retention, reduced training costs, and human capital critical to the company's success), to one that views employees as potential 'investor protectors', would go immeasurably far in creating a corporate culture that values whistleblowers and their disclosures. Boards and managers would be given a mandate to create environments that reward employees for bringing problems to light because doing so serves the long-term interests of shareholders by preventing issues from escalating and generally ensuring legal compliance.

It is interesting to consider the implications for enhanced corporate accountability in the ideal scenario of a confluence between a shift in corporate law norms that increasingly value the role of employees in corporate governance and enactment of a comprehensive whistleblower protection law for all corporate workers who report violations of law or public policy, along with mandatory investigation and resolution of the underlying concern. If blanket protection was afforded to all corporate employees who disclose significant violations of law or policy, this might create a more heightened focus on legal compliance in all arenas. Combined with a premium placed on employee disclosures as a means of protecting long-term shareholder value measured in part by accountable corporate conduct, this might ironically obviate the need for whistleblower protection at all.

In this virtuous cycle, corporate leaders would be empowered to create environments where problems are welcomed as opportunities to improve performance. Employees, those in the front-line positions to identify problems, would report concerns as a matter of course, rather than exception, without fear of reprisal. In such a landscape, the term 'whistleblower' and all of its attached stigma, could ultimately disappear, and in its place would develop a new model of corporate behaviour that values ethical employees, complies with the law, and in doing so maintains sustainable growth.

Driven by a strong, comprehensive whistleblower protection scheme, if the corporate sector ultimately viewed preventing legal non-compliance as something that would have true value to investors and recognised the role of employees in protecting that value, such a paradigm shift would have positive effects reaching far beyond the bounds of an individual company. Many of the adverse consequences of corporate behaviour that are currently borne by the public would become internalised by corporations as they sought to ensure consistent legal compliance. Further, the interests of stakeholders vested in responsible corporate behaviour outside of the corporate structure – the environment, consumers, local communities and of course workers – would indirectly be given increased weight as corporate directors fulfil their fiduciary

duties, which would likely reduce attacks on corporate policies by external constituents concerned about legal non-compliance.

The cultural, political and legal obstacles that exist between the current state of affairs and this aspiration are, however, immense. A vision of greater alignment between corporate and public interests that would foster increased legal responsibility is one for which it is critical to strive, and whistleblower protection may ultimately be the key to achieving it. We can only hope that it does not take another Enron, Bhopal or September 11-like disaster to spur us forward.

### Notes

1. Notably the Hanford site is unique in that it has a long history of whistleblower disclosures despite the culture of reprisal. Since the mid-1980s, GAP has concentrated much of its programmatic efforts on whistleblower protection to promote nuclear safety, and has offered consistent assistance to whistleblowers at the Hanford site (as well as other weapons facilities around the United States) (GAP, 2004). This degree of concerted assistance to employees and pressure on employers to address problems is unusual; there are only a few organisations like GAP in the United States, leaving the bulk of employees at other sites, let alone in other industries, without advocacy assistance or support. Further, GAP's dedicated presence at Hanford does not substantially ease the challenge of securing meaningful legal protections and remedies for employees. With its own limited resources, combined with the patchwork of protections available to whistleblowers, many whistleblowers still fall through the legal cracks and serious environmental, health, safety and national security risks remain unresolved.
2. The effectiveness of the Hanford Joint Council as a mechanism for protecting whistleblowers and addressing health and safety problems was recently reaffirmed. After several serious employee concerns emerged at the Hanford site that led to significant adverse media exposure and government investigations, CH2MHill Hanford Group, a subcontractor at Hanford and original member of the Hanford Joint Council, and the Government Accountability Project began discussions to develop a new process to handle whistleblower complaints modeled after the original Council. With the support of the Department of Energy's Office of River Protection, a new, independent 'Hanford Concerns Council', made up of CH2MHil representatives, employee advocate representatives, and neutral representatives, was launched in July 2005 that has a broad mandate to 'assess and seek full, fair and final resolution of employee concerns in a neutral, safe environment.' See [www.hanfordconcernscouncil.org](http://www.hanfordconcernscouncil.org).

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## 15 The Dutch Corporate Governance Code: self-regulation or interactive legislation?

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### **Introduction**

This chapter deals with the regulation of corporate governance in the Netherlands, in particular, the Dutch Corporate Governance Code which was introduced in December 2003. The code is more informally known as the Tabaksblat Code, named after the chairman of the committee that designed it. The Tabaksblat Code has been presented and is generally regarded in the Netherlands as an example of self-regulation. This chapter will explore whether that assumption is correct. It starts by formulating a definition of the concept of self-regulation. It will then introduce and discuss the concept of interactive regulation by way of comparison and contrast with that of self-regulation. This will be followed by a history of the code and a short introduction to it. Finally, it will be argued that it is more accurately conceptualised as an example of interactive legislation and the implications of that conclusion will be considered.

### **What is self-regulation?**

#### *Top-down and bottom-up*

In recent years the phenomenon of self-regulation has received considerable attention. From the 1980s the concept can be located more frequently in all types of legal literature. The quantity of legal provisions in which self-regulation is either directly or indirectly referred to has also increased considerably. Self-regulation can be employed for different aims and be studied from different perspectives. These include a legal perspective (is it 'law'?), an instrumental perspective (is it effective?) or a theoretical-empirical perspective (how does it work and why?). Furthermore, it is a subject often discussed within a normative context. This explains, among other things, why there is an ongoing discussion on what self-regulation is and why there is so little consensus. The question of how to formulate a definition of self-regulation has puzzled many legal theorists, and proposals reflect the various perspectives and biases of their authors. Most definitions, however, can be divided into either the top-down or the bottom-up approach. Generally speaking, at least in the Netherlands, theorists consider self-regulation in a rather instrumentalist and thus top-down manner.

The same division in thinking in either a top-down or bottom-up manner can be found in the socio-legal studies of regulation. In the top-down perspective, public policy constitutes the starting point to study (processes of) regulation. Policy goals play a central role and regulation is the enactment of institutionalised influence upon behaviour through control and adjustment (social control). The policy-maker ‘makes’ regulation which can be used as a policy instrument or tool. By contrast, the ‘social shop floor’ forms the starting point of the bottom-up perspective. Regulation originates, among other things, from social interactions. The shop floor forms the concrete social situation in which the actions and the social interaction that are the object of regulation take place (Griffiths, 2003: 19).

The significance of ‘self-regulation’ depends upon which perspective is chosen. In the top-down approach, the important question is to what extent the state leaves autonomy to ‘midfield institutions’ (for example, social organisations or interest groups) to participate in reaching certain goals set by the state. The focus lies on self-regulatory mechanisms as part of public policy. The assumption is that the state can use self-regulation where necessary as one of the possible instruments of control at its disposal. By this means, self-regulation is used to further ‘complete’ a given legal framework. In the bottom-up approach, on the other hand, the focus lies on developing the regulatory autonomy that actors on the social shop floor actually possess. Self-regulation takes place independently from, and can occasionally oppose, state regulation. The initiative to self-regulate comes from the actor and not from the state. Policy goals are not set by the state and the power to regulate is derived from one’s own authority and not from statutory regulation.

Furthermore, we can distinguish two kinds of motives for self-regulation which correspond with these two perspectives. There can be various motives for self-regulating behaviour in the top-down perspective. These include problems in connecting legislation to social processes, striving for de-regulation and de-centralisation, difficulties with control and enforcement, privatisation objectives and the search for greater legitimisation. In the bottom-up perspective, ‘private’ motives play a central role. Each self-regulatory actor can have its own specific reasons, depending upon its characteristics and circumstances. These include the wish to prevent government involvement, secure certain commercial interests or satisfy the demands of interest groups. In addition, the moral entrepreneurship of an authoritative individual or group of individuals can be a factor when the person or persons successfully convince their group members that a new rule is necessary.

#### *The definition of self-regulation*

The question remains how self-regulation should be defined for the purposes of this chapter, and a definition will be formulated that can be used for both

the top-down and bottom-up perspectives. Notwithstanding their differences, there is in fact a strong common denominator between the two perspectives. Both reflect the fact that a certain degree of autonomy for the regulating actor is an essential characteristic of self-regulation. ‘Regulation’ refers to controlling behaviour by formulating and maintaining behavioural rules. ‘Self’ refers to the ‘self’/‘other’ distinction: the ‘self’ that is regulating its own internal behaviour is distinguished from the ‘other’ who would also possibly wish to regulate that behaviour. Black (1996: 26–7) has noted that confusion surrounds self-regulation because the concept of the self can refer to both the self as an individual and the self as a collective. It is argued here that the self implies a collective behaviour. If rules are necessarily social phenomena (Winch, 1958: 24–33) and an individual cannot therefore ‘regulate’ him/herself then the self must refer to a social group.

Inspired by the socio-legal approach (Griffiths, 2003), the social organisation of the shop floor is used to further specify the notion of the self. More specifically, I propose to use the concept of the ‘semi-autonomous social field’ (SASF) as formulated by Moore (1973).<sup>2</sup> This concept is a helpful tool to study processes of self-regulation in an empirical context for both the top-down and bottom-up traditions. An SASF is defined in ‘functional’ terms: it can generate behavioural rules as well as coerce or induce compliance. It is therefore a theoretical designation for a social actor engaged in self-regulation. The defining criterion that distinguishes a mere collection of individuals from a group in the sociological sense – in other words, an SASF – is that the latter has members and (to some extent) regulates their behaviour. An SASF is only partially autonomous: the field can to a certain extent generate enforceable behavioural rules but it is simultaneously exposed to and influenced by external rules from other SASFs. The self therefore refers to an SASF as a group of persons or bodies acting together and performing a regulatory function in respect of themselves and others who accept their authority. Self-regulation is therefore a rather unambiguous concept: the regulation by a SASF of its members’ behaviour.

What distinguishes top-down from bottom-up self-regulation is the involvement of the state. Where the SASF has been invited by the state to develop self-regulation and the state has created a legal framework in which the SASF can fulfil its self-regulatory tasks on a particular topic, then we are dealing with top-down self-regulation. If, on the other hand, the SASF has independently taken the initiative to develop rules, then the correct characterisation is bottom-up self-regulation.

### **What is meant by interactive legislation?**

Related to the concept of top-down self-regulation is the concept of ‘interactive legislation’. Today’s legislator is faced with a multiplicity of issues – the

complexity of matters requiring regulation, rapid technological and scientific developments, the globalisation of law and the growing demands of citizens as a consequence of individualisation. Novel boundaries are explored and the legislative process tends to become increasingly interactive. In an attempt to formulate a theoretical response to the changing role of the legislator, several Dutch legal theorists have developed the concept of interactive legislation (Van Klink and Witteveen, 1999; Stamhuis, 2004; Van der Burg and Taekema, 2004).<sup>3</sup>

In an interactionist legislative paradigm, legislation is not unilaterally imposed by the legislator but is the result of interaction among the legislator, the judiciary, administrators, relevant interest groups, scholars and the media. The legislator does not place him/herself above society, but rather prefers a dialogue with (members of) society. The assumption is that citizens participate in the legislative process by engaging in dialogue with the legislator and accordingly promoting a more democratic process. The legislator seeks to convince citizens to comply with legal norms out of inner conviction rather than fear of punishment (Van Klink and Witteveen, 1999: 127). According to the interactive model, one of the legislator's main tasks is to establish one or more general and abstract values in the law which are considered to be fundamental within the (legal) community. In a subsequent stage these values are articulated, translated and specified in more concrete legal norms and rules through the debate between the legislator and his/her citizens. These fundamental values express issues on which at least a basic form of consensus already exists or will gradually arise within society and serve as starting points for public policy. The underlying assumption is that by formulating values in legislation, and paying close attention to them during the interactive legislative process, it becomes more likely that they will in fact be accomplished. The interactive process assigns an important role to the so-called 'interpretive community'<sup>4</sup>. The interpretive community consists of persons and institutions from society who prepare, give meaning to and apply a particular proposed law. The interactive legislative debate is thus not only conducted within parliamentary boundaries, but also takes place within the interpretive community.

The important role of the interpretive community heralds another aspect of interactive legislation: its tendency towards informality, particularly in the legislative debate (Westerman, 2003). To include interpretive communities in the legislative process carries the risk of making the process more informal. What is meant by informality in this context?<sup>5</sup> An interpretive community can generally be characterised as a so-called 'old-boys' type of network': it often consists of only a few individuals who are members of certain corresponding segments of society and who share similar backgrounds. In this setting there is a constant tendency to assume as an implicit procedural ideal the model of



an informal intimate conversation between friends (Waldron, 1999: 70–75). Within the interpretive community the debate is based upon conversational informality where there is sufficient common ground, premises are assumed and there is considerable shared confidence. The vocabulary used in the discussion and reflected in the final product – regulation – will correspond with the participants’ backgrounds: they will debate in the language most familiar to them. The idea of consensus thereby plays an important role. The members of the interpretive community generally endorse the objectives pursued and the way this is achieved. From the outset little disagreement is expected among participants because of the lack of diversity between them. Even where disagreement arises, consensus will remain the objective of the discussions.

An informal conversation between friends or close acquaintances has several obvious advantages: it is characterised by aspects of equality, openness and mutual respect. However, the tendency to ignore the formalities necessary for political discourse makes the legislative process and its outcome less democratic (ibid.: 70–75). Its weakness lies primarily in the fact that participants in the conversation share implicit understandings and that their interaction is orientated towards avoiding adversarial disagreement and achieving consensus. It should therefore be questioned whether this ideal is suitable for political deliberations concerning legislation (see further below).

The next section will consider the Tabaksblat Code. After presenting a brief description of its history and content, the question will be considered whether the code is an example of self-regulation or interactive legislation.

### **Case study of the Dutch Corporate Governance Code (Tabaksblat Code)**

First, I shall explain how corporate governance became a topic of public and political debate in the Netherlands. This will assist our understanding of the circumstances in which the Tabaksblat code was introduced. Two events mark the period before the introduction of the Code: the Peters Report of 1997 and the Social Economic Council report of 2001.<sup>6</sup>

#### *The origin of the corporate governance debate in the Netherlands*

Even though the term ‘corporate governance’ has been circulating within the English language for a considerable period,<sup>7</sup> it was not until 1995 that it appeared in the Dutch language. On 9 April 1996, the chairman of the Stock Exchange Association Foundation<sup>8</sup> installed the first corporate governance committee (the Peters Committee). The term ‘corporate governance’ thus became generally accepted within the Dutch world of trade and industry as well as that of politics and academia. The Peters Committee was established as a result of an agreement between the Association of Securities Issuing

Companies and the Amsterdam Exchanges. The committee's members included representatives from the business community, Amsterdam Exchanges, security issuing companies, academics and a coalition of investors (stockholder and pension representatives). The mandate of the committee was to initiate debate and change in the balance of power between a company's management and investors. In June 1997, the Peters Committee issued recommendations designed to increase management effectiveness, supervision and accountability to investors within the framework of current legislation. The committee focused primarily upon the interplay among the supervisory board, the board of management and the shareholders. Employees were not considered in this equation. A key element of the report was its reliance upon self-enforcement, through market forces, for implementing and enforcing recommendations. One year later the committee completed a project to assess the impact of its report (*Monitoring Corporate Governance in the Netherlands, 1998*).

The exact meaning of the term 'corporate governance' remained unclear. In particular, there was confusion about the extent to which stakeholders should be included in a model of corporate governance. The Dutch legislator asked the Social Economic Council (SEC) to identify its views. The SEC's response was not very explicit but did observe that shareholders<sup>9</sup> as well as employees were to be regarded as primary stakeholders (SER, 2001). The stakeholder – primarily in the form of the employee – has always played a significant role within the Dutch context. Apart from shareholders, other stakeholders (especially employees) are considered to deserve the possibility to enforce and effectuate their interests in one way or another. The Dutch legislator also asked the SEC to pronounce its views on the Structure Regime<sup>10</sup> in the light of relevant developments in the field of corporate governance as a whole (*ibid.*: 19).

#### *The history of the Dutch Corporate Governance Code*

On 10 March 2003, the second Corporate Governance Committee – the Tabaksblat Committee – was installed. On 9 December 2003 this committee presented the final draft of the Dutch Corporate Governance code (the Tabaksblat Code). This code replaced the 1997 Peters Report.

At the beginning of 2003, the ministers of finance and economic affairs invited six organisations to form a Corporate Governance Committee. These organisations were the Confederation of Netherlands Industry and Employers, the Netherlands Centre of Executive and Supervisory Directors, the Association of Securities-Issuing Company, the Association of Stockholders, Euronext Amsterdam and the Foundation for Corporate Pension Funds.<sup>11</sup> Next, these organisations nominated 11 people to participate in the new Corporate Governance Committee. The committee's members also included

representatives from the business community, academics, Euronext and a coalition of investors.<sup>12</sup> The committee was entrusted with developing a code containing ‘principles, rules of conduct and recommendations which can be applied in the private domain by means of self-regulation’. Furthermore, the committee had to take into account the existing statutory framework of Dutch company law and treat legislation at that time under development as given.<sup>13</sup> Where the committee encountered specific problems which could only be solved by legislation, it could make recommendations to that effect. The mandate did not clearly identify the goal or nature of any future report, but was limited to ensuring that compliance should lead to improved and more responsible corporate management.

The committee presented its first conclusions in a draft code on 1 July 2003, after which all interested parties were called upon to submit comments. Between 1 July 2003 and 5 September 2003 the committee received 257 submissions. These originated from various institutions, organisations, companies (both listed and unlisted) and private individuals. In addition, meetings were organised to discuss the draft code. The committee concluded that the code had triggered a broad public debate about the meaning of corporate governance and the adequacy of corporate supervision. The central question was whether the code had successfully constructed an adequate and thorough system of checks and balances within Dutch listed companies. Several of these comments have been made public whereas others have been designated as confidential. The public comments were generally supportive.<sup>14</sup> On this basis, the committee concluded that the existing content of the code could be maintained. The final version of the Corporate Governance Code was presented on 9 December 2003 and took effect on 1 January 2004. Henceforth listed companies must report annually on their compliance with the code.

In February 2004 the government adopted the committee’s recommendations and in March 2004 sent the code to the Second Chamber for consideration.<sup>15</sup> This occurred in June 2004. In July the First Chamber passed the bill amending the Structure Regime, including a provision that provided a statutory footing for the code. On 1 October 2004, when the law became effective, the Tabaksblat Code was given a statutory foundation.

#### *An introduction to the code*

The code contains a Preamble, principles and best-practice provisions. An explanation of terms, an account of the committee’s work, a list of 15 recommendations addressed to the legislator, the terms of reference and information on the composition of the committee have also been included.

The committee asserts that it has been influenced by existing legislation governing the external and internal relations of listed companies, including that

governing the mandatory application of the two-tier board system (otherwise known as the Structure Regime) and the case law on corporate governance. The code is based on the Dutch principle that a company is a long-term collaboration between various parties. The committee defines stakeholders as those groups and individuals who directly or indirectly influence or are influenced by the company's aims.<sup>16</sup>

The committee identifies three reasons for reviewing and updating the Peters Report. First, the Dutch Corporate Governance Foundation evaluated corporate compliance with the Peters Report during 2002 and determined that compliance was not as high as desired and some improvement was necessary. Second, a High Level Group of Company Law Experts recommended in its report 'A Modern Regulatory Framework for Company Law in Europe' that each member state should draw up a national code of corporate governance for prospective compliance by listed companies. The group also recommended that companies should be transparent about those parts of the code with which they are unable to comply. Third, there were the accounting scandals involving companies in the United States, Europe and the Netherlands which undermined public confidence in the management and supervision of companies in financial markets. These developments prompted the committee to establish a system of checks and balances with a view to restoring confidence. According to the Tabaksblat Committee, good corporate governance essentially revolves around efficient supervision of the board of management (the 'checks') and a balanced distribution of influence and power between the board of management, the board of supervisors and the general meeting of shareholders (the 'balances').

The central aim of the code is to provide a guide for listed companies to improve their governance. Compliance therewith is intended to boost confidence in responsible corporate management. Although the opinions of the capital markets are therefore critical, this is not intended to detract from the position of other stakeholders such as employees.

The code is divided into five chapters: (I) compliance with and enforcement of the code; (II) the management board; (III) the supervisory board; (IV) the shareholders and the general meeting of shareholders; and finally (V) the audit of the financial report and the position of the internal auditor for listed companies. These chapters contain 21 principles of good corporate governance and 113 best practice provisions. Individuals involved in corporate management (including members of the board of management and supervisory boards) and stakeholders should observe these principles and provisions in relation to each other.<sup>17</sup> The principles reputedly reflect the most contemporary and widely supported views on good corporate governance. The best practice provisions reputedly reflect national and international 'best-practices' in the field of corporate governance and elaborate

upon the general principles. The provisions aim to regulate the conduct of members of the management board, members of the supervisory board and shareholders.<sup>18</sup>

The system of compliance with and enforcement of the code has two different approaches with regard to principles and best-practice provisions. With regard to the principles, the committee expects companies to state each year in their annual report how they have been applied. However, the committee does not identify any procedural requirements as to how this chapter should be structured or what conditions have to be met. With regard to the best-practice provisions, the code states that listed companies may depart therefrom in certain circumstances and non-application is not by itself objectionable. The committee argues that companies are not homogeneous: they operate in different markets, have geographically diversified share ownership and different growth perspectives. In addition, the circumstances confronting a company change with frequent regularity. Shareholders, the media and businesses that specialise in rating the corporate governance structure of listed companies should not automatically treat instances of non-application as negative, but should carefully assess the reasons therefore. Shareholders as well as the boards of management and supervision should be prepared to enter into dialogue in the event of non-compliance. This dialogue is encouraged where shareholders make their objections known prior to the general meeting and both the company and the shareholders are willing to engage in dialogue outside that framework. That said, unconditional freedom to decide whether or not to apply the code is, according to the committee, undesirable. Listed companies have to explain in their annual report whether, and if so, why and to what extent, they did not apply the best-practice provisions of the code (the 'comply or explain' principle).

One of the recommendations addressed to the legislator is to facilitate compliance by providing a statutory basis for the code in the new Structure Regime. In October 2004, the bill on the revision of the Structure Regime became effective. Book 2 of the Dutch Civil Code includes a provision that a code of conduct can be designated by order in council such that the 'comply or explain' rule will apply (para. 4, Art. 2:391 of the Civil Code). However, before the order in council can be adopted, both the First and Second Chambers must be given at least four weeks in which to comment (para. 5, Art. 2:391 of the Civil Code). In the interim, this procedure was initiated by the Minister of Justice on 8 October 2004. Even though the code has a statutory footing, the main responsibility for enforcement remains with shareholders. They are expected to call management and supervisors to account in respect of applying the principles of the code and the statement on observance of the best-practice provisions.

### **Characterising the Tabaksblat Code: self-regulation or interactive regulation?**

#### *The Tabaksblat Code as self-regulation*

This section returns to consider the question formulated at the beginning of the chapter: whether the Dutch Corporate Governance Code can be conceptualised as an example of self-regulation. As noted above, self-regulation is the regulation by an SASF of its members' behaviour. Self-regulation is the defining activity of every SASF since it can generate rules and coerce or induce subsequent compliance. In this light, we can conclude that the Tabaksblat Code is not an illustration of self-regulation.

First, the historical development of the code indicates that we are not dealing with an example of bottom-up self-regulation. The state (represented by the ministers of economic affairs and finance) was involved from the beginning of the regulatory process by providing the incentive to regulate. Furthermore the ministers steered and controlled the process by selecting the organisations which formed the committee and ensured that ministry representatives were present within the committee's secretariat during drafting. The Tabaksblat Committee therefore did not independently assume the initiative to develop regulation in the field of corporate governance but was invited to do so and its members were nominated by organisations selected by the government. By (indirectly) selecting the participants, the ministers created a regulatory process with an 'exclusive' character. It is noteworthy that they did not invite any organised labour organisations to nominate members for the committee. Particularly where employees are considered to be the primary stakeholders in corporate governance, it is difficult to understand why labour was excluded from the proceedings. The fact that the group was not inclusive diminishes the democratic status of the process (see further below).

Second, at face value the Tabaksblat Code may appear to be an example of top-down self-regulation given the governmental input explained above. However, the process did not conclude with the development of rules of self-regulation. This argument is based primarily on the nature of the participants and their mutual relations. The actors involved in the regulatory process surrounding the Corporate Governance Code were the Tabaksblat Committee (and its members), the six organisations which formed the committee and the two ministers (economic affairs and finance). The SASF of relevant interest to this chapter is the committee being directly responsible for creating the (supposed) self-regulation. The committee developed, formulated and introduced a code containing rules of corporate governance. However, the rules were not directed at its members' behaviour. The code's norm addressees are management, supervisors, shareholders and even stakeholders of listed companies. These norm addressees have no (direct) relationship with the

committee, in the sense that they did not ‘grant’ the committee authority to regulate their behaviour. The same applies for the six organisations which formed the committee. The committee can thus not be regarded as an SASF regulating its members’ behaviour (the 11 individuals in the committee). Similarly, the committee has nothing to do with enforcing the code, which is left in the hands of shareholders. The SASF responsible for the regulation therefore plays no role in coercing or inducing compliance. The role of the six organisations was limited to nominating members to the committee. Thus neither the organisations themselves nor their members can be considered to be bound by the code through acceptance or consultation. In conclusion, the ‘self’ did not regulate itself, but regulated the behaviour of others who did not necessarily accept its authority in this regard.

The question that logically follows is that if not self-regulation, what is it? The answer is that the Tabaksblat Code is a link in the interactive legislative process. When the code was given its statutory foundation through the amendment of the Structure Regime, it found its way into the legislative arena.

#### *The Tabaksblat Code as interactive legislation*

As observed above, the Tabaksblat Committee functioned as a debating partner for the legislator in the interactive legislative process. It can be regarded as the interpretive community that discussed the topic of regulating corporate governance. At the outset the legislator presented the Tabaksblat Committee with an abstract value: good corporate governance. This value was then debated upon and articulated into more concrete norms within the Corporate Governance Code.

The process in which deliberations occurred can be characterised as highly informal: they were conducted on the basis of what has been called ‘conversational informality’. This is not surprising given the constitution of the Tabaksblat Committee which can be characterised as a typical old-boys’ type of network. The committee’s members share similar backgrounds, are from the same, relatively small Dutch business community and are therefore likely to be well-acquainted with one another. Furthermore, the number of participants was relatively small with only 11 members. In this setting the members were not likely to disagree on any fundamental issues. As noted above, another illustration of informality is that the vocabulary adopted in the regulation is associated with the background of the participants. This is true of the Tabaksblat Code. The code utilises the vocabulary of the business world. Indeed, the committee explicitly stated that they deliberately avoided the use of legal terminology.

So what are the implications of characterising the Tabaksblat Code as interactive legislation? Is it not a positive development when the ‘beneficent’ legislator involves citizens in the legislative process? Does that not make the

process more democratic? This is the claim made by the interactionist paradigm. This chapter claims, however, that by making the legislative process more interactive and informal one runs the risk of making it less democratic. If the Tabaksblat Code had actually been self-regulation, the model characterised by informal conversation would not have been problematic. In fact, it could have been more than sufficient. However, for statutory legislation it is unacceptable. This is because statutory legislation demands a model of deliberation that meets the requirements of procedural formality. A legislative assembly is characterised by a relatively high level of formality associated with debate, enactment and output and political deliberations which are cosy and informal conversations must be avoided.

Waldron (1999: 24) identifies three structural features of legislatures, where legislation is the end result of a particularly structured process. Characteristic of modern legislatures are their size, the diversity of their membership and the ordered nature of deliberative proceedings in the face of profound disagreement. In a legislature many individuals come together to act collectively. The importance of entrusting legislative matters to an assembly instead of a committee is that diverse community perspectives are brought to bear on proposed regulation. The reasons why this interaction is desirable and necessary also makes it unlikely that it can be conducted as an open-ended conversation among friends. There is insufficient common ground, a lack of shared confidences, premises cannot be assumed and nuances cannot be taken for granted. These members cannot interact as members of a tight-knit social group or as an old-boys' network. The only matter such members share is an overlapping sense of common problems. Accordingly, legislative members usually communicate in rather stiff and formal language during debates. In parliamentary assemblies, individuals who are not necessarily on casual 'speaking terms' with one another participate in legislative deliberations as representatives. The typical form of parliamentary debate is therefore undermined by involving a committee such as the Tabaksblat Committee to deliberate on legislative issues. Furthermore, conversational informality obscures possible discrepancies that would ordinarily float to the surface in a normal parliamentary debate on account of diverse perspectives and legitimate disagreement. Matters are more problematic given that the composition of the Tabaksblat Committee was not inclusive: there were no representatives of organised labour. In a debate on corporate governance where employees are considered the prime stakeholders, it is disconcerting that organised labour was excluded from processes of deliberation and decision-making. In contrast, a parliamentary assembly is characterised by the fact that all opinions are represented. When making regulatory processes more interactive this element must be safeguarded at all times.

In retrospect it is understandable why the government was keen to portray



the code as an example of self-regulation: to avoid the proceedings from being characterised as the non-democratically legitimised delegation of regulatory authority without a legal basis (see further Raaijmakers, 2004). In fact, the process illustrated by the Tabaksblat Code only clarifies the weakness of the interactive approach discussed earlier: the risk of democratic loss. At the outset of the regulatory process the government deliberately chose a certain regulatory strategy. The Tabaksblat Committee was engaged in the legislative process and assigned important legislative tasks (namely, the development and formulation of corporate governance rules to be adopted into statutory legislation in a later stage and the deliberations thereon). This strategy was undertaken to facilitate the subsequent implementation of the final regulation. Deliberations on the regulation of corporate governance were conducted largely outside the legislative arena in an informal setting. The following parliamentary debate was therefore marginalised: the government was not accountable for the making of the rules or their content and could justify their existence by pointing to the genesis of the code as a self-regulatory process emanating from the self-regulatory capacity of society.

In conclusion, the interactionist claim of making legislative processes more democratic through interaction between legislator and its citizenry can only be maintained first when the process is inclusive and second when a high level of formality in the debate can be assured.

## Notes

1. Thanks due to Douwe Groenevelt and Pauline Westerman for their very helpful comments on earlier drafts. Errors and omissions remain those of the author.
2. Moore (1973) belongs to the 'legal pluralist' tradition in the sociology of law which emphasises the primacy of 'folk law' and 'indigenous social ordering' over legislation and the influence of formal legal ordering over social behaviour.
3. The interactive law approach is inspired by the jurisprudential sociology of the Berkeley School in sociology, in particular the work of Philip Selznick (Selznick and Nonet, 1978; Selznick, 1992); and Lon Fuller (1964, 1981).
4. The term 'interpretive community' was first introduced by Stanley Fish in 1980: see, S. Fish (1980), *Is There a Text in This Class? Interpretive Communities and the Sources of Authority*, Cambridge MA: Harvard University Press.
5. This section draws heavily upon Waldron's *Law and Disagreement*, Ch. 4 (Waldron, 1999: 69–87).
6. The Social Economic Council (Sociaal Economische Raad) is the main advisory body of the Dutch government on national and international social and economic policy. Its position has been anchored by law since 1950 when the Industrial Organisation Act came into force. The SEC may give advice, solicited or unsolicited, on all major social and economic affairs. There are three groups of members represented in the SEC: the first two are formed by representatives of unions and employers' organisations and the third is formed by independent (crown) members, appointed by the government. The entire council has 33 members.
7. Until 1977 the term 'corporate governance' did not exist in the English language. The first to use the term were lawyers in the United States, where a debate took place on whether a federal corporate law should be introduced: see further, Frentrop (2002: 11).
8. The Stock Exchange Association Foundation (de Vereniging voor de Effectenhandel).

9. This is an uncommon point of view since the shareholder is not usually considered to be a stakeholder (see Frentrop, 2002: 415).
10. Originally known as the Structure Act, the Structure Regime regulates the supervision of large companies in the Netherlands and was introduced in 1971. It requires large companies to appoint a supervisory board to oversee the activities of the board of management. In this way, the executive and non-executive (or supervisory) functions are separated and assigned to two distinct bodies (referred to in shorthand as the two-tier board system). The 1971 legislation also regulates the appointment, dismissal, powers and activities of the supervisory boards. On 10 February 2000 the minister of justice asked the Social Economic Council for advice on the functioning and future development of the structure regime in the Netherlands. In June 2000 the Second Chamber asked the SEC for additional information. In 2001 the SEC drew up its report. After deliberation, the bill was accepted by the Second Chamber in September 2003 and the First Chamber in July 2004. The bill became effective on 1 October 2004.
11. The Confederation of Netherlands Industry and Employers (de Vereniging VNO-NCW); the Netherlands Centre of Executive and Supervisory Directors (het Nederlands Centrum van Directeuren en Commissarissen: NCD); the Association of Securities-Issuing Company (de Vereniging Effecten Uitgevende Ondernemingen: VEUO); the Association of Stockholders (de Vereniging van Effectenbezitters: VEB) and the Foundation for Corporate Pension Funds (Stichting Corporate Governance Onderzoek voor Persioenfondsen: SCGOP).
12. The majority of members belong to the business community. The two academic members also hold positions in the business community. Three of the six organisations which formed the committee, 'sent' representatives (Euronext, the Association of Stockholders and the Foundation for Corporate Pension). The secretariat of the committee comprised two representatives from the ministries of finance and economic affairs who were not considered to be members.
13. Dutch regulation concerning corporate governance is found in statutory legislation, principally Book 2 of the Dutch Civil Code. These rules primarily concern the attribution of formal competence between different organs of the company, the functioning of the supervisory board, the management board and the general meeting of shareholders and the individual rights of shareholders.
14. Listed companies and their interest organisations argued that the committee should formulate more principles and fewer code provisions. In addition, the code provisions should be fewer in number. There were also comments on the scope of the code with the claim being that the committee had been unclear in formulating its exact scope. There were also several questions concerning the 'comply or explain' rule. The committee also received criticism of the effective date of the code and the recommendation to establish a small panel that continuously reviews whether certain principles or best-practice provisions need to be adjusted or interpreted in greater detail.
15. The only recommendation that the government did not adopt was the regulation of the company secretary's position in Book 2 of the Civil Code.
16. Explicitly mentioned are employees, shareholders and other providers of capital, suppliers, customers, government and civil society.
17. In the terms of reference, one parameter for a renewed code was that the new code should be principle based instead of rule based. Hence, the spirit is thought to be of greater importance than the letter of the code.
18. Many of the best-practice provisions were inspired by the UK Combined Code as well as recent American rules.

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## 16 The influence of NGOs on the normative framework for business and human rights

*Rory Sullivan*

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### **Introduction**

Over the past ten years, non-governmental organisations (NGOs) working in the human rights field have focused significant attention on the role of companies for protecting and promoting human rights. NGO activities, mirroring the traditional NGO campaigning strategies of confrontation and protest against governments, have included high-profile boycott campaigns against clothing and shoe manufacturers and retailers, support for litigation against companies accused of involvement in human rights violations, shareholder resolutions, protests outside company offices and reports highlighting company involvement in or complicity with human rights violations. Human rights NGOs have also engaged directly with companies and have lobbied governments and international organisations to implement measures to encourage companies to improve their human rights performance.

This chapter focuses on the influence of these engagement and lobbying activities on the normative framework within which companies operate, with a particular emphasis on the campaigning activities of international human rights NGOs (such as Amnesty International) and the responses of international companies (referred to here as ‘transnational corporations’: TNCs) and governments.

### **Why are companies of concern?**

The relationship between foreign direct investment and human rights is not an easy one to assess. On the one hand are the arguments that TNCs can provide significant benefits through providing much needed jobs and development. On the other hand, recent years have seen a series of allegations of human rights violations by companies, especially in developing countries. These reports have related to issues such as children working in hazardous industries, sweatshops, security forces killing or injuring protestors, and the use of forced or bonded labour. Furthermore, as illustrated in Table 16.1, companies may be exposed to (or proximate to) human rights violations, through their operations in certain countries, through the nature of their activities or through the products they produce.

Table 16.1 Examples of corporate exposure to human rights violations

Industry sector	Examples of exposure to human rights issues
IT Hardware and Telecommunications	Sourcing of coltan from the Democratic Republic of Congo
Extractives	Labour conditions in supply chains
	Operations in countries where human rights violations are occurring (e.g., Nigeria, Colombia, Indonesia, Sudan, Sierra Leone)
	Unequal distribution of the benefits from resource extraction
	Lack of transparency on revenues, royalties
Food and Beverages	Environmental degradation
	Displacement of indigenous peoples
Pharmaceutical and Chemical	Supply chain issues (e.g., child labour, poor working conditions, constraints on freedom of association)
	Access to essential drugs and treatments
Defence	Intellectual property rights (e.g., the exploitation of 'traditional medicines' and 'indigenous knowledge')
	Clinical trials
	End-use or disposal of hazardous or toxic materials
Utility and Infrastructure	Arms trade (e.g., proliferation of small arms, use of equipment by oppressive governments to facilitate repression, torture, cruel, inhuman and degrading treatment)
	Security
	Corruption
	Access to essential services (water, sanitation, electricity) and infrastructure

Source: Adapted from Amnesty International (UK) and International Business Leaders Forum (2002).

The concerns about the impacts of companies on human rights have been exacerbated by the apparent limitations in the international legal framework for ensuring the performance of companies. International human rights law is based on the principle of state responsibility, and international law looks first to states to enforce its rules (International Council on Human Rights Policy, 2002: 11, 45). However, in many less-developed countries, the pressures for investment or development have frequently led to the weakening or waiving of legal protections for human rights or the environment, (Jochnick, 1999;

Gamble and Ku, 2000; Richter, 2001). Furthermore, the relationship between host governments and TNCs may have the effect of exacerbating human rights violations. For example, energy and mining projects are typically organised through leases from or joint ventures with local governments (see, for example, Evans et al., 2001). These governments can be highly repressive and can, in some cases (recent examples include Indonesia, Colombia and Nigeria), be engaged in what amounts to a civil war with ethnic, tribal, political or other groups.

### **NGOs and business campaigns: an overview**

#### *The beginning: Shell and Nigeria*

The United Kingdom Section of Amnesty International (AIUK) established a Business Group in 1991 with the objective of encouraging companies to use their legitimate influence in defence of the civil and political rights which were Amnesty International's main focus. Initially, the efforts of the Business Group to engage with senior members of the chief UK-based TNCs were not successful (see, further, Chandler, 2003). This changed with the controversies around Shell's activities in Nigeria in the mid-1990s, in particular the allegations of Shell's complicity in the arbitrary execution of Ken Saro-Wiwa and eight other Ogonis by the Nigerian dictatorship of General Abacha in November 1995 (Human Rights Watch, 1999). The accusations of condoning human rights violations and of complicity with an oppressive regime proved extremely damaging to the reputation of what was then one of the most respected companies in the world. The controversy led Shell to engage in a process of dialogue with stakeholders to better understand their concerns and to determine how Shell could prevent the recurrence of such events (Pax Christi, 1998; Lawrence, 2002; Chandler, 2003). These discussions resulted in Shell revising its Statement of General Business Principles to include respect for the human rights of employees and 'support for fundamental human rights in line with the legitimate role of business' (Royal Dutch/Shell, 1997). BP, which in 1996 was faced with accusations about its handling of security problems in Colombia, followed suit shortly afterwards.

#### *Engagement and dialogue*

Since the mid-1990s, human rights NGOs have established a dialogue with many companies, participating in face-to-face meetings, conferences and working groups. These dialogues have centred on both issues of specific concern (for example, specific human rights allegations and concerns) as well as broader questions around companies' human rights policies and management systems. One of the most notable features of these discussions has been the general lack of understanding within companies of how human rights may

relate to their business activities. Consequently, NGOs have produced a range of publications to assist companies better understand human rights issues. As an example, Amnesty International's publications have included: *Human Rights Guidelines for Companies* (AIUK Business Group, 1997), *Human Rights: Is It Any of Your Business?* (Frankental and House, 2000), *Business and Human Rights: A Geography of Corporate Risk* (Amnesty International (UK) & International Business Leaders Forum, 2002), and *The UN Human Rights Norms for Business: Towards Legal Accountability* (Amnesty International, 2004).

NGO–business dialogues have seen the use of ‘business case’ arguments by NGOs, with NGOs arguing that the benefits of good business performance in relation to the protection and promotion of human rights can include avoiding adverse publicity, avoiding litigation, improving reputation and a more secure ‘licence to operate’ (for a more detailed description, see Frankental and House, 2000: 24–7). These arguments have been used as a ‘point of entry’, to allow NGOs to raise specific concerns and/or to develop relationships with companies. Business case arguments have also been used to encourage companies to take specific actions, by demonstrating that there are business benefits associated with the protection and promotion of human rights. One of the challenges faced by NGOs has been to avoid the potential for these arguments to undermine the moral force of their arguments, through allowing companies to reduce human rights to a cost–benefit calculus (where ‘rational’ decisions can be made to address or not address specific human rights issues depending on whether the benefits outweigh the costs). A longer-term implication is that the NGO focus on the business case for protecting and promoting the human rights may have the effect of diminishing the moral authority of calls on companies to respect and promote human rights. For example, the reputational consequences of corporate involvement in human rights violations may be reduced if such violations are seen as ‘acceptable’ or as an acceptable consequence of a rational business decision.

### *Outcomes achieved*

For ‘western’ companies, formal policy commitments to specific actions or values are widely seen as the key starting point for developing organisational commitment to these values or actions (Sullivan and Wyndham, 2001: 25–32). In their discussions with companies, human rights NGOs have emphasised that corporate policy commitments to the protection and promotion of human rights are an essential starting point in allowing companies to effectively engage with human rights issues. Given that this has been the starting point for much of the NGO dialogue with companies, it is pertinent to review how many companies have adopted human rights policies. The Business and Human Rights Resource Centre lists 43 companies with policies that refer explicitly to

the Universal Declaration of Human Rights<sup>1</sup> and a further 21 with general policy commitments to human rights but not to the Universal Declaration of Human Rights.<sup>2</sup>

There are a number of comments that can be made about these data. First of all, progress has been slow. While human rights has been on the corporate agenda since the mid-1990s, the fact that just over 60 companies have made such policy commitments can be seen as somewhat disappointing. However, the fact that 25 have made commitments in the period from October 2002 (see a previous analysis in Sullivan, 2003) to June 2004 may be a sign that the rate at which companies are making human rights commitments is increasing. Furthermore, the companies that have made such policy commitments include some of the largest TNCs. As noted by Geoffrey Chandler, the former chair of the Amnesty International (UK) Business Group, 'a bridgehead of principle has been won from which no retreat will now be possible even under adverse economic circumstances' (Chandler, 2003: 31).

Second, these data raise questions about the effectiveness of NGO engagement activities. The majority of companies with human rights policies previously had at least one major issue with human rights or have exposure to particularly sensitive countries, are part of the extractives (oil, gas, mining) industries or see a human rights policy as a potential source of competitive advantage. From these data, it could be argued that the reality is that companies will not submit to new responsibilities without being compelled to do so and, on the occasions when they do so, it is on account of social pressure (including NGO campaigning) or because of errors, scandals or accidents involving the company concerned (Addo, 1999: 11). Freeman (2002: 134–8) makes a similar comment in relation to NGO–government relations). Consequently, it is not possible to say what the contribution of NGO engagement activity has been, relative to the other influences and pressures that have encouraged companies to make these policy commitments. It could in fact be argued that the effectiveness of NGO engagement relies on the existence of pressures that force companies to properly engage with the issue of human rights.

Third, it is interesting that very few of the companies with human rights policies have their biggest human rights exposures through their supply chains. Conversely, few companies with significant supply chain risks have made human rights policy commitments. On one interpretation, this could mean that human rights NGOs have failed to effectively engage with companies with supply chain exposures. However, a review of supply chain codes indicates that while only a small number refer explicitly to the Universal Declaration of Human Rights, the codes do address many of the key human rights issues such as forced labour, child labour and freedom of association (Jenkins, 2002: 19). Rather than seeing this as a failure of NGO activity, it



may simply reflect the need for these companies to focus specifically on labour standards (and, therefore, to refer to sources such as the International Labour Organisation's standards) rather than human rights more generally. In contrast, the impacts of activities such as mining are widely recognised as extending far beyond working conditions, and so a more expansive approach to human rights may be an appropriate approach for corporate policy. Therefore, a focus solely on human rights codes as a measure of the outcomes of the effectiveness of human rights NGOs may underestimate the influence of human rights NGOs on corporate practice more generally.

Finally, despite the NGO focus on corporate policies, there are important questions around whether or not such policies can be relied on. While company codes and policies have an important role to play in defining minimum standards of corporate behaviour, they are non-binding and can easily be flouted by less scrupulous organisations. The experience in practice has been that many organisations' policies on human rights have limited impact on the actual performance of companies (Sullivan and Frankental, 2002: 87–8). To an extent, this may reflect a cynicism on the part of the companies making such commitments. However, it is also pertinent to note that the management of human rights remains an area where knowledge and expertise is still evolving and there are many challenges faced by companies in implementing their policy commitments. Perhaps the biggest challenge is in defining what the outcomes for human rights should be. While some aspects are reasonably well understood (for example, occupational health and safety) and others are evolving (for example, corporate responsibility for state and private security forces), many remain contentious. For example, there is no agreement on how far corporate responsibility for the realisation of the right to health should extend. This lack of clarity on outcomes has direct implications for companies seeking to manage their human rights impacts as the performance (process and outcome) measures that they should be working towards are not well defined. One of the consequences has been that, even though the broad framework for human rights management systems is reasonably well understood (see Sullivan and Seppala, 2003), the majority of companies tend to have a reactive approach to human rights problems (see, generally, Sullivan, 2003)

### **Law and policy lobbying**

Human rights NGOs have been heavily involved in debates around the development of law and policy instruments for holding companies to account for their human rights impact. This section focuses on three specific, and somewhat interrelated, activities, namely efforts to create an international law framework for companies, efforts to reform domestic law to address the human rights impacts of TNCs, and efforts to develop an agreed normative human rights framework for companies.

*International law and policy*

NGO campaigns can have an effect on international law and policy processes. Perhaps the most striking examples thus far have been in the areas of trade and investment. For example, the NGO campaign against the Multilateral Agreement on Investment (MAI), proposed by the OECD, has been described as ‘represent[ing] one of the fastest, most resounding defeats for a treaty – a defeat attributable to the efforts of NGOs’ (Gamble and Ku, 2000: 255). The campaign illustrates the potential for NGOs to play a spoiling (or oppositional role) in the international law process, although it remains to be seen whether such opposition can be sustained over the longer term or whether the defeat of the MAI is simply seen as a delay rather than a derailing of efforts to develop an international investment regime. More positively, human rights NGOs (among many other actors) have played an important role in the development of international human rights law in areas such as bribery and corruption and in efforts to regulate or control the movement of certain products (for example, the Kimberley Process for diamonds).

While NGOs have campaigned for a formal international convention relating to business and human rights (for example, a corporate accountability convention of the type currently being proposed by Friends of the Earth and other NGOs: Friends of the Earth International, 2002), they have not been successful in these efforts. Such campaigns have been strongly resisted by TNCs and, as a result, governments have been unwilling to contemplate binding legal obligations for companies relating to human rights. For example, the outcomes of the 2002 World Summit on Sustainable Development (Rio+10) held in Johannesburg emphasised voluntary partnerships between governments, civil society and corporations as the primary vehicle for poverty alleviation. Despite this reluctance to support regulation, there is a growing willingness by governments to convene dialogues among companies, NGOs and national governments on specific human rights issues. One example is the Voluntary Principles and Security Rights, convened by the US and British governments and now joined by the Dutch government (see further Freeman and Hernandez-Uriz, 2003). The participants in the process are Royal Dutch/Shell, BP, Rio Tinto, Chevron, Texaco, Conoco, Freeport McMoran, Amnesty International, the International Business Leaders Forum, International Alert, Lawyers Committee for Human Rights, the International Confederation of Chemical, Energy, Mine and General Workers Union and the Fund for Peace. The purpose is to provide a framework (the Principles) and a forum for discussing security issues around the extractives industry. Another major initiative is the United Nations Global Compact,<sup>3</sup> where companies are invited to sign up to nine principles (relating to labour rights, human rights and environmental protection). To date, over 100 companies have signed up to the Global Compact. The United Nations sees that the

compact provides a forum for dialogue and experience sharing. However, the Global Compact does not include any mechanisms for monitoring or ensuring performance.

#### *Campaigns for extraterritorial legislation*

Domestically, NGOs (and other stakeholders such as trade unions) have campaigned for the introduction of legislation to ensure the performance of domestic companies when operating overseas. Corporate responsibility bills have been presented in the United States,<sup>4</sup> Australia<sup>5</sup> and the United Kingdom.<sup>6</sup> While the specific details of these initiatives differed, the proposals all included provisions relating to issues such as human rights, environment, labour and occupational health and safety, as well as requiring monitoring, reporting and, where necessary, sanctioning of companies. The public policy debate surrounding each initiative has followed a similar pattern, with NGOs supporting the legislation and companies strongly opposing the legislation. While the debates were ‘won’ by industry (that is, the bills were defeated), the discussions allowed many of the technical issues around such legislation to be addressed (for example, the Parliamentary Inquiry into the Australian Code of Conduct Bill (Parliamentary Joint Statutory Committee on Corporations and Securities, 2001: 13–26) considered the issue of extraterritoriality in some detail, including an assessment of the constitutional, statute and case law provisions that related to this issue). Furthermore, the campaigns also created some consensus around the need for some form of accountability mechanism for companies. For example, an Early Day Motion in support of the bill was signed by over 300 members of parliament. The Corporate Code of Conduct Bill 2000 was the subject of a parliamentary inquiry (ibid.). While the inquiry recommended that the bill not be adopted, both of the major opposition parties tabled dissenting reports (ibid.).

#### *Creating a normative framework through the United Nations*

Human rights NGOs have been actively involved in the four-year process of drafting the UN Norms on the Responsibilities of Transnational Corporations and other Business Enterprises with Regard to Human Rights (hereafter ‘the Norms’; see Sub-Commission on the Promotion and Protection of Human Rights, 2003). The Norms have been drafted by a working group of the Sub-Commission on the Promotion and Protection of Human Rights and the process of developing the Norms included four public meetings in Geneva (over the 2000–2003 period), meetings where representatives of business, trade unions, NGOs and academics were involved in shaping the document, various working groups and the posting of all drafts on the internet. A summary of the content of the Norms is presented in Box 16.1.

### BOX 16.1 RECOMMENDATIONS OF THE UN HUMAN RIGHTS SUB-COMMISSION ON COMPANIES AND HUMAN RIGHTS

Companies must respect and promote the following rights:

Right to equal opportunity and non-discriminatory treatment;  
Right to security of person;  
Rights of workers (companies shall not use forced or compulsory labour, shall respect the rights of children, shall provide a safe and healthy workforce, shall provide workers with remuneration that allows for an adequate standard of living for them and their families, shall ensure the freedom of association and the right to collective bargaining);  
Respect for national sovereignty and human rights (including not paying bribes, ensuring that the company's goods and services are not used to abuse human rights, respecting civil, cultural, economic, political and social rights in particular, the rights to development, adequate food and drinking water, highest attainable standard of physical and mental health, adequate housing, education, freedom of thought, conscience and religion, freedom of opinion);  
Consumer protection;  
Environmental protection.

These obligations apply to the company itself and to the company's contractors, sub-contractors, suppliers and licensees.

The Norms were strongly supported by NGOs, but strongly opposed by many business groups. The comments of the International Chamber of Commerce (ICC) and the Institute of Employers (IOE) are typical in this regard. The ICC and the IOE rejected the Norms on the basis that: (a) the Norms misstate international human rights law by imposing human rights obligations on companies (while not the subject of this chapter, it is pertinent to note that this particular argument has been strongly challenged, for example, see Muchlinksi, 2003); (b) the Sub-Commission did not respect the principles of transparency and accountability; (c) the draft Norms are extremely vague and, if put into effect, will lead to arbitrary enforcement actions and the violation of human rights; and (d) the Norms may be used to legitimise vilification campaigns targeted at private persons (ICC and IOE, 2004). While the

ICC/IOE criticisms have some merit, they also reflect a deep antipathy to the human rights agenda among many business groups. From the tone of their submission, it is clear that the human rights agenda remains to be embraced by many of the largest companies and most influential interest groups. Many of the criticisms also seem to be based on a deep suspicion of any efforts to define human rights obligations for companies, irrespective of whether or not the Norms will have a legal sanction.

The Norms were presented to the UN Commission on Human Rights in April 2004. At its meeting, the Commission requested that the Office of the High Commissioner for Human Rights compile a report setting out the scope and legal status of existing initiatives and standards relating to TNCs, and to consult with all relevant stakeholders (Commission on Human Rights, 2004). This decision represented a compromise between the views of business and the views of NGOs, and had the effect of taking some of the heat out of the debate around the Norms. At the time of writing (July 2004), the future of the Norms remains unclear. The polarisation of the debate and, in particular, the strong opposition of the business community mean that it is unlikely that the Norms (in their present form) will be incorporated into an international legal instrument or that they will achieve the status of customary international law. However, considering principles purely in terms of their influence on legislation omits the value of such principles as a political (or campaigning tool). It is here that the normative influence of NGO expectations is perhaps most important. There are three initiatives that are of particular interest here. The first has been the publication of the Norms as an Amnesty International document (Amnesty International, 2004). This document, while initially intended primarily as a campaigning tool in support of the Norms also has a greater importance as it signals that Amnesty International will use these Norms more generally as a basis for its discussions with companies. The second is that a number of major companies (ABB, Barclays, the Body Shop, MTV Networks Europe, National Grid Transco, Novartis and Novo Nordisk) have agreed to work with Respect Europe in the Business Leaders Initiative on Human Rights to further analyse and assess the applicability of the Norms to the activities of international business. The third is that NGOs (not just those focusing on human rights but also social justice and environmental NGOs) have expressed strong support for the Norms.<sup>7</sup> This consensus, along with the involvement of companies and other actors in the process of better understanding the Norms makes it likely that the Norms will continue to be relevant irrespective of what happens to the Norms within the UN system.

**Analysis: the effectiveness of NGO campaigning activities**

The effectiveness of NGO campaigning activities on the normative framework within which companies operate can be considered in terms of the following measures:

1. getting human rights on the business (and government) agenda;
2. changes in the manner in which companies operate; and
3. changes in the policy context that improve respect for human rights.

#### *Human rights on the agenda?*

Perhaps the most striking change in the human rights debate has been the increasing acceptance that businesses do have responsibilities for the protection and promotion of human rights (see generally, Sullivan, 2003). For example, it has been argued that it is generally agreed, even by business writers, that the societal expectations of companies relate, at a minimum, to integrity, health and safety as an absolute priority, avoidance of complicity with human rights violations, commitments to gender, racial and ethnic equality, commitment to sustainable development and avoiding exploitation of the poor (Willets, 1997: 221–3). The growing number of companies with human rights policies and the various initiatives supported by governments are further evidence of this. Indeed, even the strong business opposition to the Norms could be seen as a sign of how far the debate has progressed, with business fighting what is effectively a rearguard action on the issue. It could be argued that there are no longer questions about whether companies have human rights responsibilities; the question is more one of how far these responsibilities extend.

#### *Changes in companies*

Progress on encouraging companies to adopt formal human rights policies and management systems has been relatively slow, and significant gaps remain in the systems and tools for managing human rights. However, a growing number of companies are making policy commitments to the protection and promotion of human rights and there is a growing understanding of how companies should manage human rights issues. It is also relevant to note that many of the civil and political rights are already required by legislation or form a standard part of management practice, at least in developed countries.

Perhaps paradoxically, it may be that the success of NGOs in getting companies to make policy commitments to the protection and promotion of human rights may undermine the ability of NGOs to call for stronger (regulatory) approaches. Self-regulation is frequently used by companies to argue that regulation is not required. In the context of the present discussion, the capture of public policy is evidenced by the difficulties in establishing binding domestic or international legal regimes for companies. For example, one (perhaps cynical) interpretation of the outcomes of the World Summit on Sustainable Development (Rio+10) could be that TNCs succeeded in capturing the debate over regulation, through arguing that voluntary approaches and partnerships were the preferred means of ensuring the business contribution

to poverty alleviation and sustainable development. Such an assessment may be overly harsh. While self-regulation is not popular with NGOs, it may be that, given the weaknesses in international regulatory frameworks, self-regulation is the only viable approach to ensuring corporate performance on human rights. Dialogues between companies, NGOs, trade unions and governments (for example, the Voluntary Principles on Security and Human Rights, the UN Global Compact and the Extractive Industries Transparency Initiative) have been supported by companies as they offer the advantages of creating a level playing field, helping build trust between companies and other stakeholders and providing a means for companies to share experience and information in a non-competitive way. However, the outcomes (as measured by improvements in corporate human rights performance) from these initiatives remain unclear. NGOs have criticised many of these initiatives as attempts to delay or avoid taking action through the creation of discussions that do not generate substantive outcomes. It appears that a growing number of international dialogues, having started with high expectations, have stalled or dwindled into talking shops. Furthermore, 'free-riders' present a particular problem for these initiatives as none provides a mechanism for holding companies to account for non-compliance. This absence of effective enforcement processes is of particular concern to NGOs, given that companies frequently use the existence of voluntary initiatives to argue against the need for regulation.

#### *Changes in the policy context*

Despite legal accountability being a significant part of many NGO campaigning strategies over the past five years, there has been limited success in establishing such frameworks at either the national or international levels. However, the emergence of various voluntary initiatives relating to human rights may be seen as a sign that governments and companies recognise that there is a need for action. The increasing number of non-binding codes that are being drafted and adopted is leading to the establishment of a rich set of sources from which new binding standards can emerge (Muchlinksy, 2003). While these processes can be criticised on the grounds that both corporate and NGO interests are trying to capture the human rights agenda, they may be seen as a necessary starting point in the development of more binding frameworks for corporate accountability. The question is when and how these initiatives will turn into detailed legal standards that can hold companies to account at the international and national levels. In this context, the Norms represent a very important contribution to the gradual evolution of this framework. In practice, it may be that these processes lead to the frameworks relating to specific human rights issues (in a similar manner to the emergence of both domestic and international legal regimes relating to bribery and corruption). Current examples could include the discussions around security (the Voluntary

Principles on Security and Human Rights) and revenue transparency (the Extractive Industries Transparency Initiative).

It is also important not to overstate the role of binding regulations in ensuring corporate human rights performance. In many ‘hard law’ agreements, provisions concerning controversial social issues have been put into very general, and probably meaningless, hortatory language, simply to show that something has been done, but where there is little intention to see these provisions having any real legal effect (see further, *ibid.*). There are also, as discussed above in the context of international human rights law and nation states, significant questions around the manner in which binding regulations are implemented. Similar problems are likely to be faced by any efforts to create a binding legal regime for companies. For example, the relative mobility of companies means that they have considerable autonomy from both their ‘home’ governments and the governments of the countries in which they invest (Freeman, 2002: 156–7).

## **Discussion**

### *Contests of actors and legitimacy*

NGO efforts to develop a normative framework for business and human rights have occurred primarily outside the formal institutions of international law and policy, relying on strategies such as protest, direct engagement with companies, and involvement in initiatives to develop normative frameworks for companies. These strategies have reflected the absence of political interest in regulation, and the consequent recognition that there is a need to influence politicians and other opinion formers, before actually engaging in an institutional process of rule development and implementation. It is at this point that the debate is presently situated – with some signs of a growing willingness of government and companies to engage in voluntary approaches to addressing human rights issues.

The debate on business and human rights also has broader implications as it sees one set of non-state actors (that is, NGOs) working to define norms and legal obligations for another set of non-state actors (that is, companies), with limited involvement of government. This contest of influences, which is duplicated in many other corporate social responsibility debates, is likely to be an ever more common approach to the development of soft, and probably hard, international law obligations. These activities open up important questions about the relationship between NGOs and the state (and the role of the state in implementing its mandate through regulation and public policy generally). Human rights NGOs have taken the lead in defining human rights expectations of companies. On one hand, this may be seen as a positive development by adding to or supplementing the perceived ineffective and compromised traditional



mechanisms of law creation and law enforcement, and as a positive expression of growing grassroots involvement in effective rights enforcement. Alternatively, the development of such norms may be seen as a controversial development, relying on the aggregation and exercise of power by essentially unaccountable bodies, permitting the application of such norms in countries where the workers affected are neither consulted nor agree to the application of these norms. While there are obvious reasons for NGOs to focus their efforts on companies, these campaigning activities raise important public policy questions such as: is it reasonable for one non-state actor to define expectations of another? Which actors should define which expectations (for example, should trade unions have the primary responsibility for labour issues and how are non-unionised workforces to be addressed)? Who should enforce these expectations? What happens in situations where the government is incapable of action (for example, the so-called 'failed nation state')? This chapter has not sought to address these questions but it is pertinent that companies and indeed civil society representatives from the less-developed countries (see, for example, Eade and Diokno-Pascual, 2002; Utting, 2002) have increasingly started to challenge the legitimacy of NGOs to define the human rights expectations of companies. It is likely that these questions will form an ongoing backdrop to the business and human rights debate.

*From soft to hard law?*

This chapter illustrates well the challenges ahead for any efforts to develop a new social responsibility agenda for TNCs (in this case, in relation to human rights). The process is a slow one and is probably more likely to create 'soft law' obligations. That does not imply that international human rights instruments are doomed to complete legal ineffectiveness if they are not legally binding. The origin of the legal principle in a 'soft law' instrument, such as a voluntary code of conduct, is of little consequence if a consensus develops that the principle in question should be viewed as an obligatory standard by reason of subsequent practice. Given that many of the most important international expressions of welfare values tend to be in such a form, this 'hardening process' may be of particular importance. It may be that the primary contribution of human rights NGO is to create the soft law that forms the basis for international law in this area. In the specific context of the Norms, it has been argued that '[a]s a tool for risks review and for assisting in the anticipation of future regulation and societal pressure, the Norms provide the best framework for moving forward' (Cooper and Warhurst, 2004).

**Notes**

1. These are: ABB, Ahold, Amerada Hess, Anglo American, Balfour Beatty, BG Group, Body Shop, BP, BT, Cadbury Schweppes, Carlsberg Breweries, CGNU, Conoco, Cooperative

- Bank, Diageo, EMI, ENI, Freeport McMoran, GlaxoSmithKline, HP, ICI, Ikea, Intercontinental Hotels, Lloyds TSB, National Grid Transco, Nokia, Norsk Hydro, Novo Group, Philips, Premier Oil, Reebok, Repsol, Rio Tinto, Roche, Shell, Skanska, Stora Enso, Storebrand, Talisman Energy, Timberland, TotalFina Elf and Unocal ([www.business-humanrights.org](http://www.business-humanrights.org), reviewed on 15 June 2004).
2. These are: Abbott Laboratories, ABN Amro, Akzo Nobel, Alcoa, Bonnier Group, British Airways, British American Tobacco, Casino, Chevron Texaco, Colgate Palmolive, DLH Group, Dell, Dow, FLS Industries, Goldfields, Lundin Petroleum, Nestlé, SCA, Statoil, Tom's of Maine and Unilever. ([www.business-humanrights.org](http://www.business-humanrights.org), reviewed on 15 June 2004).
  3. See [www.unglobalcompact.org](http://www.unglobalcompact.org).
  4. Corporate Code of Conduct Act 2000 (House Resolution 4596).
  5. Corporate Code of Conduct Bill 2000 The Parliament of the Commonwealth of Australia draft of 28 August 2000 clause 10.
  6. See the website of the Corporate Responsibility (CORE) Coalition, [www.foe.co.uk/campaigns/corporates/core/about/bill.htm](http://www.foe.co.uk/campaigns/corporates/core/about/bill.htm).
  7. See, for example, NGO submissions that are posted on the Business and Human Rights Resource Centre website ([www.business-humanrights.org/Categories/UNIntlorgs/UNIntergovernmentalorgs/UNSubmissionstoUN-2004consultation-businesshumanrights](http://www.business-humanrights.org/Categories/UNIntlorgs/UNIntergovernmentalorgs/UNSubmissionstoUN-2004consultation-businesshumanrights), last reviewed 23 August 2004).

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## 17 The interaction between corporate codes of conduct and international law: a study of women and children in the textile industry

*Olga Martin-Ortega and Rebecca M.M. Wallace*

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### **Introduction**

The topography of international business activity is now punctuated by the plethora of voluntary codes. Although such codes are commendable they nevertheless should have some point of reference, rooted in international law. This is imperative if basic human rights are to be effectively guaranteed. The guarantee of such rights should not spawn a multinational industry whereby alleged adherence to human rights is reduced to another quality check akin to ticking a box. Subscribing to human rights should be undertaken by international businesses in respect for uniformly acknowledged standards rather than simply responding to the advice of their public relations office. Corporate codes, however stringent and robust they may appear, are the offspring of corporate discretion to afford human rights a privileged and hallowed position. This is because companies, the addressees of codes, decide their content and furthermore enjoy the power to investigate and police themselves. Although the full glare of adverse publicity has fallen upon some companies, such 'external scrutiny' has, however, been indiscriminate and random. The protection of human rights within the workplace demands more than a piecemeal *ad hoc* approach.

Do the current codes reflect internationally accepted norms? If so, is this the result of deliberate effort on the part of multinationals or merely fortuitous coincidence? Why is a reference to international law desirable? The authors will explore these questions with particular reference to the protection afforded to two vulnerable groups, women and children, within one employment sector, the textile industry.<sup>1</sup>

This chapter will not undertake an exhaustive analysis of the content of codes of conduct. Many comprehensive commentaries already exist. The narrower intention is to highlight trends with respect to corporate social responsibility (CSR) in relation to women and children. Differences in treatment and emphasis will be noted and the consequences of each considered.

### **Working in the global supply chain production system**

The textile industry serves as an important example of a supply chain production system. This system is located within the international dynamic of competitiveness for the lowest production cost, generally achieved by subcontracting to producers who can ensure the lowest price. This objective is realised by cutting labour costs, which all too often entails hiring those whose need for work outweighs any consideration for their social and economic rights. The system is simultaneously characterised by insecure commercial ties whereby commercial entities enjoy the power to negotiate lower prices and higher quality with very little, if any, opposition from producers, thereby maximising profit and minimising costs and risks (Oxfam International, 2004).

The textile sector, one of the most important industrial sectors worldwide, is particularly complex in the distribution, mobility and flexibility of production (ILO, 2000b). The minimal use of technology and a principally unskilled labour force has facilitated transferring the lower stages of production to countries where labour regulation is typically only in its infancy whereas trademarks, final distributors and large retailers have remained in their country of origin. Further delocalisation and fragmentation over the last two decades has been responsible for transforming the industry. The workforce consists mostly of women, many of them migrants, and, in some cases, children. These women and children are at the end of the chain and frequently working in export processing zones (ILO, 2002), sweatshops, maquilas or even within their own home.

These workers will not normally enjoy any formal labour relationship with any particular employer. They may also hold partial contracts characterised by an absence of several contractual terms and conditions, variable tasks and remuneration dependent upon fulfilling daily objectives. Such contracts by their nature deny to workers financial security and even if they enjoy access to trade union protection there is frequently an active pressure to discourage them to seek it (Oxfam International, 2004). Textile workers face long hours (up to 12 to 16 hours per day), unpaid overtime, extensive resort to apprenticeships (characterised by half the minimum wage and precarious working conditions) and a lack of employment security. Associated health problems include exhaustion, back pain, tired eyes, breathing difficulties, lesions from needles, renal problems owing to restricted toilet use and a number of consequential physical and psychological problems (*ibid.*). The cumulative effect of these factors is a less than desirable working environment.

The adverse position of women, typically constituting the majority of textile workers (ILO, 2000a; Oxfam International, 2004),<sup>2</sup> is accentuated by additional gender-specific harms. First, women will have had minimal education or their education will have been curtailed by a need to assume family

responsibilities or to commence work. Second, women frequently face discrimination, particularly in relation to wages and labour promotion (ILO, 2000a), sexual harassment, invasive medical examinations (for example, compulsory pregnancy tests) and possibly social exclusion where working women are rejected by their local communities. Finally, women are expected to discharge family responsibilities even when working, and where pregnant, if not immediately dismissed, will frequently find that concessions are not made for their condition which will in turn bring its own consequential health problems (Oxfam International, 2004).

### **Women and children in codes of conduct**

Social and environmental scandals can prompt companies to re-evaluate the issue of human rights violations, particularly by way of protection against NGO criticism. This scrutiny has encouraged corporations to adopt several initiatives in order to self-regulate labour, environmental or/and human rights standards. The textile industry was the first sector to adopt codes of conduct in response to the accusation that working conditions in third-world countries approximated slavery. The emergence in 1992 of Levi Strauss's code of conduct paved the way for others.<sup>3</sup>

The instruments of corporate social responsibility vary and range from codes of conduct, annual social and environmental reports, certification initiatives and partnership programmes. The focus of this chapter is primarily upon codes of conduct. Codes vary considerably in content. This is normally determined by the particular sponsor of the code and the sector concerned. Codes formulated by intergovernmental organisations and governments tend to be general in scope whereas industry-centred codes are more frequently drafted by social groups such as NGOs, trade unions and business associations. For example, it is relatively common for larger companies and specific trademarks to have their own codes. This is particularly true of the textile industry sector. In addition are those codes issued by so-called 'stakeholder partnerships' or collaborative efforts between social groups and business in order to adopt, implement or/and verify compliance with a code. This is the method generally used for more complex systems of CSR such as certification schemes and environmental and social labelling.<sup>4</sup> The textile industry is also one of the industrial sectors in which relatively more business/social group partnerships are being formed to establish codes of conduct.<sup>5</sup>

The clauses contained in these codes vary from those related to business practices and marketplace behaviour *vis-à-vis* their competitors (in other words, the most traditional clauses of business ethics) to proper social responsibility provisions. The latter link society and those affected by commercial activities to the company's internal organisation and external behaviour. This category of clauses includes provisions with respect to social and labour

rights, environmental standards and corporate citizenship more generally. Such provisions reflect the more recent evolution of social expectations concerning business conduct (OECD, 1999). The analysis presented within this chapter concentrates on the labour and human rights provisions.

As a general rule, most corporate codes of conduct contain labour rights as a specific category. Among the labour standards reflected in these codes, one or several of the following (very rarely all of them) are normally included: non-discrimination; freedom of association and collective bargaining; avoiding forced and child labour; fair wages; the terms and benefits of employment (including working hours, prohibiting harassment or abuse and disciplinary actions); and finally maintaining a healthy and safe work environment (ILO, 1998: para. 546–59; OECD, 1999: 10; 2000: 24–6; World Bank, 2003: 6–12). The textile industry has developed codes in which there are frequently more references to labour relations and working conditions than those of any other industry (OECD, 2000: 12–13). Furthermore, they tend to focus primarily, if not exclusively, upon a relatively narrow range of labour issues (*ibid.*: 24). The most frequently mentioned labour provision is the prohibition of child labour (ILO, 2000a: 94; OECD, 2000: 25). However, other provisions relating to freedom of association and the right to collective bargaining are seldom mentioned, notwithstanding their recognition as an indispensable prerequisite for respect for fundamental rights at work. The social standards most often mentioned in these codes refer to non-discrimination, preventing harassment in the workplace and the prohibition of forced labour. An increasing number of codes also now incorporate a ‘decent remuneration’ component (ILO, 2000a: 94).

The codes of conduct formulated within the textile sector rarely embrace other aspects of CSR. This is clearly apparent in relation to environmental standards, in contrast to the codes developed by enterprises within the oil/chemicals sectors and the extractive industries which focus principally upon environmental issues (OECD, 2000: 24; World Bank, 2003: 12).

The fact that corporate codes carry the hallmark of the industry to which they apply reinforces the conclusion that they are a product of their sectoral environment and strongly influenced by pressures brought to bear by consumers and NGOs. These pressures are significantly evident in relation to child labour within the textile industry. This observation sharply contrasts to the corporate scrutiny given to the employment conditions of women.

### *Children*

The issue of child labour is a recurring feature of codes of conduct in the textile industry. Indeed, as noted above, prohibiting child labour is the most frequently mentioned commitment within these codes. This could reflect the sector’s self-awareness of the possibility of children being employed in their

production system as well as a self-interested response to the extensive publicity that child labour has received in recent years. In contrast to other sectors, particularly heavy industry, technology, pharmaceutical and banking sectors rarely address the issue of child labour. Several entities have issued specific codes focused exclusively upon child labour, such as the Code of Best Practice for Child Labour by the World Federation of the Sporting Goods Industry.<sup>6</sup>

As a general rule, all codes which mention child labour do so uniformly, albeit with a slight difference in emphasis. Most employ statements such as ‘no use of child labour’ or ‘there shall be no use of child labour’ and several contain references linking the issue to forced labour. The commitment is simply to refrain from using child labour and seldom involves any further duty (Jacobs, 2000: 200). The types of clauses included – ‘child labour must not occur’ or business shall not ‘use’ or ‘employ’ child labour – do not imply business participation in its abolition but only restraint from resort to it (with the exception of provisions concerning transitional aid that will be referred to below).<sup>7</sup>

One of the most important features of the reference to child labour in CSR instruments is the definition of child labour itself, that is, establishing the minimum age of access to work. Although most of the codes focus upon the 14–16 age group, there is great divergence in the formulation of these age limits. These limits normally refer to local or national law, and not as might be expected to the ILO’s international norms on the minimum age. A common standard of reference is the age for completing local compulsory education, either alone or in conjunction with a minimum established age.<sup>8</sup> The references to 14 year olds are typically accompanied by the caveat ‘if domestic law in the country of manufacture allows’ or ‘where the law and regulations of the country of manufacture allow’. The higher age limit is normally 16. In addition, several codes differentiate the age limits in relation to the type of work (see, for example, the provisions of Nike’s code in relation to the production of footwear where workers have to be 18 years old, whereas for the production of apparel, accessories or equipment workers need only be 16 years old). Other codes contain specific references to work at night or in hazardous conditions for which the age limit is raised to 18 years.<sup>9</sup>

That said, the codes containing these clauses do not provide mechanisms to control the access of children to work. Several interesting exceptions require official documentation verifying each worker’s date of birth or in the absence thereof other reliable age assessment measures may be demanded.<sup>10</sup>

Typically these features are the extent of the provisions relating to child labour within codes of conduct. However, several codes make more explicit references including provisions concerning apprenticeships, parents and children in the workplace, transitional assistance and young workers. Particularly noteworthy are those codes promoted by stakeholder partnerships. For example,



SA8000 calls for establishing procedures 'for the promotion of education' for children and young workers and the Ethical Trading Initiative (ETI) provides 'for transition of child labourers to educational programs until they are no longer children'. In general, codes formulated by individual businesses do not contain any of these provisions, although an exception is the Hennes & Mauritz (H&M) code which has a relatively extensive section concerning child labour. In relation to apprenticeships, for example, this code provides that 'where [the] country permits apprenticeships programmes for children between 12 and 15 years of age' the company will accept that children of this age work for only a few hours per day. The total number of hours is fixed in accordance with ILO Convention No. 33 whereby the daily hours spent at school and for light work should never exceed seven. In addition, the factory in which apprentices are employed must be able to prove that this work is not interfering with their education, is aimed at their training, and that the child is properly compensated. The company states that if they have any reason to doubt that these conditions are being met then such apprenticeship programmes will not be accepted in factories which produce garments for them.

The issue of transitional assistance is particularly important since it involves the company in the child's future, and thereby plays an important role in the development of the country. The empirical evidence of the desirability for transitional assistance is well established since children who are dismissed from their jobs do not merely return to school, but find jobs in other factories, work for underground subcontractors or are forced into begging or prostitution. These were the alleged consequences of denouncing the use of child labour in Bangladesh garment factories which resulted in the US Child Labor Deterrence Act of 1993 (known as the Harkin Bill) and its subsequent banning in Bangladesh within three months (Khair, 2000: 135; Dickerson, 2001: 612–14). The H&M code referred to above also contains a transitional aid provision whereby factories must act in a working child's best interest and any measures adopted should aim to improve, not worsen, his/her situation. In particular, the child should not be dismissed without considering the implications for his/her future and any educational costs must be paid for by the factory.

### *Women*

Codes of conduct in relation to women may be classified as falling into one of three categories: those that make no reference whatsoever to women or gender but contain a general non-discrimination clause; those that identify gender or sex as one of the grounds of prohibited discrimination; and finally those that make particular provision regarding women's working conditions or address their specific needs.

Virtually all the codes of conduct contain several non-discrimination guarantees and the majority have a non-discrimination clause encompassing gender (World Bank, 2003: 9). The coverage of the non-discrimination clause varies significantly, pertaining solely to hiring and employment practices generally or more specifically to wages, benefits, training, advancement and retirement.<sup>11</sup> However, several firms provide only general safeguards through clauses which prohibit 'unlawful discrimination' or provide that non-discrimination guarantees should be 'in conformance with local and national law' (ibid.: 10). This leaves the door open to practices which could be considered discriminatory or prohibited by the law of most countries, but not in those states with no or very low standards.

There is rarely any further reference to women or specific gender conditions in the codes of conduct of the textile industry. Several codes mention pregnancy and maternity, either alone or in relation to non-discrimination. Examples include the New Balance Code, which prohibits any screening for pregnancy before or during employment; Nike, which rejects discrimination based upon maternity status; and the Timberland Company, which prohibits discrimination regarding the 'capacity to bear children, or pregnancy'. Similarly, the H&M code considers that the 'dismissal of pregnant female workers is unacceptable'.

Many of the codes contain provisions on the prohibition of sexual harassment at work. Such harassment, even if not exclusively suffered by women, has traditionally been used as a tool for the control of women and as will be seen below is considered by the Committee on the Elimination of Discrimination against Women to be a form of female discrimination. In several codes this clause is linked with employee abuse and disciplinary action. Although most of the codes prohibit such practices, many are not specific about the kind of behaviour that will not be tolerated. Exceptions include the codes of Adidas-Solomon, New Balance, Pentland, Reebok and Timberland, all of which offer comprehensive statements which explicitly prohibit physical, sexual, psychological or verbal harassment or abuse. Reebok's code goes further to state that there must be 'no condoning, creating, or contributing to an intimidating, hostile, or offensive work environment'. Although such clauses are to be welcomed, it should also be noted that no specific reference to women is made.

Other codes contain more protective clauses such as that of H&M in relation to childcare, which recommends that factories with predominantly female workers arrange day care for children below school age. Generally, there are no specific provisions concerning women's rights or working conditions. One interesting exception is the Worker Rights Consortium Model Code of Conduct. Although not formulated specifically for the textile industry but rather to enable a group of universities to control the way their licensed goods

are produced, the code is nevertheless applicable to textile businesses. It contemplates non-discrimination on the basis of gender and the right of workers to be treated with dignity and respect free from physical, sexual, psychological or verbal harassment or abuse. The code also includes specific rights for women such as equal remuneration (including benefits), equal treatment and equal evaluation of the quality of their work; equal opportunity to fill all the positions open to male workers; prohibiting pregnancy tests as a condition of employment; prohibiting dismissal or the threat of dismissals, loss of seniority or deduction of wages for maternity leave; the possibility of returning to their former employment at the same rate of pay and benefits; not to be compelled or pressured into using contraception; not to be exposed to hazards, including glues and solvents, which may endanger their safety, including reproductive health; and to be provided with appropriate services and accommodation in the event of pregnancy.

### **Voluntary obligations and international law**

Codes of conduct make little if no reference to international legal instruments. Several codes refer to international human rights norms but the majority simply ignore their existence, set their standard of conduct in relation to local or national law, or are silent with respect to the sources of their self-imposed obligations. Businesses are in effect enunciating the principles applicable to their behaviour, irrespective of already defined and interpreted human rights.

The most-cited international instruments are UN declarations and treaties concerning human rights and environmental protection as well as ILO conventions and recommendations. On many occasions, references are made to international standards in an unspecific way such as ‘sustainable development principles’ or ‘universal’ or ‘internationally recognised human rights’ (OECD, 1999: 16). The codes that typically contain references to particular treaties are those issued by stakeholder partnerships.<sup>12</sup> Very few codes mention intergovernmental instruments which delimit corporate responsibilities such as the OECD Guidelines on Multinational Enterprises, the ILO Tripartite Declaration on Multinational Corporations and Social Policy or the UN’s Global Compact.

The codes of conduct applicable to the textile industry and making references to women and children are no exception. In relation to child labour, the few businesses that promote codes containing references to international instruments establishing age limits and children’s protection do so in general terms, referring for example to ‘UN standards on the rights of the child’. However, even those which might be regarded as most specific limit citation to the UN Convention on the Rights of the Child. References to ILO conventions concerning child labour are rare.

The minimum age of access to work, as previously observed, is generally

determined without reference to the relevant ILO instruments. Of particular cause for concern are those codes that refer to 'the local legal age', given that this may be lower than that in the ILO Convention. More encouraging are those codes that follow the ILO minimum age 'even where such labour is permitted by the laws or the country of manufacture' (Jacobs, 2000: 200). Jacobs argues that where the ILO minimum age is higher than the national minimum, companies may comply with the former in accordance with the fundamental principle of labour law that entitles private parties to deviate from statutory standards in favour of workers (*ibid.*).

Even where codes do not mention international legal instruments relevant to identifying age limitations, it may be argued that the general trend supports a minimum age of 15 years or the age for completing local compulsory education, thereby conforming with the ILO Minimum Age for Admission to Employment Convention (No. 138). However, the basic statements concerning the minimum age contained in that convention ignore other standards established by the ILO, in particular Convention No. 182 and Recommendation No. 190 on the Worst Forms of Child Labour. The ILO thus provides for more extensive protection for children than those mandated in most corporate codes. These include provisions which refer to higher ages of access depending on the nature of the employment. For example, employment regarded as 'dangerous', likely to jeopardise the health, safety or morals of young persons is reserved for those aged 18 years and over (art. 3.1), except when it can be shown that these factors are not compromised and the age may be lowered to 16 years (art. 3.2). Additionally, few firms comply with ILO Recommendation No. 146 concerning Minimum Age for Admission to Employment which provides that for any child engaged in labour, the firm must allow for school attendance and not employ children during school hours.

That the absence of an international legal reference creates a void in protection is most acutely seen in relation to women. Few if any businesses promote codes containing references to international legal standards concerning women's rights. Although references to non-discrimination are occasionally accompanied by a general reference to ILO Convention No. 111 concerning Discrimination in respect of Employment and Occupation, there is seldom any reference made to the Convention on the Elimination of All Forms of Discrimination against Women (CEDAW) or any other relevant ILO instruments (such as the Convention concerning Equal Remuneration for Men and Women Workers for Work of Equal Value (No. 100), the Maternity Protection Convention (No. 103) as revised by Convention No. 183 or the Convention concerning Equal Opportunities and Equal Treatment for Men and Women Workers: Workers with Family Responsibilities (No. 156)). These absences are consistent with the lack of gender sensitivity reflected in corporate codes of conduct.

The inclusion of the non-discrimination principle in these CSR instruments is particularly important in the textiles sector. Such a principle may play a crucial role in safeguarding the human rights of women, in particular their economic, social and cultural rights (Frostell and Sheinin, 2001). Once again, a failure to refer to international legal standards will not give cognisance to recent trends of interpretation, such as the disadvantage model. This model avoids an automatic and formal application of the non-discrimination principle which could result in several women's human rights issues being inadequately and insufficiently addressed.

The formal interpretation of the equality principle (where equality is typically understood as equal treatment for similarly situated individuals) may not provide satisfactory protection to women. The equality principle presupposes that a comparison can be made between women and men and resulting conclusions can be drawn as to whether women and men occupy a similar situation (*ibid.*). Its self-evident weakness is that the female is compared against the male standard. Moreover, the equality principle is inapplicable where a 'comparable male' standard is absent. This arises, for instance, in situations exclusively peculiar to women such as procreation and maternity, but is also evident in social, economic and political life where women are either excluded or make up the majority of individuals. The last-mentioned situation coincides with the present case study, in which nearly all of the workers are women. Accordingly it would be difficult to assess the degree of gender discrimination experienced.

The textile industry provides an example of gender segregation in the labour market where the formal application of the non-discrimination principle could lead to indirect discrimination. Work is defined as full-time employment: a minimum of hours per day and a number of days per week. Since most of the work within the textile industry is part-time or 'informal', the rights ordinarily flowing from labour relations are absent, such as equal pay for equal work, work promotion, social security rights, retirement benefits, pension schemes and health assistance. The inaccurate conclusion may be made that women do not experience discrimination in the textile industry or within the supply chain production system.

Furthermore, discrimination against women is often interwoven with discrimination on other grounds (so-called 'multiple discrimination') where women are treated differently not only on the basis of gender. The UN Human Rights Committee has recently drawn attention to this circumstance.<sup>13</sup> This is apparent where women working in supply chain production systems such as the textile industry are mostly migrants and therefore more likely to be exposed to poor treatment and less protection. Finally, a wider interpretation of the non-discrimination principle includes violence against women. In its Comment to Article 11 of the CEDAW contained in General

Recommendation 19, the UN Committee on the Elimination of Discrimination against Women considers sexual harassment within the workplace to be a form of discrimination. The committee recognises that 'equality at work can be seriously impaired when women are subjected to gender-specific violence, such as sexual harassment in the workplace' (para. 17). Sexual harassment is not only humiliating but can constitute a health and security problem. Moreover, it is discriminatory when the woman has sufficient grounds to believe that her adverse treatment could cause problems in relation to her work (para. 18). A gender-sensitive approach to the non-discrimination principle would comply more closely with the requirements of international human rights law. However, such an approach is rarely, if ever, reflected in corporate codes of conduct.

### **Conclusion**

It has been shown above that the protection afforded to each of the groups under consideration differs: children typically appear to be a specific category afforded protection whereas women rarely merit specific mention in the text of the corporate code. In any event, the fact that a company has a code of conduct containing provisions purporting to protect children's and women's rights does not guarantee that the behaviour of this corporation will conform to those rights nor to its own provisions on the matter. Codes have to be implemented and thereafter properly monitored. What has been discussed here is merely the starting point for this process: defining these obligations, how companies limit their behaviour and in accordance with which principles.

The objective was to consider the extent to which the substantive provisions of the many wide-ranging voluntary codes adopted by multinationals reflect contemporary international legal norms. Although particular provisions of these codes may reflect international standards, it is also apparent that there is no recurring reference as to the source of these obligations. In short, there is no reference to an international normative framework rooted in accepted legal principles to underpin the corpus of voluntary codes.

International human rights instruments provide those minimum standards and act as a safety net. For businesses to self-enunciate their duties fails to take into consideration the concept of human rights and its subsequent interpretation by international human rights bodies. Although this body of law is addressed to states and is therefore not directly applicable to companies, at least at its current stage of development, human rights are authoritatively defined by such instruments. They reflect the consensus of the international community on defining minimum standards of treatment for the benefit of, in the present context, women and children.

Codes are self-regulatory mechanisms, creatures of the very transnationals

they seek to regulate. However, transnational corporations are engaging in activities which by definition are international. If their conduct within the international system is to be regulated and monitored, account must be taken of the existing international legal framework. Corporations should not be permitted the luxury and self-indulgence of selecting for themselves the benchmark applicable to their behaviour.

The prospective regulation of international business activity is poised between the ever-increasing morass of voluntary codes and the 'less glamorous world of international law' (Klein, 2000: 442). Although the former may rather subconsciously and randomly reflect international human rights norms, only the latter can claim an established corpus of norms founded upon formal sources of law. If women and children are to be afforded protection in the workplace, then protection can only be adequately ensured if instruments of CSR obtain their legitimacy from international law.

## Notes

1. In line with the ILO, this study defines the textile industry as including the footwear, leather, textile and clothing industries.
2. Oxfam notes that in Kenya, women represent 75 per cent of the labour force in factories; 85 per cent in Sri Lanka; 90 per cent in Cambodia (where one out of five women from 18 to 25 years old work in the textile industry) and 85 per cent in Bangladesh.
3. According to Redmond (2003: 87), the first significant appearance of voluntary codes dealing with human rights occurred in the late 1980s among US-based clothing manufacturers and retailers. However, the Levi Strauss Code is frequently cited as the first corporate code of conduct which puts the management of ethics and labour rights within the context of international supplier relations (Kolk et al., 1999: 145).
4. Important initiatives in this context include Social Accountability 8000 by the Council of Economic Priorities (CEP) and the Base Code of the Ethical Trading Initiative (ETI), an alliance of companies, NGOs and trades union organisations.
5. Among the many examples which maybe cited are the Clean Clothes Campaign Code of Labour Practice in the Apparel Industry including Sportswear; the Charter by Social Partners in the European Textile and Clothing Sector; the Code of Conduct issued by the European Apparel and Textile Organisation (EURATEX) and the European Trade Union Federation of Textile, Clothing and Leather (ETUF: TCL); the Code of Labour Practice for Production of Goods Licensed by FIFA established by the partnership between the Fédération Internationale de Football Association (FIFA), the International Federation of Free Trade Unions (IFFTU) and the International Textile, Garment and Leather Worker's Federation; and the US Apparel Industry Partnership Workplace Code of Conduct.
6. The International Organisation of Employers has also concentrated on the issue of child labour. Following a Resolution on Child Labour of its General Council (3 June 1996) the IOE issued an Employer Handbook on the matter (1998, updated 2001). Similarly, IKEA, for example, has formulated a strategy to distance itself from child labour through 'The IKEA way on preventing child labour' (December 2002).
7. Calls for the effective inclusion of companies in the abolition of child labour essentially originate from intergovernmental instruments such as the OECD Guidelines (Section IV, c) or the ILO Tripartite Declaration (para. 36). The UN Global Compact also asks companies to work towards 'the effective abolition of child labour' (principle 5). The recent UN Norms on the Responsibilities of Transnational Corporations concerning Human Rights use a different formula, effectively stabilising the obligation to respect a child's right to be protected from economic exploitation (art. 6).

8. For example the WRAP (World Responsible Apparel Production) Principles prohibit child labour in these terms: 'Manufactures of Sewn Products will not hire any employee under the age of 14, or under the age interfering with compulsory schooling, or under the minimum age established by the law, whichever is greater'. Examples of company codes include The Clean Clothes Campaign Code of Labour Practices for the Apparel Industry including Sportswear which provides that 'There shall be no use of child labour. Only workers above the age of 15 years or above the compulsory school-leaving age shall be engaged'. Other company codes include the Adidas-Solomon Standards of Engagement, Levi Strauss, Liz Claiborne, C&A, New Balance or the Timberland Company.
9. For example, the ETI or the World Federation of Sporting Goods Industry Codes.
10. For example, the codes of New Balance, Gap and Reebok.
11. SA8000, the ETI and the Fair Labor Association (FLA) provide that there shall be no discrimination with respect to hiring, compensation, advancement, termination or retirement. Among the most comprehensive codes are the WFSGI and WRAP, Adidas-Solomon, New Balance, Nike and Reebok, Liz Claiborne and Marks and Spencer.
12. For example the EURATEX-ETUF: TCL Charter by the Social Partners in the European Textile and Clothing Sector cites the Universal Declaration of Human Rights and ILO Conventions Nos 29, 87, 98, 105, 111 and 138, The World Federation of the Sporting Goods Industry Code of Best Practice Concerning Child Labour cites ILO Conventions and Recommendations, the UN Convention on the Rights of the Child and the UN Supplementary Convention on the abolition of slavery, the slave trade and institutions and practices similar to slavery.
13. See further General Comment No. 28 on equality of rights between men and women, para. 30.

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# PART IV

## REGIONAL AND INTERNATIONAL INITIATIVES TOWARDS CORPORATE LEGAL RESPONSIBILITY



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# 18 A multilateral contribution to corporate standards of behaviour: the ILO's declaration on multinational enterprises

*Kee Beom Kim*

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## **Introduction**

Concerns over the social impacts of multinational enterprises (MNEs) have had a lingering tenacity. The perceived threats to the sovereignty and welfare of host countries posed by MNEs ignited an international effort to develop a multilateral framework for corporate regulation in the 1970s. The neo-liberal paradigms of the 1980s and early 1990s effectively replaced apprehension with more accommodating stances. Since the mid-1990s, however, the social conduct of MNEs has again come under public scrutiny, albeit by different actors from those in the 1970s. In response, many enterprises have voluntarily engaged in unilateral or multi-stakeholder initiatives to improve the social impacts of their own operations as well as those of their business partners. Furthermore, a growing number of enterprises have recognised that social responsibility can contribute to the sustainability of their businesses. None the less, the voluntary nature of corporate social responsibility (CSR) activities has raised a number of credibility and verification issues, which in turn have led some actors to call for legally binding frameworks for the regulation of MNEs.

This chapter evaluates historical achievements, weighs them against recent trends, considers future prospects for the regulation of international business and raises a number of policy implications. Specifically, the chapter examines the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy and the growing number and diversity of voluntary private sector initiatives. The various legal issues which have arisen from the multilateral framework and the CSR initiatives of companies challenge the dichotomy between legally binding and voluntary means of regulating MNEs. Considering the adoption of the former to be unlikely in the near future, this chapter highlights complementarities between voluntary multilateral instruments and private sector initiatives which could informally ensure proper social conduct by MNEs.

## **Historical background: multilateral framework**

The expansion of international trade and investment following the Second World War gave rise to the increasing number and predominance of MNEs on

the world economic scene. Against this backdrop, the regulatory mechanisms embedded at the national level were seen to be insufficient and by the early 1970s, there were increasing calls, especially by developing countries, for an international framework for the regulation of MNEs. Actions at the multilateral level to address these calls were first undertaken in 1972 when the Chilean government accused the International Telephone and Telegraph Company (ITT) of intervention in national politics at a meeting of the United Nations Economic and Social Council (ECOSOC). As a result, ECOSOC called for the appointment of:

[a] Group of Eminent Persons . . . to Study the Impact of Multinational Corporations on Development, especially that of the developing countries, and on International Relations, to formulate conclusions which may possibly be used by Governments in making their sovereign decisions regarding national policy in this respect, and to submit recommendations for appropriate international action. (UN Economic and Social Council Resolution 1721 (LIII), 1972)

These developments were taking place in the United Nations within the broader context of the need to overhaul the existing international economic order to better recognize the sovereign rights of states and redress the economic development and social gaps between developing and developed countries. Led by developing countries and newly independent states, the UN General Assembly (UNGA) in May 1974 adopted the Declaration on the Establishment of a New International Economic Order (NIEO). MNEs at the time were viewed by developing countries as playing an overall negative role in the economic and social development of host countries, and the declaration stipulated that the NIEO should be founded upon, *inter alia*, regulation of the activities of MNEs (UNGA Resolution No. 3201 (S-VI), 1974). The Programme of Action adopted with the above declaration observed that ‘all efforts should be made to formulate, adopt and implement an international code of conduct for international corporations’ (UNGA Resolution No. 3202 (S-VI), 1974).

In August 1974, soon after the adoption of the NIEO, ECOSOC considered the study undertaken by the Group of Eminent Persons, and decided to establish the UN Commission on Transnational Corporations with the UN Centre on Transnational Corporations as secretariat. This commission had as a priority the formulation of a code of conduct for MNEs. Negotiations for such a code were conducted over several decades but without success, and the commission was formally closed in 1992. One of the key differences between the negotiating parties was whether the code should be legally binding or voluntary.

During the mid-1970s, work on similar codes of conduct began to take place in other multilateral fora, in particular the Organisation for Economic

Cooperation and Development (OECD) and the International Labour Organisation (ILO). In January 1975, the OCED Council established the Committee on International Investment and Multinational Enterprises to examine measures to foster better cooperation among OECD member countries on international investment matters. Following negotiations, the OECD in June 1976 adopted the Declaration on International Investment and Multinational Enterprises, which laid a framework for facilitating investment among OECD member states. It initially contained three elements: Guidelines for Multinational Enterprises, an instrument on National Treatment and an instrument on International Investment and Disincentives.<sup>1</sup> These elements were to be reinforced by a consultation and review procedure. While the other instruments were backed by decisions of the OCED Council (which are legally binding upon member countries), the Guidelines for Multinational Enterprises is the only instrument that explicitly states that it is ‘voluntary and not legally enforceable’ (OECD Guidelines for Multinational Enterprises, Concepts and Principles, para. 1). The guidelines represent recommendations which provide ‘voluntary principles and standards for responsible business conduct consistent with applicable laws’ (ibid., Preface, para. 1). The guidelines, which were revised in 2000, are addressed to enterprises and contain 10 chapters covering a broad range of issues from employment and industrial relations to taxation.

### **The ILO’s tripartite declaration of principles concerning MNEs and social policy**

Created in 1919 from the Treaty of Versailles, which established the League of Nations, the International Labour Organisation is the recognised competent body to formulate and support internationally recognised labour standards. The ILO’s unique tripartite structure, where workers and employers have an equal voice with governments in decision-making, provides a platform where the parties can come together to adopt labour standards in the form of conventions and recommendations. Conventions create legally binding obligations to implement their provisions through ratification by member states. Furthermore, membership of the ILO creates an obligation to comply with the principle of freedom of association whether or not the relevant ILO convention has been ratified. Moreover, in 1998 the ILO adopted the Declaration on Fundamental Principles and Rights at Work. This declaration commits ILO member countries, regardless of ratification, to promote and uphold the principles concerning the right to freedom of association and collective bargaining; the elimination of forced and compulsory labour; the abolition of child labour; and the elimination of discrimination in the workplace. The application of ILO instruments is supervised by an elaborate reporting procedure and through technical assistance.

Since labour-related and social policy issues are among the specific

concerns to which MNE activities give rise, the ILO was also drawn towards international guidelines within its sphere of competence. In October 1972, a tripartite meeting of experts on the Relationship Between Multinational Corporations and Social Policy was mandated to ‘explore and submit recommendations to the Governing Body on the desirability and possible scope of ILO action in this area’ (ILO, 1972). That meeting was characterised by diametrically opposed views on the role of the MNEs: industrialised country governments and employer groups viewed MNEs as a conduit for economic growth and job creation, whereas developing countries and worker groups viewed them as a threat to national sovereignty and livelihoods. Given such irreconcilable positions, the key conclusion of the meeting was for the International Labour Office to undertake a series of intensive studies concerning MNEs.

After these studies, and in the light of other actions then being undertaken at the United Nations, a second tripartite meeting of experts was held in May 1976. At this meeting the tripartite partners agreed to initiate a declaration concerning MNEs and social policy that would be non-mandatory in character; to avoid inequality of treatment between multinational and national enterprises; to cover all MNEs irrespective of their ownership pattern; to give due consideration to existing ILO instruments; to direct efforts to governments, employers/multinationals and workers; and to transmit the outcome to the United Nations for incorporation in its code of conduct then under consideration.

The code of conduct being undertaken by the UN Commission on Transnational Corporations was a key impetus to the agreement. Employers felt that the ‘the chapter of the proposed United Nations’ text on multinational enterprises dealing with labour and social matters was best authored within the ILO where both workers and employers had a voice, rather than in a solely governmental organization such as the UN General Assembly’ (Charles H. Smith Jr in ILO, 1999: 66). The worker group, on the other hand, had favoured more legally binding measures in the form of a convention on MNEs. However, they decided to ‘go along with it as a step in that direction, hoping that through the implementation of its provision, some positive results could be achieved and would eventually lay the ground for a future Convention on this important subject’ (Amal Mukherjee in ILO, 1999: 44).

Following extensive negotiations, the Governing Body of the ILO in November 1977 adopted the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (the MNE Declaration). ILO conventions and recommendations reinforce the provisions of the MNE Declaration and in March 2000, the text of the MNE Declaration was revised to incorporate the ILO’s Fundamental Principles and Rights at Work.

The two interdependent aims of the MNE Declaration are to encourage the



positive contributions of MNEs to economic and social progress, and to minimise and resolve the difficulties to which their operations may give rise. Addressed to governments, employers' and workers' organisations as well as MNEs, the MNE Declaration seeks to advance these aims by providing guidance on the social policy measures and actions which can be taken individually and jointly.

The MNE Declaration is divided into five sections: general policies, employment, training, conditions of work and life, and industrial relations. Under general policies, the MNE Declaration recommends compliance with national legislation, respect for international standards (including the Fundamental Principles and Rights at Work) and support for the development priorities of the countries where MNEs invest. The MNE Declaration does not seek to differentiate its treatment of multinational or domestic enterprises, and its principles reflect good practice and guidance for all types of enterprises.

In the area of employment, the MNE Declaration encourages productive employment in MNEs (either directly or through linkages with local enterprises), the employment of host-country nationals, pursuing equality of opportunity and treatment, and enhanced employment security in the establishment and restructuring of operations.

The MNE Declaration encourages cooperation in developing policies and programmes for vocational training which meet the needs of both MNEs and host countries, and additionally links skills development and vocational guidance to employment. Furthermore, MNEs are encouraged to assist the development of the domestic private sector by participating, alongside national enterprises, in local skills development programmes and by making available both resources and personnel to help conduct training.

In the area of conditions of work and life, MNEs are called upon to offer wages, benefits and conditions of work as favourable as those provided by comparable employers and to ensure the highest standards of safety and health. In order to secure the effective abolition of child labour, the MNE Declaration expects multinational and domestic enterprises to respect legislation regarding the minimum age for employment.

In the area of industrial relations, the parties are encouraged to respect freedom of association and the right to bargain collectively as well as to provide systems for consultations on matters of mutual concern.

The follow-up to the MNE Declaration is ensured through periodic surveys and an interpretation procedure. Under the survey procedure, governments, employer and worker organisations submit reports – either jointly or independently – on the effect of the MNE Declaration. Although the ILO has to date carried out eight such surveys, there are lingering doubts regarding their effectiveness. Commentators and stakeholders have noted that many governments do not collect labour statistics, information which is specific to particular

MNEs precludes a satisfactory overall picture, and that anecdotal evidence does not necessarily reflect general practice (ILO Doc GB.288/11, 2003). Notwithstanding these limitations, the resulting information has proved useful in bringing about a rapprochement of views held by different social partners and by highlighting social and economic issues which can either validate or initiate research by economists and social scientists. For example, the question whether foreign firms in developing countries pay higher wages than domestic enterprises has been a topic of extensive literature and empirical inquiry (see further, Aitken et al., 1996; Dirk and Morrissey, 2001). Many respondents to the ILO surveys indicated that wages in MNEs 'were equal to or better than those of comparable employers in the country'. However, this proposition was qualified by emphasising that higher wages were sector specific and based on worker characteristics and skills levels (ILO, 2001: para. 97).

A more tangible impact of the survey procedure is evident at the national level. Respondents are encouraged to undertake tripartite consultations in completing the questionnaire. The resulting dialogue between the national social partners can lead to the identification of policies regarding MNEs and development. For example, in the Philippines the government, employers, trade unions and the ILO guided by the MNE Declaration concluded a Memorandum of Social Understanding. This identifies appropriate courses of action for the social partners in an effort to foster a mutually beneficial relationship between the Philippines and its investors (see further, Institute for Labour Studies, 1999).

Under the interpretation procedure, the ILO Governing Body can be requested to clarify the meaning or application of one or more provisions of the MNE Declaration. The importance of this procedure lies in its availability to contribute to the harmonious development of labour relations. Recourse to it may encourage disputants to confront their difficulties and secure perspectives capable of mutual accommodation. Thus the interpretation procedure 'operates more as a preventive response in areas prone to conflict through the building of patterns of adverse consequences, rather than a mechanism for dispute settlement in specific cases' (Diller, 1999b: 21).

To date, five cases have been the subject of decisions by the ILO Governing Body. The first case, in 1984, involved a US multinational bank operating in the United Kingdom that had decided to reduce its workforce. The Governing Body interpreted, *inter alia*, the MNE Declaration to require reasonable prior notice of intended changes in operations to be given to the workers' representatives and their organisations, where such organisations were identifiable under national law and practice. It was insufficient to inform the affected workers on an individual basis where such representatives and organisations existed (ILO Doc GB.229/13/13, 1985).

The second case involved a Belgian subsidiary of a French MNE that had

informed its works council of its decision to close the plant. The interpretation procedure found, *inter alia*, that attempting to minimise the negative social repercussions alone did not fulfil the purpose of the declaration. Any such action should be consistent with the twin goal of contributing to economic and social progress and moreover must be compatible with national social and economic policy imperatives (ILO Doc GB.239/14/24, 1988). The third case involved a MNE intending to expand its investment in a country where, according to an international trade union, there was total disregard for all workers' and human rights. However, the request was considered irreceivable since there was no actual dispute between workers and management or between the enterprise and the government (ILO Doc GB.255/10/12, 1993). In the fourth case, a secretary-general of a union had been appointed to participate in a sectoral tripartite meeting. The union leader requested his employer to: (a) grant him 'union leave' (that is, paid leave, non-deductible from annual vacation) to attend the session; and (b) provide company safety and health information for use at that meeting. The employer granted 'leave without pay' but declined to provide safety information and statistics on the grounds that these 'are proprietary and for company use' only (ILO Doc GB.264/13, 1995). The members of the subcommittee entrusted with examining the case were unable to agree on an interpretation.

In the final case, a senior executive located at a multinational's headquarters in another country announced at a press conference that one of its factories would be closing down later that year. The interpretation found, *inter alia*, that management should give reasonable prior notice of any intended changes which would have major employment effects. Providing notice after the final, irrevocable decision had been made but before its implementation was considered insufficient. Prior notice was necessary to facilitate discussions and identify possible measures of mitigation to minimise the negative employment effects (ILO Doc GB.272/MNE/1, 1998).

The low number of cases received to date and the promotional nature of the interpretation procedure has not escaped scrutiny. Worker organisations have remarked that determining the receivability of a particular case is dependent upon a unanimous decision by the officers of the Subcommittee on Multinational Enterprises, and if no agreement is reached, then upon a decision by the full subcommittee. Such a procedure is 'cumbersome, tough and discouraging' (Bill Brett in ILO, 1999: 7). Furthermore, the interpretation procedure has been criticised as 'anachronistic' (Neil Kearney in ILO, 1999: 40). Whereas the global dimensions of MNEs necessitates the pursuit of industrial relations at the international level, the interpretation procedure is perceived to be anchored at the national level, with international trade unions able to submit cases on behalf of national affiliates only under certain conditions.<sup>2</sup> International trade unions correctly observe that this procedure 'ignores

the fact that some of the greatest problems occur precisely in countries where trade union activity is effectively banned' (ibid.: 40). On the other hand, given the voluntary nature of the MNE Declaration, the high thresholds for receivability have prevented the procedure from becoming a tribunal which airs allegations of violations of the declaration by individual enterprises.

### **The emergence of private sector initiatives**

Were the multilateral frameworks for the regulation of MNEs, reflected by instruments such as the OECD Guidelines and the MNE Declaration, a 'preemptive strike by the industrialized states to avoid more stringent controls' (Hepple, 1999: 353)? Did MNEs engage with these instruments 'as a means of delaying an issue until it quietly disappear[ed]'?<sup>3</sup> Although developments in the 1980s could well provide credibility to their validity, circumstances in the 1990s and at the beginning of the twenty-first century suggest only initial and partial success.

By the mid-1980s, the attitude towards the regulation of MNEs had changed considerably. Countries began losing interest, most clearly manifested by the lack of progress on the negotiations for a code for MNEs at the United Nations and the subsequent closure of the Commission on Transnational Corporations. Furthermore, states began to institute more accommodating regimes to attract foreign direct investment, to the point where many countries were following a policy of offering special incentives to foreign investors.

There were several reasons behind the shift in thinking. First, neo-liberal paradigms which had become prevalent from the early 1980s emphasised decreased government intervention in market activities, including in the area of trade and investment. Second, the debt crisis of the early 1980s prompted many developing countries to seek non-debt-creating sources of capital, including MNEs. Third, successful national experiences in hosting multinationals increased awareness of their benefits as a source of know-how and technology transfer which increased export markets, tax revenues and direct and indirect employment.

The de-emphasis on public sector regulation and the accentuation of corporate rights characteristic of the 1980s was followed by a period in which enterprises began to undertake a number of voluntary initiatives that acknowledged their responsibilities to the natural environment, employees, business partners and society at large. These initiatives have been broadly classified under the umbrella of corporate social responsibility. No consensus has yet emerged on a definition for CSR or on the specific social responsibilities of enterprises.<sup>4</sup> Some consider CSR to be exceeding legal requirements, others as merely corporate philanthropy whereas to some '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' (Friedman, 1962, p. 133).

Flurries of activity based on different perceptions of CSR have taken place since the early 1990s. Haufler (2001) identifies three major factors which have driven such initiatives: the risk of government regulation, the need to maintain or develop corporate reputation as a global asset, and the spread of knowledge among businesses concerning the benefits of voluntary action. Corporate codes of conduct have been the most proliferate means for enterprises to define their responsibilities. Increasingly these codes of conduct apply not just to a company's own operations but also to those of business partners such as suppliers. An ILO review of 258 codes of conduct which addressed labour practices found that codes were more likely to be found in sectors that dealt directly in consumer products (including textiles, clothing, leather and footwear (TCF)), commerce, food and beverages, chemicals and toys (Urminsky, 2001). There was, however, a significant level of selectivity in terms of the labour issues these codes addressed. Codes in the TCF sector focused upon child and forced labour whereas the other sectors gave special attention to the issues of health and safety. Topics such as freedom of association and collective bargaining were addressed in only a third of those codes reviewed.

In addition, most codes of conduct contain subjective definitions of desired labour practices (Diller, 1999a). References to national law are the most frequent provision and most codes do not refer to international labour standards. The text of several codes could even be interpreted as contravening international labour standards, particularly those regarding freedom of association (ILO Doc GB.286/WP/SDG/4(Rev), 2003). Reference to national law, while articulating a useful minimum standard, does not identify appropriate conduct where there is no national legal framework or institutional capacity.

The lack of comprehensiveness and subjective definitions has diminished public confidence in codes of conduct. In response, enterprises have turned to both internal and external means of managing control. An internal measure that has become particularly prominent among MNEs is corporate reporting on the social and environmental impacts of operations. Recent ILO research that examined the social reports of the world's 150 largest MNEs also reveals that reporting is highly selective. The research compared 64 indicators derived from the MNE Declaration to the labour issues reported by MNEs and found the most frequent topics addressed to be wages, non-discrimination, training, health and safety and full employment. The fundamental labour principles of child labour, forced labour, freedom of association and collective bargaining were covered in fewer than 10 per cent of those reports analysed.

External control measures include accreditation and certification programmes (commonly referred to as 'social labelling'), monitoring and

inspection initiatives. However, social labelling programmes suffer from similar shortcomings as codes of conduct. Furthermore, they apply almost exclusively to export industries, which may overlook problems in others and rely heavily on consumer purchasing behaviour that might be undermined where the market is saturated with labels lacking credibility.

As a confidence-building measure, an increasing number of enterprises have engaged in multi-stakeholder initiatives which involve entities such as civil society organisations in design, implementation and monitoring. Notably, these types of initiatives tend to contain more references to international labour standards than unilateral initiatives. In a related measure, MNEs have entered into partnerships with intergovernmental organisations. The UN Global Compact is perhaps the best-known private–public partnership ([www.unglobalcompact.org](http://www.unglobalcompact.org)). It brings companies together with UN agencies, labour and civil society to support ten principles in the areas of human rights, labour, the environment, bribery and anti-corruption. These principles are based upon universally recognised multilateral instruments. The new partnership approach in promoting CSR has been favourably received by enterprises and organisations from around the world and there are currently over 1800 participants. Although the explicit goal of the Global Compact is not to enforce the conduct of enterprises, the initiative has none the less come under criticism from various quarters for failing to ensure that companies are committed to and abiding by the principles ('Global Compact, Little Impact', *Business Week*, 14 July 2004).

Investors are also increasingly using their financial influence to promote responsible behaviour among enterprises. Although socially responsible investment (SRI) represented a negligible proportion of invested capital during the mid-1980s, it has grown rapidly in the past decade and increased the likelihood that enterprises could be excluded from several sources of capital. According to one report, 'more than one out of every nine dollars under professional management in the United States' in 2003 constituted SRI (Social Investment Forum, 2003, p. 1). That said, the labour criteria used in identifying socially responsible enterprises are also lacking in specificity and standardisation (ILO Doc GB.286/WP/SDG/4(Rev), 2003).

### **Legal implications of multilateral and private initiatives**

The analysis of multilateral instruments for the regulation of MNEs and the private sector initiatives considered above has highlighted various inherent limitations of both frameworks. However, the aim of this chapter is not to abrogate their positive contributions. Multilateral instruments such as the MNE Declaration and the OECD Guidelines have been critical for establishing comprehensive reference points upon which to base enterprise policies and initiate dialogue between stakeholders. Private initiatives have played an

important role in leveraging market outcomes to further social goals and in promoting greater awareness that enterprise profitability and social development are not mutually exclusive outcomes.

The limitations common to both frameworks have their roots in their voluntary and legally unenforceable nature. In recognition of that fact, there have been increased calls for corporate accountability based upon legally binding measures. In particular, the World Summit on Sustainable Development of 2002 mobilised various civil society organisations to demand a binding international normative framework (Friends of the Earth, 2001; Graymore and Bunn, 2002). That said, the existing multilateral framework and the private sector initiatives are not totally devoid of legal implications. It is worthwhile to recall the deliberations of the UN Commission on Transnational Corporations:

A code of Conduct on transnational corporations, whether in legally binding or non-binding form, represents an effort to formulate expectations which Governments collectively feel justified to hold with regard to the conduct of transnational corporations. It becomes thereby a 'source' of law for national authorities as well as for the transnational enterprises themselves, since both can rely on and utilize the Code to fill gaps in relevant laws and practices. In this manner, the Code may become a springboard for legally creative action by national courts and other authorities, and even by transnational corporations themselves, to the extent that the latter may help to shape pertinent legal principles through their continuous practice. (UN Commission on Transnational Corporations, 1978)

There is a further reason why particular follow-up procedures such as reporting were insisted upon during the negotiations for these multilateral instruments. Pointing to the voluntary nature of a multilateral instrument does not 'exclude the possibility of the emergence of customary international law on any issue of MNE conduct on which there is state practice, including such practice in the context of follow-up proceedings' (Baade, 1980, p. 407).

Voluntary private initiatives have also raised a number of legal implications. The first question is whether corporate reports or public statements on their labour practices can be subject to legal challenge. This was considered when the California Supreme Court ruled that Nike's statements concerning the labour practices and working conditions within its factories amounted to 'commercial speech' (that is, was directed at consumers for the purpose of promoting sales) and was thus subject to anti-competition and false advertising laws.<sup>5</sup> The court, however, was careful to point out that:

Our holding, based on decisions of the United States Supreme Court, in no way prohibits any business enterprise from speaking out on issues of public importance or from vigorously defending its own labor practices. It means only that when a business enterprise, to promote and defend its sales and profits, makes factual

representations about its own products or its own operations, it must speak truthfully. (*Kasky v Nike, Inc.*, 27 Cal. 4th 939)

Mandatory reporting on the non-financial aspects of an enterprise's operations is a further legal development. These reporting requirements are gaining ground particularly in Europe, largely as a measure to enhance corporate governance. Beginning in 2005, Directive 2003/51/EC of the European Parliament and of the Council of the European Union will require large and medium-sized companies to report on environmental and employee issues where such information is 'necessary for an understanding of the company's development, performance or position'. The UK has also undertaken a parallel initiative. The government has completed draft regulations regarding mandatory reporting on environmental and social issues and is currently undertaking a consultative process before laying them before Parliament. Under the new regulations, all quoted companies in the UK would have to submit an operating and financial review (OFR) from the fiscal year 2005. The review would present an analysis of commercial operations, and must 'consider whether it is necessary to provide information on a wide range of factors which may be relevant to an understanding of the business, such as information about employees, environmental matters and community and social issues' (Department of Trade and Industry, 2004: 7).

Mandatory reporting on social and environmental issues is not novel within Europe. Since 1977, France has required all enterprises with more than 300 employees to submit annually a *bilan social* (social report). The document contains only statistical information and is aimed at stimulating dialogue between workers and management. Belgium also requires an analogous *bilan social* (Urminsky, 2003). Another French law of 2001 (*Nouvelles réglementations économiques*) requires listed companies on the French stock exchange to report on how they take into account the social and environmental consequences of their operations.<sup>6</sup> Labour indicators under this law include the promotion of and respect for the ILO's fundamental conventions among subcontractors with respect to employment, working time, remuneration, equity, collective bargaining, health and safety, training and diversity.

Finally, a number of lawsuits brought before courts in Australia, Canada, the United Kingdom and the United States are considering whether courts of the home countries of these MNEs can be used to ensure that they do not violate human rights standards within host countries (International Council on Human Rights Policy, 2002). While the threat of litigation can force MNEs to take their human rights responsibilities more seriously, it does not present an effective means of ensuring corporate social responsibility.



### **Policy conclusions**

After more than 30 years of multilateral and unilateral efforts, concern for the social impacts of MNEs has not dissipated. It is interesting to note that whereas industrialised countries and MNEs were opposed to the imposition of legal means to ensure appropriate standards of MNE behaviour during the 1970s, these actors are now more willing to entertain such measures. Various legal initiatives in several industrialised countries were discussed above. Furthermore, one survey of leading corporations has concluded that more than half of the respondents favoured strong laws on CSR and strong enforcement thereof (Berman and Webb, 2003). Such laws provide a level playing field for all enterprises and would obviate free-riders. On the other hand, it is unclear whether developing countries would now support legally binding measures. Obligations on the part of MNEs to be socially responsible, which extend to ensuring that suppliers and business partners in developing countries conduct themselves in an identical manner, could be perceived as protectionist. Furthermore, the costs for monitoring compliance could simply be passed down the global commodity chain. To counteract protectionist tendencies, groups in industrialised countries responsible for driving the CSR agenda need to ensure that their honest efforts to protect workers in developing countries do not override the realities and hopes within those states. Further dialogue with and the participation of developing countries within this agenda are therefore imperative.

It is unlikely that a compromise on legally binding measures to hold MNEs accountable will be achieved in the near future at the multilateral level. This makes it all the more important to leverage the existing platforms and ensure that multinational instruments and voluntary initiatives complement each other. Greater coordination is all the more important since socio-economic development is not a single-sided challenge for only one actor but requires multifaceted partnerships with predefined individual responsibilities. Mandatory reporting at the national level is an important step in this direction since it provides governments and other social partners with more information with which to assess the social conduct of MNEs and design appropriate social policies. Mandatory reporting also serves the practical purpose of augmenting reporting requirements under the follow-up procedures of multilateral instruments. The provisions found in multilateral instruments such as the MNE Declaration should provide useful indicators for this purpose. It would also address the shortcomings with respect to the selective and self-defined nature of voluntary initiatives, thereby bringing greater convergence and firmer public trust.

### **Notes**

1. An instrument on Conflicting Requirements was added in 1991.
2. In order for an international organisation of workers or employers to submit a request for interpretation, it must do so on behalf of a representative national affiliate and only if (a) the government concerned has declined to submit the request and (b) three months have

- elapsed since the organisation addressed the government without a statement of the government's intention. See Procedure for the Examination of Disputes concerning the Application of the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy by means of Interpretation of its Provisions, ILO (1986), *Official Bulletin*, Vol. LXIX, Series A, No. 3: 196–7.
3. International Federation of Chemical, Energy and General Workers' Unions (ICEF), quoted by Dan Gallin in ILO (1999: 20).
  4. The European Commission, for example, has defined CSR as a 'concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis' (Commission of the European Communities, 2002: 5). The Prince of Wales International Business Leaders forum defines CSR as 'open and transparent business practices that are based on ethical values and respect for employees, communities and the environment . . . designed to deliver sustainable value to society at large, as well as to shareholders.' Available at [www.pwblf.org/csr/csrwebassist.nsf/content/a1.html](http://www.pwblf.org/csr/csrwebassist.nsf/content/a1.html) (visited 10 April 2004).
  5. Nike subsequently appealed to the US Supreme Court, which refused to rule on the 'commercial speech' judgment. Nike eventually settled out of court.
  6. Law No. 2001-420 of 15 May 2001, available at [www.legifrance.gouv.fr/WAspad/UnTexteDeJorf?numjo=ECO0000021L](http://www.legifrance.gouv.fr/WAspad/UnTexteDeJorf?numjo=ECO0000021L) (visited 26 October 2004).

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## 19 Corporate environmental liability within the European Union

*Catherine Wijnants*

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### **Introduction**

The Sixth Environment Action Programme defines the priorities and objectives of the European Union's environmental policy up to 2010 (European Community, 2002). It recognises that legislation remains central to meeting environmental challenges. A few weeks later, the *Prestige* oil tanker disaster, which, in November 2002, caused serious pollution along the Spanish and French Atlantic coast, confirmed that environmental liability is an issue of utmost importance. The Sixth Environment Action Programme also aims at promoting collaboration and partnership with enterprises with a view to improving the environmental performance of enterprises. In Europe, the debate is currently growing over how corporate accountability to various stakeholders (as well as shareholders) can be increased. The next section examines the substantive grounds for environmental corporate liability in Europe with the directive on environmental liability discussed in some detail.<sup>1</sup> Contemporary initiatives regarding criminal liability will be reviewed in the subsequent section. The penultimate section considers the implications of these developments for corporate social responsibility within the EU. The final section concludes.

### **Substantive grounds for environmental liability at the EU level**

#### *The environmental liability directive<sup>2</sup>*

*Background and justification for an EC environmental liability regime* On 23 January 2002, the European Commission adopted a proposal for a directive on environmental liability addressing both prevention and restoration of environmental damage.<sup>3</sup> The Commission then submitted this proposal to the European Parliament and to the Council of the European Union with a view to the adoption of a comprehensive Community scheme.

The purpose of this proposal, which is the first Community legislative instrument based on 'the polluter-pays' principle, is to establish, at EU level, a harmonised system of environmental liability that would ensure that environmental damage is either prevented by taking appropriate measures or effectively

remedied if the damage has already been done. Subject to certain exceptions, the operator of the potentially or actually damaging activity is held financially liable and has to bear the cost of the necessary preventive or remedial measures. The idea is to induce operators to adopt measures and develop practices to minimise the risks of environmental damage.

The directive was published in the *Official Journal* on 30 April 2004 and entered into force on that day (OJL 143, 56). Member states have until 30 April 2007 to implement the directive in national law.

This directive relies on a number of previous initiatives which go back more than a decade and which gave rise to wide debates involving several interested parties. In 1993, the Commission published a 'Green Paper'<sup>4</sup> on remedying environmental damage, which presented the concepts for a potential Community liability regime (European Commission, 1993). In February 2000, the Commission adopted a 'White Paper'<sup>5</sup> on environmental liability, the objective of which was to explore how the 'polluter-pays' principle, one of the key environmental principles in the EC Treaty, can best be applied to serve the aims of Community environmental policy (European Commission, 2000). The Commission considered a range of instruments and options in the course of developing an approach to environmental liability. This included Community accession to the Council of Europe's Lugano Convention of 1993 (Council of Europe, 1993) but the idea was subsequently abandoned. The White Paper concluded that the most appropriate option is a Community framework directive on environmental liability. In July 2001, the Environment Directorate-General of the Commission released a working paper which set out the principles upon which the future regime could be based (European Commission, 2001a).

The directive proposal comprises an Explanatory Memorandum in which the Commission gives several reasons as to why there is a need for Community intervention, notwithstanding that almost all member states already have national legislation which directly or indirectly addresses liability issues. In the Commission's view, the key issue is not whether liability rules are desirable but whether it is desirable to enact rules at Community level rather than at the national one. The Commission relies upon a distinction between site contamination and biodiversity damage. As far as site contamination is concerned, the Commission considers that community action is needed because:

1. liability is necessary to prevent further soil pollution;
2. not all member states have adopted soil sanitation legislation;
3. most member states' legislation does not tackle orphan sites; and
4. without a harmonised framework, operators could take advantage of the differences in member states' approaches and try to avoid liability.

In the case of biodiversity, the Commission states that the loss of biodiversity in the Community has accelerated in recent years. Community action to protect and restore biodiversity is based upon two main grounds: ensuring that socially efficient means are used to finance remediation and encouraging efficient prevention (Explanatory Memorandum, p. 5).

The Commission has to justify Community action by explaining how the principles of subsidiarity and proportionality have been met.<sup>6</sup> With respect to the proposed environmental liability directive:

The objective of the proposed action, namely to establish a common framework for the prevention and remedying of environmental damage at a low cost to society, cannot be sufficiently achieved by the member states and can therefore be better achieved at Community level by reason of the scale of the proposed action and the implementation in respect of other Community legislation. (Directive, Recital 3)

However, such a justification for the subsidiarity principle is completely circular and justifies EC intervention because member states cannot take EC action (Bergkamp, 2002b: 296). Moreover, the proposed directive fails to meet the proportionality principle since, among other things it imposes a strict liability regime, as will be considered further below (see also *ibid.*: 297).

### *Main features of the EC Environmental Liability Regime*

THE SCOPE OF THE DIRECTIVE AND DEFINITION OF KEY TERMS As mentioned before, the purpose of the directive is to establish a framework for environmental liability based on the polluter-pays principle to prevent and remedy environmental damage.

Article 3 of the directive defines the scope of the directive:

Art. 3. This Directive shall apply to:

- (a) environmental damage caused by any of the occupational activities listed in Annex III and to any imminent threat of such damage occurring by reason of any of those activities;
- (b) damage to protected species and natural habitats caused by any occupational activities other than those listed in Annex III and to any imminent threat of such damage occurring by reason of any of those activities, whenever the operator has been at fault or negligent.

This provision thus defines what kind of damage and what kind of activities are covered by the directive. 'Environmental damage' is defined under Article 2(1) of the directive as damage to protected species and natural habitats, water and land. As far as the covered activities are concerned, the directive makes a distinction between environmental damage caused by the

'occupational activities' listed in Annex III and to damage to protected species and habitat caused by any 'occupational activities' other than those listed in Annex III. 'Occupational activity' under Article 2(7) of the directive means any activity carried out in the course of the economic activity, a business or an undertaking, irrespective of its private or public, profit or non-profit character. The occupational activities mentioned in Annex III include for instance waste management operations subject to permit or registration in pursuance of Directive 75/442/EEC of 15 July 1975 on waste. To be considered further below, the distinction between occupational activities listed in Annex III and other occupational activities implies different liability rules.

Article 4 of the directive provides for several exceptions. First, the directive does not cover environmental damage or an imminent threat of such damage caused by act of armed conflict, hostilities, civil war or insurrection, or a natural phenomenon of exceptional, inevitable and irresistible character.

Second, the directive does not apply to environmental damage or to any imminent threat of such damage arising from an incident in respect of which liability or compensation falls within the scope of any of the international conventions listed in Annex IV in force for the member state concerned. The listed international conventions deal with the issue of civil liability in relation to specific fields such as oil pollution (art. 4(2) of the directive). Similarly, the directive does not apply to nuclear risks (art. 4(4)).

Third, under Article 4(5) the directive does not apply to environmental damage caused by pollution of a widespread, diffuse character, where it is impossible to establish a causal link between the damage and the activities of individual operators. Recital (13) of the directive observes:

Not all forms of environmental damage can be remedied by means of the liability mechanism. For the latter to be effective, there need to be one (or more) identifiable actors (polluters), the damage needs to be concrete and quantifiable, and a causal link should be established between the damage and the identified polluter(s). Liability is therefore not a suitable instrument for dealing with pollution of a widespread, diffuse character, where it is impossible to link the negative environmental effects with the acts or failures of certain individual actors.

The relevance of this exception is questionable: pursuant to general principles of tort law, if the causal link cannot be established, there will not be any liability. Such an exception violates the equality principle: if all operators responsible for pollution other than diffuse pollution have to pay restoration costs when the causal link is established, one does not see why operators responsible for diffuse pollution should not have to bear these cost in (the exceptional) case the causal link is established (Betlem, 2002: 30). Fourth, and without offering justification, under Article 4(6) the directive does not apply to military activities. Fifth, the directive under Recital 14 does not apply to

cases of personal injury, to damage to private property or to any economic loss and does not affect any right regarding these types of damage.

**LIABILITY RULES** Liability rests on the operator of the activity that caused the environmental damage or the imminent threat of such damage.

An operator is any natural or legal, private or public person who operates or controls the occupational activity or, where this is provided for in national legislation, to whom decisive economic power over the technical functioning of such an activity has been delegated, including the holder of a permit or authorisation for such an activity or the person registering or notifying such an activity. (Article 2(6))

Hence, both individuals and corporations can be operators and thus liable. The directive provides for two distinct liability regimes: a strict liability regime and a fault liability regime, depending upon the kind of damage. Under Article 3(1)(a), the strict liability regime applies to environmental damage caused by those occupational activities listed in Annex III. The fault liability regime applies only to damage to protected species and natural habitat caused by those occupational activities outside Annex III. This means that operators of activities outside Annex III may also be liable under the directive for the costs of preventing or restoring biodiversity damage but only where they have been at fault or negligent (art. 3(1)(b)). The burden of proof regarding the operator's negligence lies with the government.

Operators declared liable will either have to (i) directly finance either the preventive measures (where the environmental damage has not yet occurred but there is an imminent threat) or the remedial measures<sup>7</sup> (where the environmental damage has occurred) or (ii) reimburse these costs where the government took the necessary measures. The insolvency of operators is one factor that may hinder cost recovery consistent with the polluter-pays principle by competent authorities. However, the impact of this may be limited by adequate financial insurance for potential damage. Under the directive, member states are free to implement adequate financial security arrangements.

**DEFENCES** Subject to certain exceptions, the operator that has caused the environmental damage or an imminent threat of such damage occurring has to bear the cost of the necessary preventive or remedial measures (the polluter-pays principle).

Article 8(3) and (4) of the directive foresees some defences which are justified by the need to ensure legal certainty and safeguard innovation. Pursuant to Article 8(3), an operator will not be required to bear the cost of preventive or remedial actions taken pursuant to the directive when he/she can prove that the environmental damage or imminent threat of such damage:



- (a) was caused by a third party and occurred despite the fact that appropriate safety measures were in place; or
- (b) resulted from compliance with a compulsory order or instruction emanating from a public authority other than an order or instruction consequent upon an emission or incident caused by the operator's own activities.

Pursuant to Article 8(4), member states may allow the operator not to bear the cost of remedial actions taken pursuant to the directive where he/she can prove that he/she was not at fault or negligent and that the environmental damage was caused by:

- (a) an emission or event allowed under applicable laws or in the permit issued to the operator;
- (b) emissions or activities which were not considered likely to cause environmental damage according to the state of scientific and technical knowledge at the time when the emission was released or the event took place [i.e., the state-of-the-art exception].

The Article 8(4) exceptions are likely to be controversial. However, it seems that there are strong reasons for their inclusion as they are critical elements of a well-balanced liability regime. These defences will provide companies with a degree of predictability as to costs and liabilities, provide a strong incentive to operate strictly within their permit limits and encourage them to identify and follow the state of the art. The Article 8(4) exceptions will not apply if the operator was at fault or negligent. This caveat is troubling. How can a company negligently comply with a permit or the state-of-the-art exception? With respect to Article 8(4)(a), an operator is either in compliance or not in compliance. With respect to Article 8(4)(b), the state of the art identifies the level of care needed to be satisfied in order to benefit from the exemption. How can an operator satisfy the state of the art yet still be negligent?

**NATURE OF THE REGIME AND TEMPORAL APPLICATION** The directive does not establish a civil liability regime but an administrative one. The proposed regime is 'government-centric'. 'The regime centers on the state's obligation to issue prevention and remediation orders (or take measures itself) with respect to covered environmental harm and recover the cost of prevention and remediation in case the operator does not act' (Bergkamp, 2002b: 295, 329; see also Betlem, 2002: 29). The directive seeks to offer a minimum level of protection and member states are free to maintain or adopt more stringent provisions under Article 16(1). Pursuant to Article 17, the directive has no retrospective effect. Moreover, the directive does not apply to damage if more than 30 years has passed since the emission, event or incident, resulting in the damage, occurred.

*Environmental criminal liability*

The concept of corporate liability is particularly interesting in the area of criminal law. Environmental crimes are usually committed within the framework of a legal person whereas practice reveals serious difficulties in prosecuting natural persons who are acting on their behalf. For example, in view of the size of corporations and the complexity of their decision-making structures, it becomes increasingly difficult to identify a natural person who may be held responsible for the offence. Moreover, if an agent of management is convicted, the sanction can easily be compensated for by the legal person. The contemporary international trend supports the general recognition of corporate criminal liability even in countries which only a few years ago formally adopted the principle whereby corporations cannot commit criminal offences.

In the field of environmental criminal law, there are three important developments at the European level: (i) the Convention of the Council of Europe on the Protection of the Environment through Criminal Law; (ii) the European Commission proposal for a directive on the Protection of the Environment through Criminal law; and (iii) the Council Framework Decision of 2003. This section will examine each of these initiatives and identify the implications of the new regime on the liability of corporations.

*Convention of the Council of Europe on the Protection of the Environment through Criminal Law*

**GENERAL FEATURES** On 4 November 1998, the Council of Europe adopted the Convention on the Protection of the Environment through Criminal Law. Although important for criminal law, the convention has not yet entered into force.<sup>8</sup> As stated in its explanatory report, the purpose of the convention is to improve environmental protection at European level by using the solution of last resort – criminal law – in order to deter and prevent conduct which is most harmful to the environment. It also seeks to harmonise national legislation in this field. Contracting states are obliged to introduce specific provisions into their criminal law or to modify existing provisions in order to establish as criminal offences certain acts committed intentionally or through negligence where they cause or are likely to cause lasting damage to the quality of air, soil, water, animals or plants, or result in the death or serious injury of any person. The convention thus makes a distinction between intentional and negligent offences.

Article 2 covers the most serious environmental offences which are committed intentionally. It states the following:

## Art. 2 Intentional offences

1. Each Party shall adopt such appropriate measures as may be necessary to establish as criminal offences under its domestic law:

- (a) the discharge, emission or introduction of a quantity of substances or ionising radiation into air, soil or water which:
    - (i) causes death or serious injury to any person, or
    - (ii) creates a significant risk of causing death or serious injury to any person;
  - (b) the unlawful discharge, emission or introduction of a quantity of substances or ionising radiation into air, soil or water which causes or is likely to cause their lasting deterioration or death or serious injury to any person or substantial damage to protected monuments, other protected objects, property, animals or plants;
  - (c) the unlawful disposal, treatment, storage, transport, export or import of hazardous waste which causes or is likely to cause death or serious injury to any person or substantial damage to the quality of air, soil, water, animals or plants;
  - (d) the unlawful operation of a plant in which a dangerous activity is carried out and which causes or is likely to cause death or serious injury to any person or substantial damage to the quality of air, soil, water, animals or plants;
  - (e) the unlawful manufacture, treatment, storage, use, transport, export or import of nuclear materials or other hazardous radioactive substances which causes or is likely to cause death or serious injury to any person or substantial damage to the quality of air, soil, water, animals or plants, when committed intentionally.
2. Each Party shall adopt such appropriate measures as may be necessary to establish as criminal offences under its domestic law aiding or abetting the commission of any of the offences established in accordance with paragraph 1 of this article.

This provision comprises two parts: (a) which protects only humans and which does not require an unlawful discharge and (b) to (e) which are not restricted to pollution endangering persons but are also applicable to pollution causing substantial damage to animals, plants or protected monuments. The latter do require infringing legal provisions (unlawfulness). Pursuant to Article 2(a), anyone who intentionally discharges a hazardous product into the environment is criminally liable even if he/she holds a permit for the discharge. This is justified by the fact that a permit does not give the right to cause damage to third parties (Roef, 2001: 128). Also noteworthy is that Article 2(a)(ii) refers to ‘significant risk of causing death or serious injury to any person’ whereas Article 2(b) uses the expression ‘is likely to cause death or injury to any person’. Article 2(a) thus requires a higher degree of risk than the other subsections.

Article 3 extends the scope of Article 2 to those cases where the offence is committed ‘with negligence’. Article 3 also allows states to restrict the application of that article to offences committed with gross negligence. The concept of gross violation implies a serious violation of duties of care. Article 4 extends the scope of the convention to a wide range of environment-related

illegal behaviour (for example, unlawfully causing noise). It is thus a catch-all provision comprising abstract endangerment offences. The contracting states can choose to impose criminal sanctions and/or administrative measures for these offences. The relevant sanctions must include imprisonment and pecuniary sanctions. However, reinstatement of the environment is only an optional provision in the convention (arts 6 and 8).

**CORPORATE LIABILITY** Noteworthy for present purposes is Article 9 of the convention which refers to the liability of legal persons. Article 9(1) obliges contracting states to adopt the necessary measures enabling them to impose sanctions on legal persons on whose behalf an offence referred to in Articles 2 and 3 has been committed by their organs, members or representatives. Clarification of the three conditions to Article 9 is in order. First, an environmental criminal offence must have been committed as specified in Article 2 (intentionally) or Article 3 (by negligence). Second, the offence must have been committed 'on behalf of' the legal person. This condition is an application of the organ theory: the legal person will be criminally liable only where the offences are committed by an organ. The criminal liability of legal person is thus derived from the liability of specific natural persons.<sup>9</sup> Third, the 'organ, a member of its organs or other representatives' of the corporation must participate in the criminal offence, assuming that these physical persons are in law or in fact in a position to engage the liability of the legal person. It is also worth noting that Article 9(1) does not require that the sanctions have to be criminal in nature. Contracting states are therefore free to impose criminal and/or administrative sanctions on legal persons.

Article 9(2) provides that corporate liability does not exclude individual liability. In a concrete case, different spheres of liability may be established simultaneously, for example, the responsibility of an organ distinct from the liability of the legal person as a whole. Individual liability may arise within any of these liability categories. Finally, pursuant to Article 9(3), each party may declare that it reserves the right not to apply section 1 of this article. One possible reason for such a reservation is that several states still address these problems through administrative or civil law.

*European Commission proposal for a directive on the protection of the environment through criminal law*

**GENERAL FEATURES** On 13 March 2001, the European Commission adopted a proposal for a directive on the protection of the environment through criminal law (European Commission, 2001b). The Commission justified its proposal as follows:

Experience has shown that the sanctions currently established by the member states are not always sufficient to achieve full compliance with Community law. Not all member states provide for criminal sanctions against the most serious breaches of Community law protecting the environment. There are still many cases of severe non-observance of Community law on the protection of the environment which are not subject to sufficiently dissuasive and effective penalties.

Moreover, the Commission argued:

In many cases, only criminal penalties will provide a sufficiently dissuasive effect. First, the imposition of criminal sanctions demonstrates a social disapproval of a qualitatively different nature compared to administrative sanctions or a compensation mechanism under civil law. It sends a strong signal, with a much greater dissuasive effect, to offenders. For instance, administrative or other financial sanctions may not be dissuasive in cases where the offenders are impecunious or, on the contrary, financially very strong. Second, the means of criminal prosecution and investigation (and assistance between member states) are more powerful than tools of administrative or civil law and can enhance effectiveness of investigations. Furthermore, there is an additional guarantee of impartiality of investigating authorities, because other authorities than those administrative authorities that have granted exploitation licences or authorisations to pollute will be involved in a criminal investigation. (European Commission, 2001b)

The most controversial feature of this proposal is that it compels member states to use criminal law when certain activities breach Community law with respect to environmental protection as specified in the Annex. Legal scholars consider that the use of criminal penalties is incompatible with the character of a directive (Faure, 2004: 19; see also Roef, 2001: 145; Faure, 2003: 228). Pursuant to Article 249 of the EC Treaty, a directive is binding as to the result to be achieved but not as far as the choice of methods or instruments. The EU traditionally identifies the norms of European environmental law and member states are free to choose the preferred implementation technique.

The central provision of the proposed directive is Article 3, which requires member states to ensure that the following activities are criminal offences when committed intentionally or with serious negligence in so far as they also breach EC environmental protection law and/or the rules adopted by member states in order to comply with EC law:

- (a) the discharge of hydrocarbons, waste oils or sewage sludge into water;
- (b) the discharge, emission or introduction of a quantity of materials into air, soil or water and the treatment, disposal, storage, transport, export or import of hazardous waste;
- (c) the discharge of waste on land or into water, including the operation of a landfill;

- (d) the possession, taking, damaging, killing or trading in protected wild fauna and flora species or parts thereof;
- (e) the significant deterioration of a protected habitat;
- (f) trade in ozone-depleting substances;
- (g) the operation of a plant in which a dangerous activity is carried out or in which dangerous substances or preparations are stored or used.

For the purposes of legal certainty, the Annex to the proposed directive contains an exhaustive list of 51 directives and regulations which prohibit those activities described in Article 3 (for example, Council Directive of 15 July 1975 on waste).

SANCTIONS AND CORPORATE LIABILITY Article 4 of the proposed directive states:

Art. 4. Member States shall ensure that the offences referred to in Article 3, and the participation in or instigation of such offences are punishable by effective, proportionate and dissuasive sanctions.

- (a) As concerns natural persons, member states shall provide for criminal penalties, involving in serious cases deprivation of liberty.
- (b) As concerns natural and legal persons, where appropriate, member states shall provide for fines, exclusion from entitlement to public benefits or aid, temporary or permanent disqualification from the practise of commercial activities, placing under judicial supervision or judicial winding up orders.

The proposed directive has interestingly taken into account the fact that in some member states the concept of criminal liability for legal persons does not exist. Article 4(b) therefore allows those member states to impose sanctions other than criminal penalties as long as they are effective, proportionate and dissuasive. It is questionable, however, whether this is not a striking contradiction with the overall goal of the proposed directive: resort to criminal law as a deterrent to corporate misbehaviour.

#### *Council Framework Decision on the Protection of Environmental Law through Criminal Law*

GENERAL FEATURES The final initiative of particular note is the Framework Decision adopted by the Council on 27 January 2003 (European Council, 2003). In 1999, the 1998 Convention of the Council of Europe considered above had not been ratified by any of the EU member states. To break the inertia, Denmark submitted a proposal for joint action (recast as a draft framework decision following the entry into force of the Amsterdam Treaty) that repeated several proposals made in the 1998 Convention. The Framework Decision of 27 January 2003 refers explicitly to the 1998 Council of Europe Convention in

its preamble and approximately replicates its most important provisions. Hence, the Council Framework Decision also distinguishes between intentional offences (art. 2) and negligence offences (art. 3). Article 6 of the Framework Decision also provides that each member state shall take the necessary measures to ensure that the conduct referred to in Articles 2 and 3 are punishable by criminal penalties. The Framework Decision took effect on 5 February 2003, the day of its publication in the *Official Journal* of the European Union. Pursuant to Article 10 of the Framework Decision, member states have to implement it before 27 January 2005.

CORPORATE LIABILITY Article 6 of the Framework Decision provides that each member state shall take the necessary measures to ensure that legal persons can be held criminally liable. This provision notably differs from the proposed Commission directive considered above which rejected the obligation to introduce corporate criminal liability.

*Institutional conflict on the protection of the environment through criminal law* The proposed Commission directive has not yet been adopted and is still pending in the legislative process. However, the publication of the Council Framework Decision of 27 January 2003 led to an interesting institutional conflict. There are presently two texts on the same subject but possessing a different legal basis. The Treaty of the European Union (TEU), signed in Maastricht on 7 February 1992, is divided into three pillars: the original pillar of Community law (the 'first pillar') and two new pillars: common foreign and security policy (the 'second pillar') and police and judicial cooperation in criminal matters (the 'third pillar'). The Council Framework Decision has been adopted under the third pillar, whereas the Commission has presented its draft directive under the first pillar. The TEU specifies several rules to prevent conflict between the respective competencies as defined under the three pillars. Nevertheless, a serious conflict emerged between the Commission and the Council concerning environmental protection through resort to criminal law. On 31 March 2003, the European Commission challenged the Framework Decision before the European Court of Justice with a view to having it declared invalid.<sup>10</sup> The case is still pending as of January 2005.<sup>11</sup>

### **Corporate social responsibility within the EU**

In the light of these legal developments, this section will conclude the chapter by briefly reviewing the concept of corporate social responsibility as it has evolved within the EU. Environmental policies over the last three decades have generally been based on an 'adversarial or confrontational approach' whereby governments imposed new regulations upon polluters and limited

operators to severe operating conditions. Environmental policy was thus dominated by law. Meeting the challenges of today's environmental problems contemplates looking beyond a strictly legalistic approach and adopting a more strategic approach which employs a variety of measures and instruments to influence decision-making by corporations, consumers, policy planners and citizens. The contemporary approach to environmentalism is thus based on cooperation: it involves the industry in the process of setting rules and objectives (Bergkamp, 2002a: 136).

One of the most significant illustrations of the cooperative approach within the EU is corporate social responsibility. On 18 July 2001, the European Commission adopted a Green Paper promoting a European Framework for Corporate Social Responsibility (European Commission, 2001c). The Commission intends to launch a wide debate on how the EU can promote corporate social responsibility at both the European and international levels, exploit existing experiences, encourage innovative practices, introduce greater transparency and increase the reliability of evaluation and validation. The Green Paper suggests an approach based upon deepening of partnerships in which all actors have an active role (*ibid.*: 3).

The Green Paper defines corporate social responsibility as 'the concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment'. More specifically it is a 'concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis'. It follows that 'being socially responsible means not only fulfilling legal expectations, but also going beyond compliance and investing more into human capital, the environment and the relations with stakeholders' (*ibid.*: 4, 6). The overall idea is to render corporations responsible for environmental problems beyond strict legal compliance.<sup>12</sup>

However, the Green Paper clearly states that corporate social responsibility should not be seen as a substitute to regulation or legislation concerning environmental standards, including developing new legislation as appropriate. According to the Commission, corporate social responsibility extends beyond the doors of the company into the local community and involves a greater range of stakeholders in addition to employees and shareholders: business partners, suppliers, customers, public authorities, NGOs and the environment. The Green Paper asserts that stakeholders can play a decisive role in prompting corporations to adopt socially responsible practices (*ibid.*: 15). It also suggests a series of management tools to implement corporate social responsibility, such as best practices, codes of conduct (European Parliament, 1999), training, auditing, reporting and eco-labels. By these means, corporate social responsibility can be a positive contribution to the strategic goal identified at the European Council in Lisbon in 2000 'to become the most competitive and dynamic knowledge-based



economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.’ (Council resolution on the follow up to the Green Paper on corporate social responsibility, 2002/C 86/03).

The Green Paper states that the European approach to corporate social responsibility has to reflect and be integrated within various other international initiatives such as the UN Global Compact (2000), the ILO’s Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (1997/2000) and the OECD Guidelines for Multinational Enterprises (2000). A European approach would complement and add value to these existing activities by:

- (i) providing an overall European framework, aimed at promoting quality and coherence to corporate social responsibility practices;
- (ii) supporting best practice approaches to cost-effective evaluation and independent verification of corporate social responsibility, thereby ensuring their effectiveness and credibility (European Commission, 2001c: 6).

## Conclusions

The EU directive on environmental liability deservingly introduces the concept of environmental damage into the national legal orders of member states. However, it will certainly raise several serious questions (for example, with respect to the defence provisions) in respect of its concrete application. In the field of criminal environmental liability, three developments are of interest at the European level and a legal action is currently pending before the European Court of Justice. Consequently, administrative and criminal liability grounds will both have important implications for corporations operating within the EU in the near future. With respect to corporate social responsibility the role of the EU is appreciably embryonic at this stage (see further, Bergkamp, 2002a: 139).

## Notes

1. This chapter considers the law as at January 2005 and does not take into account the potential legislative changes that may have occurred after 6 January 2005.
2. See <http://europa.eu.int/comm/environment/liability/>.
3. Proposal for a directive of the European Parliament and of the Council on environmental liability with regard to the prevention and remedying of environmental damage, COM (2002) 17 Final, 23 January 2002.
4. Green Papers are ‘discussion papers . . . addressed to interested parties – organisations and individuals – who are invited to participate in a process of consultation and debate. In some cases they provide an impetus for subsequent legislation’, [http://europa.eu.int/documents/comm/index\\_en.htm](http://europa.eu.int/documents/comm/index_en.htm).
5. White Papers ‘contain an official set of proposals in specific policy areas and are used as vehicles for their development’, [http://europa.eu.int/documents/comm/index\\_en.htm](http://europa.eu.int/documents/comm/index_en.htm).
6. The principle of subsidiarity provides that the objectives of the proposed action cannot be sufficiently achieved by member states and can therefore be better achieved by action on the part of the Community. The proportionality principle requires EC action not to go beyond what is necessary to achieve the objectives of the treaty. See Protocol on the application of the principles of subsidiarity and proportionality, which is annexed to the Amsterdam Treaty, *Official Journal, Communications* (OJC), 340, 10 November 1997.

7. The remedial objectives are detailed in Annex II of the directive.
8. The entry into force of the convention requires three ratifications. On 6 January 2005, there was only 1 ratification (Estonia). For the text of the convention and the ratification status, see <http://conventions.coe.int/Treaty/en/Treaties/Html/172.htm>.
9. For a critical assessment of the organ theory, see Roef (2001: 130). In Belgium the law of 4 May 1999 introducing corporate liability into the Criminal Code is not based upon the organ theory: corporate liability is an independent liability.
10. Case C-176/03: Action for annulment of Council Framework Decision 2003/80 *Justice and Home Affairs* (JHA) of 27 January 2003 on the protection of the environment through criminal law.
11. For a justification of the European Commission's position, see Comte (2003: 148).
12. For a critical assessment of corporate social responsibility and the cooperative approach, see Bergkamp (2002a: 151).

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## 20 Corporate responsibility: the UNEP experience

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### **Introduction**

Since its creation in the 1970s, the United Nations Environment Programme (UNEP) has been working with the private sector in various ways to advance greater environmental awareness and responsibility. In the early days more energy was invested in putting out fires, focusing on end-of-pipe solutions and policy approaches based on dilution and treatment downstream. Over the years we have been learning with business and industry, going upstream with a focus on cleaner production and – in more recent years – a focus on sustainable consumption and life-cycle approaches. Following more holistic approaches also meant increasingly dealing with social challenges, based on the integration that sustainable development requires. This also implied taking on the growing debate on what some preferred to call ‘corporate social responsibility’ (CSR). The CSR debate was driven by new questions being asked about the societal role of big companies in the aftermath of the Cold War and unease about raising inequalities accompanying the process of globalisation.

This chapter will focus on corporate environmental responsibility and the related activities of UNEP. A few words about legalistic approaches and the legal profession are also called for. In the CSR debate some critics have questioned the role of the legal profession and company lawyers for forcing company decision-makers to focus more on ‘liability’ than ‘responsibility’, causing many companies to follow a minimalist approach that leaves little room for proactive leadership. At UNEP’s 20th Annual Consultative Meeting with Industry Associations, held in Paris in October 2003, one participant from the USA referred to recent litigation in that country and argued ‘if you want real change go to the law schools, not the business schools’.<sup>1</sup> One could of course argue that ‘liability’ and ‘responsibility’ are two sides of the same coin. Being liable for something implies not having acted responsibly in a particular case. So let us start then by asking what ‘environmental responsibility’ requires from a company, before going into a more general discussion of corporate environmental and social responsibility (CESR) as called for in the 2002 Johannesburg Plan of Implementation.

### **Corporate environmental responsibility: sustainable production and consumption as foundation**

The UN Global Compact challenges business to promote greater environmental responsibility. Chapter 30 of Agenda 21, agreed to by governments at the 1992 UN Conference on Environment and Development (UNCED), described ‘environmental responsibility’ as requiring from business the following:

responsible and ethical management of products and processes from the point of view of health, safety and environmental aspects. Towards this end, business and industry should increase self-regulation, guided by appropriate codes, charters and initiatives integrated into all elements of business planning and decision-making, and fostering openness and dialogue with employees and the public.

What steps should the company take today if it wishes to display environmental responsibility? From the experience of UNEP, it is clear that key steps should involve the following:

1. *redefine company vision, policies and strategies to include the ‘triple bottom line’* (Elkington, 1997, 2004) *of sustainable development* – economic prosperity, environmental quality and social equity;
2. *develop sustainability targets and indicators* – economic, environmental, social;
3. *establish a sustainable production and consumption programme* with clear performance objectives to take the organisation beyond compliance in the long term;
4. *work with suppliers to improve environmental performance*, extending responsibility up the product chain and down the supply chain;
5. *adopt voluntary charters, codes of conduct, codes of practice* in global and sectoral initiatives to confirm acceptable behaviour and performance;
6. *measure, track and communicate progress in incorporating sustainability principles into business practices*, including reporting against global operating standards; and
7. *ensure transparency and unbiased dialogue* with stakeholders.

In doing the above, the existence of appropriate management systems is crucial in helping the company to meet the organisational challenge. Key tools for the company are:

1. assessment/audit tools:
  - (i) environmental impact assessment, environmental risk assessment;
  - (ii) technology assessment;
  - (iii) life-cycle assessment.

2. management tools:
  - (i) environmental management systems;<sup>2</sup>
  - (ii) technology management;
  - (iii) ecodesign.
3. reporting and communication tools:
  - (i) corporate environmental reporting and sustainability reporting;
  - (ii) stakeholder dialogue.

A central action in the above is the formulation of a sustainable production and consumption programme. Let us start with production. When formulating its policy and strategy, a company can find key principles in a policy tool that UNEP launched in 1998. The International Declaration on Cleaner Production outlines a set of principles that can lead to increased awareness, understanding and ultimately, greater implementation of what came to be known in the 1990s as 'cleaner production', similar to the concept of eco-efficiency as advanced by WBCSD (2000). For companies in particular, the declaration serves as a practical tool to facilitate the adoption of a cleaner production strategy.

Cleaner production is a strategy for increasing the efficiency of natural resource use and minimising wastes. Pollution and risks to human health and safety are reduced at the source, rather than the end of the production process, that is, the 'end-of-pipe' stage. The adoption of cleaner production by companies typically involves improving maintenance practices, upgrading or introducing new technology, or changing production process. It results in meeting consumers' needs with more environmentally compatible, quality products and services. As well as reducing pollution, this strategy also generates tangible economic savings for a business enterprise by improving the overall efficiency of production. The potential benefits of implementing the strategy with its principles are listed in Table 20.1.

Of particular relevance in a discussion on corporate responsibility and liability is also the fact that cleaner production implies a precautionary approach as set out by the Rio Declaration of 1992. Precaution is included as one of the principles of the UN Global Compact. A key element of a precautionary approach is the idea of *prevention* rather than *cure*. In other words, it is more cost-effective to take early action to ensure that irreversible environmental damage does not occur. Companies should consider the following:

1. While it is true that preventing environmental damage entails both opportunity and implementation costs, remediation of environmental harm after it has occurred can cost much more.
2. Investing in production methods that are not sustainable, that is, that deplete resources and degrade the environment, has a lower, long-term return than investing in sustainable operations. In turn, improving environmental

Table 20.1 *The benefits of implementing cleaner production*

Principle	Potential benefits
Leadership	<ol style="list-style-type: none"> <li>1. Improved dialogue along the supply chain</li> <li>2. Increased confidence from consumers, suppliers, users</li> </ol>
Awareness, education and training	<ol style="list-style-type: none"> <li>1. Increased confidence from consumers, suppliers, users</li> <li>2. Long-term culture change: greater industry motivation</li> <li>3. Strengthen internal capacity</li> </ol>
Integration	<ol style="list-style-type: none"> <li>1. Integration of a cost-effective environmental strategy</li> <li>2. Linkages with international conventions</li> </ol>
Research and development	<ol style="list-style-type: none"> <li>1. Innovation spurred</li> <li>2. Potential for new markets</li> </ol>
Communication	<ol style="list-style-type: none"> <li>1. Improved public perception</li> <li>2. Potential for new partnerships</li> </ol>
Implementation	<ol style="list-style-type: none"> <li>1. Due diligence</li> <li>2. Reduce risk and liability</li> <li>3. Realise economic saving</li> <li>4. Improve state of local, regional, global environment</li> </ol>

*Source:* See [www.uneptie.org/pc/cp/declaration/home.htm](http://www.uneptie.org/pc/cp/declaration/home.htm).

performance means less financial risk, an important consideration for insurers.

3. Research and development related to more environmentally friendly technology and products could have significant long-term benefits.

What then do we mean by ‘sustainable consumption’? The concept refers to different and more efficient consumption, sharing more resources between rich and poor peoples, protecting the environment and not threatening the basic needs of future generations. During the 1992 Rio Earth Summit (UNCED) the issue of ‘consumption patterns’ was identified as a key factor in sustainable development and the future of our planet (Agenda 21, Chapter 4). A decade later, during the 2002 Johannesburg Summit (World Summit on

Sustainable Development: WSSD), governments highlighted the need to develop awareness programmes dealing with the importance of both sustainable production and consumption patterns (Johannesburg Plan of Implementation: JPoI).

After years of working on cleaner production and more recently sustainable consumption, the WSSD in 2002 challenged its participants to revisit the debate by specifically looking at the interrelation of production and consumption. This new approach is encapsulated in the new heading 'Sustainable Consumption and Production', for which a ten-year framework of programmes is being developed with the close involvement of UNEP.<sup>3</sup> Behind the new approach lies some important trends of the preceding ten years that became clear. First of all, it became evident that the gains made in productivity or eco-efficiency are overtaken by the overall increase in production. Second, while the environmental problems during the production process are better understood and controlled, problems during the use of the products are far from being addressed. Third, newly emerging or quickly developing sectors of 'the new economy' are posing increasing threats that are yet to be effectively addressed. Fourth, it is clear that environmental concerns are often not integrated into programmes for economic and social progress and vice versa. The call for a new approach from the conception of a product to the end of its life following consumption is also a call for better integration across all pillars of sustainable development.

What does this require from business? Action is needed to re-orientate social and economic development to remain within the carrying capacity of the earth by:

1. continuing improvements in production *processes*;
2. accelerating improvements in the *design* of goods and services; and
3. re-orientating *consumer choices* – of individuals, industry and public institutions – towards more sustainable lifestyles and purchasing decisions.

In addition to continuing and expanding cleaner production programmes, sustainable consumption policies need to be developed and integrated into mainstream decision-making. Consumption decisions have to be re-orientated. This poses new challenges for companies in communicating with their consumers and developing appropriate marketing and communications strategies. Faced with consumers who do not always behave consistently and expected costs resulting from the introduction of sustainability into their marketing mix, pioneer companies are managing to overcome the traditional barriers with a view to creating or anticipating new business opportunities. This also requires changes in core management areas. If sustainability is to go

mainstream, a revised definition of reputation risk needs to be at the heart of corporate policies and strategies. In a context where reputation and brand value are viewed as key ‘assets’, more and more companies are beginning to consider whether sustainable development may become the decisive ‘value’ driver. Responding to consumer citizens and public opinion on the emerging CESR agenda, the question is how innovative companies can meet the challenge in the area of sustainable consumption.

As is clear from the above, the advancement of sustainable consumption and production lies at the core of displaying corporate environmental responsibility. The call for corporate environmental responsibility was addressed by environment ministers at UNEP’s first Global Ministerial Environment Forum, held in Malmö in May 2000, when they discussed the private sector and the environment. The Malmö Declaration<sup>4</sup> asked for a greater commitment by the private sector ‘to endanger a new culture of environmental accountability’. Questions raised in the Malmö Declaration echoed in debates at the WSSD on corporate responsibility and accountability, with some NGOs campaigning for the creation of a new international convention on this topic. It was therefore no surprise that the Johannesburg Declaration called for private sector corporations ‘to enforce corporate accountability’. Addressing CESR, paragraph 18 of the JPoI called for actions to:

[e]ncourage industry to improve social and environmental performance through voluntary initiatives, including environmental management systems, codes of conduct, certification and public reporting on environmental and social issues, taking into account such initiatives as the International Organisation for Standardisation (ISO) standards and Global Reporting Initiative guidelines on sustainability reporting . . .

Ongoing discussion on the societal role of business reflects a growing awareness that the distinction between what happens within and outside the factory gate is no longer clear-cut. What is viewed as a social cause or external event today may easily turn out to be a business question related to internal operations tomorrow. This awareness of shifting boundaries in rights and responsibilities applies not only to business but to all societal actors, governmental and non-governmental, as we develop a better comprehension of the complexity of environmental and social problems that are systemic, transnational and occurring globally. The bottom line is that proactivism is expected from all. In this respect the role of business and industry as part of the solution is critical. It is unlikely that the private sector will be engaged by threats and doomsday theories. The way to attract the business mind and to spur innovation is to present these global problems as challenges. This was the approach followed, for example, in a state of the world publication by UNEP, WBCSD and WRI (2002) which was aimed at the business community and appeared



under the title *Tomorrow's Markets: Global Trends and Their Implications for Business*. In the section 'Innovation', the chapter on consumption reminded readers that '[r]ising consumption creates environmental risks and business opportunities for innovation'. As regards the engagement of business in the developing world, there is a growing business case that highlights gains in emerging markets such as cost reductions and higher sales (as opposed to reputational gains and brand value that apply more typically in the developed world; SustainAbility, IFC, Ethos, 2002: 52).

### **Corporate citizenship and the UN Global Compact**

The promotion of core values and principles in the global market is the driving force behind the UN Global Compact. The initiative serves as a reminder to companies that they, like citizens, have both rights and duties. The UN Secretary-General is reminding companies that while they benefit much from liberalisation in international trade, the increased freedom to operate globally brings with it an accompanying duty to meet some internationally agreed minimum standards. It is this awareness of the two elements 'rights and duties' encapsulated in the concept 'citizen' that has led the Global Compact to advance the concept of 'corporate citizenship'. Some prefer to use the term 'CSR', which is linked with ethical business responsibility and stakeholder theory, claiming that a corporation has a responsibility to all those groups who are harmed by, or benefit from, the operations of a company (Matten et al., 2003: 110). It is important to note that these responsibilities include environmental responsibility, which is often underplayed in CSR debates and which is why the WSSD texts used the term 'CESR'. The company displaying corporate citizenship is aware of its rightful place in society, next to other 'citizens', with whom it forms a community.

The birth of the UN Global Compact dates back to a speech by UN Secretary-General Kofi Annan at the World Economic Forum in January 1999. Months before Seattle, he warned of a backlash against globalisation since (i) its benefits are distributed highly unequally, (ii) it is characterised by an imbalance in rule-making, and (iii) it enhances a global identity crisis (people want to know 'who' is in control) (Ruggie, 2001: 3–4). As global wealth is rising but the income gap grows wider, his warning remains as valid as ever. World business leaders have been challenged to enhance shared values for the global market and promote corporate citizenship globally. The Global Compact challenges companies to integrate into their operations a set of core values in the areas of human rights, labour standards, environment protection and anti-corruption. These values are embodied in ten principles that have been taken from existing intergovernmental agreements. The first four years since the launch of the Global Compact in mid-2000 focused on human rights, labour and the environment. A tenth principle on corruption was

added at the Global Compact Leaders Summit, hosted by Kofi Annan in New York on 24 June 2004. Following an extensive consultation and survey among participants in the Global Compact, it was clear that a principle against corruption reinforces the other nine principles. Examples of this range from the site level (for example, bribes offered to an environmental inspector), to the board level (for example, misrepresentation of facts in emissions trading).

The three environmental principles advanced under the Global Compact have been taken from the 1992 Rio Declaration. They require business to:

1. support a precautionary approach to environmental challenges;
2. undertake initiatives to promote greater environmental responsibility; and
3. encourage the development and diffusion of environmentally friendly technologies.

The three environmental principles are fundamental in the sense that certain minimum requirements must be met, yet aspirational in the sense that there is always room for improvement. We all know that a principle such as precaution is complex, which is why it is all the more valuable for participants in the Global Compact to share their experiences in its implementation. The application of these principles is at stake in all activities undertaken by UNEP in its work with companies and associations in different industry sectors.<sup>5</sup> The role of four of the core UN agencies involved in the Global Compact is to act as guardians of the ten principles, to ensure that their interpretation and implementation follows current consensus on what constitutes acceptable or best practice. These four core agencies are the Office of the High Commissioner for Human Rights (OHCHR), the International Labour Organisation (ILO), UNEP and the United Nations Office on Drugs and Crime.<sup>6</sup>

Today the Global Compact has a solid participants' base. It has become the world's largest voluntary corporate citizenship network, with around 2000 companies participating. More than half of the participants are headquartered outside the OECD. There are 45 local Global Compact networks at the country and regional level. The participation of all companies starts with a letter from the chief executive to the UN Secretary-General, committing to work towards implementation of the ten principles and supporting the initiative. This reflects the need to engage top management in bringing about change for sustainability within large companies. That commitment needs to be followed up by middle management and employees. With this in mind the Compact has offered opportunities for dialogue and learning, developing a data base with case studies of company good practices and developing – through the core UN agencies and business organisations – training materials and guides for companies. For example, UNEP has been closely involved in the development of the Global Compact Resource Package (UN Global Compact, 2003) and

Performance Model (Fussler et al., 2004) with its listing of management tools that companies can employ.

### **Global voluntary initiatives by industry sector**

The Compact has built upon the existing experience of agencies such as UNEP who have been involved in setting up voluntary initiatives with different industry sectors since the early 1990s. While it presents the cross-sectoral umbrella, UNEP's sectoral voluntary initiatives look more specifically at the application of the environmental principles in individual sectors. Among the various activities that UNEP undertakes with companies and associations in different industry sectors, five sectoral initiatives are the best established.<sup>7</sup> These engage participant companies on an ongoing basis to develop environmentally sound practices along the lines of the Rio principles.

A Tour Operators' Initiative for Sustainable Development has been developed in cooperation with the World Tourism Organisation and the United Nations Educational, Scientific and Cultural Organisation since March 2000. It has been signed by 25 tour operators which together handle over 20 million tourists a year. Founding members have agreed that, to ensure the profitable future of tourism, they have to work towards sustainability and maintain the quality of the environment. The initiative is currently developing tools for the integration of environmental and social questions in contracting and supply chain management.

The Global e-Sustainability Initiative (GeSI) was created by representatives of major telecommunications operators and suppliers in conjunction with UNEP, the International Telecommunication Union (ITU) and the European Telecommunication Network Operators Association and launched in June 2001. GeSI currently has 12 members who are involved in working groups to address issues such as corporate responsibility in supply chain management and the role of information and communications technology in combating climate change through processes such as dematerialisation, efficient management of public buildings and computerised traffic regulation.

UNEP's Advertising and Communication Forum originated from the recommendation by governments at the Rio +5 Conference of 1997 that business, the media, advertising and marketing sectors need to be encouraged to help shape sustainable consumption patterns. As a result the Advertising and Communication Forum was set up in partnership with the European Association of Advertising Agencies in 1999. Current activities under this forum include follow-up to the 2004 Global Compact Policy Dialogue on Sustainable Consumption: Marketing and Communications. Issues addressed include responsible advertising and ways of communicating to consumers in a manner that enables them to make informed choices.

In 2002, in cooperation with various automotive manufacturers, UNEP

created the Mobility Forum. Involving all major car manufacturers, the Forum aims to protect the environment while maintaining healthy and profitable business operations within the framework of sustainable development. Participant companies have, among others, worked with non-industry experts to develop a sector supplement to the Global Reporting Initiative (GRI) Guidelines for sustainability reporting by the automotive sector.

The UNEP Finance Initiative (UNEP FI) resulted from the merger of two initiatives started after the Rio 1992 Summit involving banks and insurance companies. These were the UNEP Statement by Financial Institutions on the Environment and Sustainable Development and the UNEP Statement of Environmental Commitment by the Insurance Industry. Currently involving over 270 companies, UNEP FI conducts activities through working groups dealing with issues such as asset management, climate change, environmental management and reporting. UNEP FI is also responsible for follow-up to reports issued in June 2004 by major brokerage firms at the Global Compact Leaders Summit on corporate responsibility and sustainability (considered further below).

An important consideration in these initiatives is the credibility of the UN agency in providing a multi-stakeholder platform with global reach (see Nelson, 2002: Ch. IV). The role of UN agencies is supported by the fact that public institutions are key actors when externalities and harmonisation need to be addressed at the global level. These international voluntary initiatives complement intergovernmental processes, help to implement international agreements and fill gaps in global governance. The same argument for engaging non-state actors in voluntarism applies at the national level. As John Ruggie, adviser to Kofi Annan, wrote in the *Financial Times* of 25 October 2002, p. 13: '[s]ociety, therefore, has come to demand help from the corporate sector in coping with adversities that stem from governance gaps and governance failures, ranging from securing investments in community development to preventing conflicts and diseases'.

Voluntary initiatives have been used increasingly by industry and governments since the 1992 Rio Summit as an approach to improve environmental performance. Recognising its responsibilities, business and industry has increasingly been involved in the development of voluntary initiatives at the national and international levels. These have taken various forms, including voluntary codes of conduct and standards adopted by industrial sector associations, or agreements on performance targets between a government and a company, a group of companies or an industry sector. Voluntary initiatives are non-legislatively required commitments or obligations agreed to by one or more organisations, or by companies making commitments to improve their environmental performance beyond legal requirements. These initiatives often take the form of negotiated agreements between industry and

public authorities (see UNEP, 1998; OECD, 1999). While voluntary, such initiatives may nevertheless be:

1. *Legally binding*, in the case of a signed, contractual agreement, and thus enforceable if broken;
2. *Mandatory*, if it becomes a condition for membership in an industry association;
3. *Compulsory*, if it becomes a de facto marketing requirement (for example, ISO 14000), or when, as in countries with an established consensus-based approach, it has the same weight as traditional regulations; and
4. *Used to encourage compliance* with existing laws.

At the international level, various industry associations have been involved in the creation of international voluntary codes and guidelines in the environmental field. These include the International Chamber of Commerce, the International Council of Chemicals Associations, the World Coal Institute, the International Federation of Consulting Engineers, the International Iron and Steel Institute, the International Council of Metals and Mining, the International Petroleum Industry Environmental Conservation Association and the World Travel and Tourism Council (UNEP, 2002a, 2002b). Some would refer to the growing prominence of international voluntary initiatives as the 'partial privatisation' of global governance, as the institutional loci shifts away from state institutions and intra-institutional systems of self-regulation begin to assume greater importance. This suggests a growing 'public role for the private sector', built on the expectation that private actors have superior information regarding production processes, are more flexible in responding to technological and market trends, and can best ensure that standards are actually implemented. The important point here is not to fall into the trap of thinking in 'either/or' terms, but to advance the complementarity between regulatory and voluntary approaches in different policy mixes (see Gunningham and Grabosky, 1998).

### **Measuring and communicating progress: sustainability reporting**

Voluntary initiatives inevitably encounter scepticism from others who argue that they are full of idealistic goals yet weak on implementation and monitoring. First, voluntary initiatives are the product of considerable preparation and negotiation. The more stakeholders involved, the more complicated conception becomes. Often its mere establishment is an accomplishment not to be underestimated. That said, praiseworthy statements and goals need to be followed up with praiseworthy action and the transparent communication of results. This highlights the importance of reporting, not simply as a monitoring mechanism but also as a vehicle to maximise learning and enable continuous improvement.

After four years of campaigning and recruiting greater numbers of participants from all regions, the Global Compact has been confronted with the same challenge. The value of sustainability reporting was recognised at an early stage and underlined by UNEP as one of its core agencies. On 28 November 2001, the Global Compact Office and the GRI announced a 'cooperative framework' under which company sustainability reporting along the GRI Guidelines can be considered to qualify as submissions fulfilling the participation requirements of the Global Compact. At the inauguration of the GRI in New York on 4 April 2002, Kofi Annan referred to the GRI as an 'important complement' to the Compact. Consistent with that position, UNEP has been advancing the development of sector specific indicators for sustainability reporting and benchmarking through sectoral voluntary initiatives established in conjunction with business and industry.

Case studies are also valuable in communicating progress and demonstrating the dilemmas confronting companies when implementing environmental principles. During the first two years of the Global Compact, companies were encouraged to submit annually examples that evidenced how they were implementing some or all of the nine principles. Several key themes emerged from a review of initial submissions. First, it was clear that implementation of the principles requires a substantial degree of organisational change. Important organisational and managerial factors included training, change management and leadership. The submissions also demonstrated that many businesses faced difficulties assessing the priority of corporate citizenship responsibilities relative to other profit-seeking business activities (see McIntosh and Thomas, 2004).

The original intent was that these case studies would form the basis of a learning bank on the Compact website where, through transparent public commentary and analysis, best practices would be identified. This approach also identified several shortcomings, including the lack of an analytical framework, lack of capacity, language barriers and lack of resources on the part of participants to comment and analyse. Consequently, the Global Compact Advisory Council agreed in January 2003 that companies would no longer be required to submit annual examples as a precondition for participation. Rather, companies will be asked to indicate in their annual financial and sustainability reports what steps they have taken to implement the ten principles. This new approach of 'Communications on Progress'<sup>8</sup> encouraged companies to use indicators such as those included in the sustainability reporting guidelines of the GRI but left the door open for other non-report forms of communication by smaller companies who may, for example, highlight their actions in company newsletters, brochures and websites. Particularly noteworthy in the light of the fact that the Compact follows a learning as opposed to a policing approach is the idea of encouraging the measurement, tracking and communication of progress through reporting (Van der Lugt, 2004: 141–3).

The growth in corporate sustainability reports that cover environmental, economic and social performance of companies has been facilitated by the GRI, an internationally recognised framework produced through an ambitious multi-stakeholder process.<sup>9</sup> The GRI process was launched in 1997 by UNEP and the Coalition of Environmentally Responsible Economies. The mission of the GRI is to develop and disseminate globally applicable sustainability reporting guidelines. The aim is to elevate the quality of reporting to a higher level of comparability, consistency and utility. The guidelines can be used by any organisation – corporate, governmental or non-governmental. They are subject to continuous revision and refinement in a multi-stakeholder process involving participants from all regions of the world. The GRI is now a permanent institution in the form of a UNEP Collaborating Centre located in Amsterdam with a multi-stakeholder board and 60-member Stakeholder Council. Close to 600 companies worldwide are presently producing GRI-based sustainability reports.

In addition to realising its managerial value, the growth in reporting by companies over the last ten years has also been the result of increased pressure from investors, rating agencies, other companies, authorities, campaigners, customers, NGOs and the media. Reporting has been supported by the emergence of legislated corporate governance disclosure, with a number of countries extending disclosure requirements to embrace social and environmental risk management issues. The Asian financial crisis of the 1990s was an early reminder of the importance of transparency in financial governance which helped to identify risks, improve efficiency and stabilise markets in uncertain times.

The GRI process is concerned with sustainability (covering the triple bottom line), transparency, accountability and stakeholder engagement. Participants in the process have also agreed on 11 principles which are essential to producing a balanced and reasonable report on an organisation's economic, environmental and social performance. They relate to the framework of the report as well as its content, quality, reliability and accessibility. The 11 reporting principles are: (i) transparency, (ii) inclusiveness, (iii) auditability, (iv) completeness, (v) relevance, (vi) sustainability context, (vii) accuracy, (viii) neutrality, (ix) comparability, (x) clarity, and (xi) timeliness.

The GRI Guidelines indicate that these principles define a compact between the reporting organisation and the report user, ensuring that both parties share a common understanding of those matters underpinning the report (GRI, 2002: 22). They were designed with the conviction that new knowledge and learning will continue to advance performance measurement over the long term. An international review process is currently under way to develop the third revised version of the GRI Guidelines for 2006.

**The business case: from risk avoidance to leadership**

When the corporate sustainability manager says ‘responsibility’, the corporate lawyer responds by warning ‘liability’. Is it as simple as that? Why are more companies introducing sustainability and CSR to their strategic planning and joining voluntary efforts in support of corporate citizenship and sustainable development? We are currently observing an ongoing trend that departs from the traditional reductionist approach of saying ‘the business of business is business’. Support for corporate citizenship is based on a new vision of the social contract between the company and the society within which it operates. Many companies become involved because of trigger events such as negative experiences or adverse criticism of their practices. We often learn by burning our fingers. But increasingly companies are also becoming involved as a result of positive inducements, taking note of the growing business case for sustainable development. Many companies today view proactive corporate citizenship as good business, helping to advance their overall performance, profitability and corporate image (see SustainAbility/UNEP, 2001).<sup>10</sup>

Greater pressure from consumer-citizens moves more businesses to take moral or ethical positions and acknowledge social responsibilities. In addition, investors and shareholders also support the emerging business case for sustainable development. In particular, global companies increasingly face questions from ethical or socially responsible investment funds. Indexes such as the Dow Jones Sustainability Group Index and the FTSE4Good Index motivate global companies to follow a more integrated sustainability approach. This is where the social responsibility of business becomes a ‘near rational’ economic choice (UNGA, 2001b: 11). Corporate citizenship as advanced under the Global Compact and the sectoral voluntary initiatives under UNEP auspices are therefore very different from traditional conceptions of corporate philanthropy (see UNCTAD, 1999: 3).

The increasing body of research on the business case encourages efforts to standardise sustainability indicators, improve our ability to measure and meaningfully communicate progress, benchmark company performance across different sectors and develop more elaborate sustainability reports. If business generally and individual champions within companies wish to answer these critical questions directly, they need to meet three central challenges: (i) develop and disclose clear boundaries, (ii) make the link with financial accounting, and (iii) engage local development actors in building new business models.

*Clarify the boundaries*

Liability, for example in the form of accountability for environmental harm done to society, requires a sense of responsibility from companies. It compels them to consider the consequences of their actions, to identify the boundaries

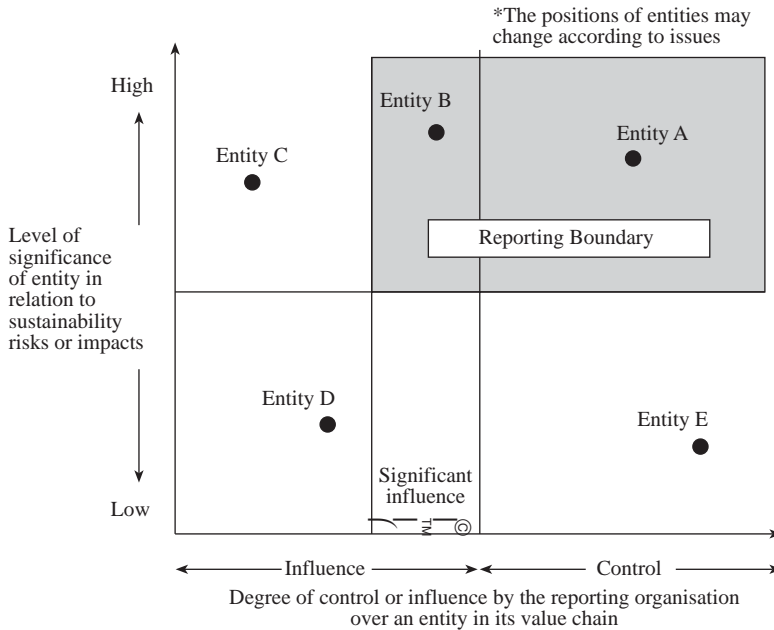


of their responsibilities and – in the case of liability – what they can be held accountable for. Boundary issues are often complex and unclear. CSR appears to be elastic: the more the company does the more is expected of it. Inevitably this raises the questions faced by sustainability managers and corporate lawyers. How much is expected from the firm, from corporate headquarters or local sites in the field? How far are we willing (or can afford) to go? If we are expected to apply life-cycle approaches, how far upstream and downstream should we go? Do we take responsibility for our first-, second- or third-tier suppliers? Do we take responsibility for the way our consumers consume? Essentially, what are the parameters of our responsibilities?

Any effort to quantify the costs and benefits of following the triple bottom line approach needs to be based on clear parameters in terms of temporal scope (short- or long-term profits and losses?) and organisational scope (do we include the costs of pollution caused by our supplier, subsidiary or consumer?). The challenge of ‘setting boundaries’ is also reflected within sustainability reporting. One of the most difficult and immediate decisions for companies is to decide from which entities to gather data. Presumably that which you include in your report is that for which you are willing to assume accountability. During the early years, most organisations measured and reported impacts based on the boundary criteria used in financial reporting, that is, legal ownership and direct control. We have increasingly seen the need for clearer methodology since significant dimensions of an organisation’s economic, environmental, and social footprint may fall outside traditional financial boundaries.

In this context the GRI has mandated a Boundaries Working Group to draft the pilot version of a GRI Boundaries Protocol to enable companies to identify the sustainability ‘footprint’ of their organisation and activities. The draft protocol developed by this multi-stakeholder working group was made available for public comment in late 2004. Figure 20.1 usefully sets out the issues a company has to consider when determining its reporting boundaries and defining the building blocks upon which the business case can be quantified.

The figure confirms that the boundary is determined using the intersection of two concepts – ‘significance’ and ‘control/influence’. A sustainability report should cover the entities that generate significant risks or impacts over which the reporting organisation has control and/or significant influence. This enables the reporting organisation to determine which entities are within its reporting boundary. All entities falling in the top right (high risk/impact and high control) clearly belong within it. Typical examples of where a company has significant control or influence would be a subsidiary where the reporting organisation owns, directly or indirectly, more than 50 per cent of the voting power, or a contractual relationship where the reporting organisation has purchasing agreements accounting for a substantial portion of sales by the



Source: 'Boundary Technical Protocol', 2005, Global Reporting Initiative, Amsterdam, The Netherlands.

Figure 20.1 Visual tool to define a reporting boundary

supplier. While the definition of 'control and influence' may be a fairly technical exercise in terms of legal and financial accounting rules, the determination of 'significant impact' may involve political considerations such as the perception of public needs.

### **Connect sustainability performance and financial performance**

The challenge for the sustainability manager is to communicate integrated costs and benefits to senior management, shareholders and financial analysts. It is of course easier to quantify material resource efficiency. More progress has therefore been made in defining the business case as far as cleaner production processes are concerned. Such savings are often measurable and go directly to the financial bottom line. There is also strong empirical evidence that superior environmental performance reduces costs over time (SustainAbility/UNEP, 2001: 19). Yet social issues are increasingly prominent in building the business case. First, a persuasive body of evidence exists as far as workplace conditions are concerned. Employee-friendly work practices

contribute to increased revenue since motivated employees are more productive. The quantification of cause and effect in monetary terms for more complex issues such as climate change, sustainable consumption and external stakeholder engagement becomes more complicated. The frustration in defining 'the elusive business case' is largely due to different timeframes (short, medium or long term?), the framework conditions under which companies operate (is there a level playing field and at what level?) and different approaches to and degrees of internalising 'externalities' (where lies the boundary?). Companies who wish to 'make profit while doing good' are also desperate to get recognition from financial markets which has been slow to materialise.

The financial services community accordingly has a central role in the unfolding business case. In one of 22 sector reports prepared for the WSSD in a process facilitated by UNEP (2002a), the finance sector frankly admitted its lethargy in linking financing with sustainability. Credit, insurance and investment portfolios incorporated environmental risks and opportunities only to a limited extent. However, a more holistic and integrated approach to fiduciary responsibility has also been emerging. Increasingly, financiers are paying close attention to the 'upside' or revenue potential for those firms who proactively manage sustainability issues in a manner that minimises risk but also generates increased sales and market share. This new approach has now reached a critical threshold with the position assumed by mainstream investment brokers during the June 2004 Global Compact Leaders Summit. Through the Materiality Report (UNEP FI, 2004) the UNEP Finance Initiative and 12 fund managers called upon investors, government and business leaders to embed environmental, social and governance best practices at the core of their markets. UNEP Executive Director Klaus Töpfer observed that '[t]his new report is a crucial recognition from major financial institutions that the environmental and social components of sustainable development, as well as the economic considerations, should sit at the heart of investment and capital market considerations'.<sup>11</sup> The financial analysts who undertook the research were clearly convinced that sustainability issues impact long-term shareholder value. Its first key finding was that 'environmental, social and corporate governance criteria affect shareholder value both in the short and long term'. They accordingly argued that research to determine the financial materiality of these criteria should use longer time spans than is currently the norm. Just as the obsession with short-term profit is being questioned, so too is the meaning of 'risk' taking on a new dimension. One of the brokerage house reports noted that

while the 'holy grail' of empirically linking CSR performance to financial or stock price performance is something we believe is most likely never to be found . . . we

believe good CSR practices minimises business risks . . . understanding CSR risks gives a deeper understanding of the company and the business threats it faces. (Ibid.: 14–15)

In addition, 18 major investment companies developed and endorsed a report entitled *Who Cares Wins* in which they discussed how the industry should address environmental, social and corporate governance issues (UN GC, 2004). They recommended that analysts better integrate sustainability factors into their research, that financial institutions commit to integrating sustainability factors in a more systemic way and that stock exchanges include environmental, social and corporate governance criteria in their listing considerations for companies. With respect to investment, the report noted that ‘many studies confirm that the way a company manages environmental, social and corporate governance issues is often a good indicator of overall risk levels and general management quality’ (ibid.: 9). From both these reports it is therefore evident that innovative techniques to financially analyse environmental, social and corporate governance criteria are being developed in response to growing investor demand.

#### *Engage local development actors in building new business models*

For the innovative company, building a strong business case based on long-term vision will depend upon its ability to work with local communities and engage local entrepreneurs. Prahalad and Hart (2001) highlighted the business opportunities of commercial engagement with the world’s four billion poorest people as consumers, employees or entrepreneurs. However, the company expecting to enter these emerging markets by management ‘at arm’s length’ or driven by headquarters is in for a surprise. Large companies have to earn their ‘licence to operate’ in a spirit of *co-entrepreneurship*. This implies following a business model that is flexibly orientated towards the local: company activities within the community, local employees, the extent to which the company is involved in local relationships and its ability to work with local social and business entrepreneurs. Ambitious commitments by large corporations to help alleviate poverty and meet millennium development goals will have limited success if other courses are pursued.

High-impact sectors such as oil and gas have observed over recent years how emerging corporate citizenship issues have moved beyond traditional hot topics such as oil spills and CO<sub>2</sub> emissions to bigger picture questions such as socio-economic impacts and revenue sharing (UN GC, 2004: 29, quoting a study by Arthur D. Little and Business in the Community). In the construction sector, transnational companies have been drawn into local governance issues when new infrastructure stimulates economic development and population growth. Mining companies have dealt with HIV/Aids, introduced high-quality

health care for employees and encountered complicated relationships with the rest of society and local authorities. At times the division of accountability between states and large companies is unclear, resulting in an accountability vacuum in which neither takes responsibility (see Ward, 2003). The proactive company is one that tackles these social issues through partnership with local development actors. One example of risk management is the community approach of the Awareness and Preparedness for Emergencies at the Local Level (APELL) programme of UNEP (see Box 20.1). It can also take the form of developing new business ventures with local entrepreneurs, jointly developing new innovations (for example, in micro-financing, energy and water services provision) or local manufacturing. To bridge the gap between the 'corporate economy' and the 'livelihoods economy', The RING Alliance (2003: 8) highlighted that 'a business agenda for poverty reduction needs to reflect better understanding of the development significance of small and medium-sized enterprises, the informal sector, co-operatives, and other forms of business organisation operating at the level of the human economy'. One of its key recommendations to the UN Global Compact was 'building understanding of the business relevance of civic entrepreneurship'.

**BOX 20.1 AWARENESS AND PREPAREDNESS  
FOR EMERGENCIES AT LOCAL LEVEL  
(APELL) PROGRAMME OF UNEP**

Think of recent industrial accident headlines: 'Ammonium Nitrate Explosion in Toulouse – France, 21 September 2001'; 'Prestige Tanker – Oil Spill Accident in Spain, 14 November 2002', 'Gas Well Blowout in Gao Qiao, Chongqing, China, 23 December 2003, 243 people died, 9,000 injured, and 64,000 evacuated'; 'Ammonium Nitrate Explosion in Ryongchon Train Station, North Korea, 22 April 2004, 161 people killed and 1,300 people injured'. It is part of a long list, going back many years. In late 1986, following various chemical accidents, UNEP suggested a series of measures to help governments, particularly in developing countries, to reduce the occurrence and harmful effects of technological accidents and emergencies.

A key outcome of this has been the development of the APPELL Programme (Awareness and Preparedness for Emergencies at Local Level). This has been undertaken with the International Council of Chemical Associations and other industry associations, governments and local communities. The aim has been to minimise the occurrence and harmful effects of technological

accidents and emergencies by raising awareness within local communities and by improving communication between the parties. APELL provides a well-structured, detailed process for developing a coordinated, integrated and well-functioning emergency response plan for local communities. It is a tool for bringing people together to allow effective communication concerning risks and emergency responses. This process should help to:

- reduce risk;
- improve effectiveness of response to accidents;
- allow people to react appropriately during emergencies.

It is clear under APPEL that industries have a responsibility both to minimise risks and to ensure effective planning for response, even though it is normally government agencies that have the statutory responsibility to address emergencies outside industrial facilities. The APELL concept has been successfully introduced in more than 30 countries and in over 80 industrialised communities world wide. APELL was also featured at the World Conference on Disaster Reduction, held in Kobe (Japan) in January 2005, where international priorities and mandates in disaster prevention for the following 10 years have been established. See further, [www.uneptie.org/pc/apell/home.html](http://www.uneptie.org/pc/apell/home.html).

A growing part of UNEP's programme of work involves SMEs and supporting local entrepreneurs. UNEP is helping to catalyse SME development and finance through its Rural Energy Enterprise Development programmes in Brazil, China and five African countries.<sup>12</sup> These programmes provide enterprise development support and seed capital for innovative new companies who offer cleaner energy products or services to customers currently without access to clean and secure energy supplies. The key to success is the ability to connect local entrepreneurs with NGOs, companies and financial institutions who can help the local business to start up or to scale up. Having said this, one should have no illusions about large companies partnering overnight with local entrepreneurs to set up new businesses which benefit local communities. It takes long and hard work by committed individuals. Preparing the ground for the business case at the local level also requires sufficient investment in human capital through capacity building. Working with partner organisations to this end, UNEP provides various types of training materials to SMEs. For example, the Efficient Entrepreneur calendar for SMEs is a month-by-month action programme that introduces the small

company to environmental management and reporting. UNEP is also supporting local entrepreneurs in partnership development with the UNDP and the IUCN – The World Conservation Union through the Seed Initiative, launched simultaneously at the World Economic Forum and World Social Forum in January 2004.<sup>13</sup>

## **Conclusions**

This chapter has provided an overview of how UNEP interprets ‘corporate environmental responsibility’, a key principle it advances as a UN agency under the UN Global Compact. It has also described how companies can be engaged to assume that responsibility in a more proactive manner through voluntary initiatives, partnerships and sustainability reporting, inspired by the emerging business case for sustainable development. We commenced by questioning the role of the legal profession. One analyst remarked:

Where the CSR agenda focuses on responsibility, legal risk management focuses on liability. Whereas the CSR agenda focuses on transparency, legal risk management focuses on confidentiality, and where the CSR agenda focuses on bridge-building and partnerships, the legal risk management approach is typically one of cautious defensiveness. (Ward, 2003: 27)

The contemporary challenge is to build a body of evidence that moves company management to address the sustainability agenda not in terms of a risk avoidance strategy but in terms of a window of opportunity. This puts the onus upon us all to move the business case argument beyond a collection of selected best-practice case studies to the definition of a convincing business model in which the word ‘liability’ becomes associated with ‘lack of taking action’ or ‘failure to act’.

## **Notes**

1. See meeting report at [www.uneptie.org/outreach/business/ind\\_meeting.htm](http://www.uneptie.org/outreach/business/ind_meeting.htm).
2. Companies have become more concerned about their corporate image. This, coupled with the emergence of stringent environmental legislation with liability implications in a number of countries over the last ten years, has reinforced the case for a certifiable environmental management systems. Since its publication in 1996 as a mandatory compliance standard, the growth in ISO14001 certification has been significant.
3. On the series of regional and international consultations on this Framework organised by UNEP and the UN Department of Economic and Social Affairs, see [www.uneptie.org/pc/sustain/10year/home.htm](http://www.uneptie.org/pc/sustain/10year/home.htm).
4. See the full declaration at: [www.unep.org/malmo/malmo\\_ministerial.htm](http://www.unep.org/malmo/malmo_ministerial.htm).
5. UNEP advances work in the area of environmentally friendly technologies through its International Environmental Technology Centre in Japan and web-based services such as MaESTro ([www.unep.or.jp/maestro2/](http://www.unep.or.jp/maestro2/)) and the Sustainable Alternatives Network (SANet, [www.sustainablealternatives.net](http://www.sustainablealternatives.net)).
6. Furthermore, the United Nations Development Programme (UNDP) is helping to support Global Compact outreach at the national level and the UN Industrial Development Organisation (UNIDO) is focusing on the promotion of the Compact among small and

- medium sized enterprises (SMEs). Around a quarter of current company participants are SMEs.
7. See [www.uneptie.org/outreach/vi\\_home.htm](http://www.uneptie.org/outreach/vi_home.htm).
  8. See further, [www.unglobalcompact.org](http://www.unglobalcompact.org).
  9. See [www.globalreporting.org](http://www.globalreporting.org).
  10. The proactive and leadership role of individual businesses contrasts to the preference of laggards to hide behind lowest common denominators as defined collectively in their industry associations (see SustainAbility/GPC, 2001). UNEP hosts an annual consultative meeting in Paris with industry associations to focus on constructive contributions and challenges. Associations can be crucial allies in involving smaller companies, particularly those from the developing world (see UNGA, 2001a: 38).
  11. See UNEP FI press release at <http://unepti.net/stocks>.
  12. See [www.ared.org](http://www.ared.org).
  13. See [www.seedinit.org](http://www.seedinit.org).

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## 21 Corporate accountability: an NGO perspective

*Craig Bennett and Helen Burley*

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### **Introduction**

Environmental organisations like Friends of the Earth have campaigned against the socially and environmentally destructive practices of companies for as long as they have been in existence. Over the years, groups have won campaigns against companies on a range of issues but how much has really changed in the corporate world?

We argue that the corporate sector's response to campaigns by civil society (ethical consumerism and corporate social responsibility: CSR) fails to address the unprecedented social and environmental challenges faced by humanity in the twenty-first century. In particular, it fails to challenge the growth of unaccountable corporate power. As a result, we now see the development of a 'corporate accountability movement'.

Corporate accountability can be defined as the ability of those affected by a corporation to control that corporation's operations. It is a concept that demands fundamental changes to the legal framework in which companies operate. These include social and environmental duties being placed on directors to counterbalance their existing duties on financial matters and legal rights for local communities to seek compensation when they have suffered as a result of directors failing to uphold those duties.

In this chapter, we briefly review how the concept of corporate accountability has come about and how it is fundamentally different to voluntary CSR. We outline some of the mechanisms that could help deliver corporate accountability at an international and EU level, but we also explore in some depth how the principles and components of these mechanisms would be transposed and made to work within one jurisdiction in particular: the UK.

### **From corporate campaigning to campaigning for corporate accountability**

Friends of the Earth's first campaign action in the UK, shortly after it was established in 1971, was a mass 'bottle-drop' outside the London offices of Schweppes in protest against their plans to start selling drinks in non-returnable plastic bottles.

Over the years, Friends of the Earth and other non-governmental organisations (NGOs) have fought countless campaigns against companies over specific issues. They have forced companies to abandon plans to build roads, ports, mines, dams and pipelines in protected areas both here and abroad; bullied some high street banks into begrudgingly developing some limited expertise in environmental matters after it was exposed how investors had been unwittingly financing rainforest clearance, human rights abuses and polluting industries; and cajoled certain oil and gas companies to withdraw from lobby groups set up specifically to stop governments from taking action on climate change.

Their consumer campaigns have persuaded hundreds of thousands of shoppers to buy recycled paper, peat-free compost, fair trade and organic coffee, tea, chocolate and bananas, genetically-modified (GM)-free food, timber that has been certified as sustainable by the Forest Stewardship Council (FSC), and more.

With other campaign groups, Friends of the Earth have been able to expose some of the worst examples of corporate behaviour and indicate what kind of behaviour might be better. Green consumerism has shown that it is possible to make and sell products in an ethical way.

The Confederation of British Industry (CBI) recently said (emphasis added):

Commercial opportunities have arisen for businesses to meet customer expectation of higher environmental standards, either as a core part of their brand or through *discrete* parts of their product range. *For some*, the beneficial effects on image and reputation of being environmentally pro-active is also an important driver of behaviour. (CBI, 2004: 8)

The argument put forward by the CBI, among others, is that the corporate sector's response to social and environmental campaigns (ethical consumerism and CSR) has been so successful that a more regulatory approach is not necessary; the solution to social and environmental problems is the free market. Some, including UK government ministers, are clearly so content with this neo-liberal *modus operandi* that they have thanked NGOs for driving these developments by acting as the 'whistleblowers and enforcers'<sup>1</sup> and urged Friends of the Earth to continue with their fine work.

While some may seek to perpetuate the view that ethical consumerism and CSR are somehow going to deliver in an adequate manner, there are very few campaigning organisations that share this perspective.

A proper assessment of the social and environmental challenges facing us in the twenty-first century, an examination of the limits of ethical consumerism, the limits and failings of CSR and the scale and nature of corporate power suggests that a new way forward is required.

**The challenge**

The social and environmental challenges facing the world in the twenty-first century are unprecedented in human history.

Global biodiversity is being lost at a rate many times higher than that of natural extinction. Although insufficient information is available to determine precisely how many species have become extinct in the past three decades, about 24 per cent (1130) of mammals and 12 per cent (1183) of bird species are currently regarded as globally threatened. The net loss in global forest area during the 1990s was about 94 million hectares (equivalent to 2.4 per cent of total forests). Deforestation of tropical forests is almost one per cent annually. About one-third of the world's population live in countries suffering from moderate-to-high water stress – where water consumption is more than 10 per cent of renewable freshwater resources. Some 80 countries, constituting 40 per cent of the world's population, suffered from serious water shortages by the mid-1990s (UNEP, 2002a).

Meanwhile, social and economic development is proceeding too slowly. For many countries the 1990s was a decade of despair. Some 54 countries are poorer now than in 1990. In 21, a larger proportion of people are going hungry. In 14, more children are dying before age five. In 12, primary school enrolments are shrinking. In 34, life expectancy has fallen. The income of the richest one per cent of the world's population, about 60 million people, is equal to the income of the poorest 57 per cent, some 3.4 billion people. Twenty per cent of the world's people, 1.2 billion of them, exist on less than one US dollar a day (UNDP, 2003).

Poverty, particularly within societies, can often be linked to human rights abuses and injustice, with communities losing rights to access natural resources such as land, water and forests, which they may have relied on for generations, as corporations and national governments see the potential to exploit and 'develop' these resources. Information about such 'development' projects is often inadequate or non-existent and those people affected are all too often excluded from the relevant decision-making processes. Evidence from parts of the developing world show that where governments and corporations take control of such resources, individuals and even whole communities can face eviction, loss of livelihood and even violence and intimidation. All too often the natural environment also pays a price (FOEI, 2002a, 2004).

The environment and the world's poor are also at risk from the impacts of climate change, which looks set to exacerbate the problems of uneven development and environmental injustice. Globally, average temperatures have increased by 0.6°C since 1860 and the Intergovernmental Panel on Climate Change (IPCC) projects that global temperatures could rise by between 1.4 and 5.8°C by the end of this century (IPCC, 2001).

The impacts of these changes in temperature are likely to be felt most

harshly in developing countries. In Africa, increases in droughts, floods and other extreme weather events will add to the current stress on water resources, food production and human health. In Asia, tens of millions of people will be displaced from their land as sea levels rise. Forest fires, flooding and droughts are likely to become more frequent. The consequences could be particularly devastating for the poorest countries – which are least able to take measures to adapt to the changing climate (Simms et al., 2004).

The challenges are immense and demand urgent action from world leaders. But in today's global economy, it is not just the politicians that hold the power. The role played by corporations in shaping our world, makes it clear that any solutions must also include the corporate world. Of the 100 largest economic entities in the world, 51 are now corporations and 49 are countries. The top 500 corporations now control almost two-thirds of world trade (Anderson and Cavanagh, 2000). One-third of world trade occurs within transnational corporations (TNCs) (Simms et al., 2000).

It could be argued that corporate globalisation has led to a situation where companies face little choice but to put profits above such considerations as environmental protection. The 'need' for companies to remain 'competitive' in the global economy is regularly cited in support of the deregulatory agenda.

Take for example the energy sector, the driving force within the modern global economy. At a time when the majority of scientists are agreed on the urgent need to tackle the level of emissions from fossil fuels which contribute to climate change, oil and gas companies are putting unprecedented levels of investment into finding yet more fossil fuels to extract from the ground – while investing a tiny proportion of their profits in the development of cleaner energy supplies (Simms et al., 2004).

Take the food industry, for example, where commodities such as coffee, sugar, cocoa and palm oil are transported around the world to satisfy our endless appetites for cheap food, regardless of the impacts on the communities where these products are grown. In Indonesia and Papua New Guinea, rain-forest is being felled to make room for palm oil plantations – so that this cheap vegetable oil can find its way into one in three products on our supermarket shelves (Friends of the Earth, 2004).

Take the growing market for cheap flights and holidays: regardless of the impact of the increasing number of flights on our climate, the impact of aircraft noise on individuals, or the impact of tourism on the communities around the world whose villages are displaced to make way for hotel chains and restaurants, in exchange for jobs serving, feeding and cleaning up after their visitors.

Many argue that the corporate sector is part of the solution by generating the wealth that will eventually 'trickle down' to poorer communities and so provide higher social and environmental standards in the 'global south'. But

the evidence suggests that billions of people are still waiting for this ‘trickle down’ while seeing their human rights, communities, livelihoods and local environments impinged upon while, across an incredibly diverse range of sectors, companies make money to satisfy unsustainable consumption in the ‘global north’.

Sustainable development, and social and environmental justice will not be realised unless the corporate sector is part of the solution. The question is, how can our leaders ensure that it is in the interest of the world’s most powerful companies to contribute to that solution? Will companies embrace the need for sustainable development voluntarily, do they need financial incentives, or do we need to see fundamental changes to legal frameworks and power dynamics in which corporations operate before real change will occur?

### **Ethical consumerism**

One suggested way forward is through the development of an ethical business sector, offering consumers the chance to choose between products that are produced in an environmentally and socially responsible way, and those that are not. There is a market-based logic to such a solution. If consumers want to buy ethical products, then companies will respond to their demand and so the environmental impacts of corporations, and of consumption, will be reduced.

Such a market-based solution has indeed developed over recent years. The international fair-trade mark, *Fairtrade* has become part of mainstream culture, with *Fairtrade* products available alongside the ‘unfair’ varieties in most major supermarkets in the UK. Similarly organic food – less damaging to the environment because it relies on far fewer chemicals – is labelled as such and is widely available, albeit often at a higher price. Shoppers who want to buy responsibly have the option to do so – at least when it comes to buying certain products. And a growing number seem to be opting for the ethical choice. The Co-operative Bank’s *Ethical Consumerism Report* (2003) estimated the value of ethical consumption at £19.9 billion – an increase of 44 per cent in the period from 1999 to 2002. This sounds impressive, until it is considered that, overall, ethical goods and services account for just 1–2 per cent of the total market share.

Indeed, the limits to green consumerism should be obvious. Greener products are often more expensive and often represent a niche market compared to those products that are merely produced as cheaply as possible. A more fundamental limit is that even the most ardent, the most caring, the most affluent green consumer, will never possess enough knowledge to buy ethically all the time. *Fairtrade* marks, certification schemes and clear labels exist for some products, but they account for only a small proportion of the range of goods that the average consumer buys.

The average supermarket contains tens of thousands of product lines.

Social and environmental issues are ever more complex and dynamic. How can we possibly expect consumers to keep abreast of all the latest developments and then have the time to work out for themselves what this means for their shopping basket – in a world where people are increasingly time poor? How is an ethical consumer supposed to boycott a company – such as a mining company – which may be involved in the supply chain of thousands of products but their brand is on none? What if there is no ethical version of the product I need to buy?

Even where ‘green labelling schemes’ do exist, they have limitations. Although the UK government has noted that ‘[b]y making sure manufacturers and retailers provide useful and honest information about their products, consumers will be able to make an informed choice when buying green’ (DTI, 2004: 19), NGO experience of labelling schemes is mixed.

In 1993, Friends of the Earth, Greenpeace, the World Wide Fund for Nature, some retailers and forest companies came together to form the Forest Stewardship Council, which aimed to provide a credible guarantee to consumers that wood products came from well-managed forests. The FSC has surely benefited from more coordinated promotion than any other eco-labelling scheme. The NGOs have promoted it to their members, retailers have promoted it via point-of-sale advertising, it has enjoyed celebrity endorsements (most notably from James Bond actor Pierce Brosnan) and been the subject of mainstream advertising campaigns. Greenpeace has used high-visibility direct action events to expose prestigious restoration projects that failed to use FSC timber (such as at the Cabinet Office in London). In many respects, the FSC has set a standard for other eco-labelling schemes to follow.

And yet, ten years on, the vast majority of western consumers continue to buy timber without considering where it has come from. One of the FSC’s greatest successes has been in the Netherlands, where unprompted recognition of the FSC label rose to 33 per cent among consumers in 2004 following the third annual awareness-raising campaign which involved some 30 companies, including major ‘do-it-yourself’ (DIY) retailers, timber importers, and several NGOs (FSC, 2004). In other words, two-thirds of Dutch consumers did not recognise the logo. The FSC has not been helped by the less scrupulous parts of the timber industry setting up rival certification schemes with lower standards that many suspect were established specifically to undermine the FSC.

More recently, the Marine Stewardship Council, a similar certification scheme for sustainably sourced fish, has struggled to gain any significant recognition from consumers (Gribben, 2003).

The point here is not to criticise the efforts of those involved in the FSC or other eco-labelling schemes. They have provided ethical consumers with a clear choice and have shown that ethical trading is technically possible. Indeed, there certainly appears to be a role for schemes that satisfy those

consumers who demand higher standards than those required by legislation. But surely eco-labels cannot be developed and promoted for every one of the 30,000 product lines in the average supermarket? And even if one could, is a shopper's choice between the ethical and non-ethical brand really the way to protect the planet?

The experience of the FSC tells us that eco-labels are not the answer to the world's drastic social and environmental problems. In the case of timber, there will always be a large number of companies that are happy to sell unsustainably sourced timber products and a large number of consumers that are prepared to buy them. And yet, the problems that result from global forest loss affect us all. The real injustice is that the communities who suffer the most have almost certainly never been inside a western DIY store or furniture shop.

Ethical consumerism has a role to play, but those who rely on it as the primary driver of change do so because they would be content for social and environmental concerns to remain peripheral to mainstream business concerns.

### **CSR and voluntary initiatives**

Another possible way forward, embraced by many within the corporate sector, is the adoption of corporate social responsibility. This involves companies voluntarily choosing to improve their social and environmental standards and so reduce their negative impacts on the environment. After all,

[The UK government sees] CSR as *the* business contribution to sustainable development. There are many definitions but we are all talking about how business takes account of its economic, social and environmental impacts in the way it operates – maximising the benefits and minimising the downsides. (Timms, 2004, p. 3, emphasis added)

The argument has been made, time and again, that there is a strong business case for CSR that goes beyond image and public relations. Weiser and Zadek (2000) have observed that proactive programmes to improve a company's social and environmental performance can improve sales and marketing; employee recruitment, retention and motivation; operational regularity; product service, progress or brand innovation; and risk and reputation management.

Business leaders give an impression that the whole corporate sector is fully engaged in CSR. Digby Jones, Director General of the Confederation of British Industry has commented that 'business today understands fully that its responsibilities extend beyond maximising profitability to include addressing the needs of its wider stakeholders' (Jones, 2001, p. 7).

Political leaders trumpet the 'huge uptake' in CSR. Nigel Griffiths MP, the UK's minister for CSR, has recently noted that '2000 international companies



regularly report on their environmental and social impacts' (Griffiths, 2004). Kofi Annan, UN Secretary-General, has boasted how nearly 1500 firms, from 70 countries are participating in the Global Compact, a UN voluntary initiative (Annan, 2004). The initiative is based on ten principles in the areas of human rights, core labour standards, environmental protection and anti-corruption but it promises not to 'police, enforce or measure the behaviour or actions of companies', relying instead on companies 'enlightened self-interest'.

But there are not just 2000 companies in the world, but an estimated 61,000 TNCs and over 900,000 foreign affiliates (UNCTAD, 2004) implying that only 3.2 per cent are reporting on their social and environmental impacts and only 2.5 per cent have signed up to the Global Compact. Leaving aside questions about the poor standard of most CSR reports and the serious concerns that many NGOs have with the Global Compact (for example, see Bruno and Karlinger, 2002), these figures still beg the question: in what realm of life other than the strange world of CSR would a 2–3 per cent take-up rate be considered to be a success? The truth could not be much starker: the vast majority of the corporate world is failing to volunteer to be part of the voluntary approach.

This quantitative assessment is supported by the more rigorous qualitative assessment undertaken by UNEP, published in May 2002, which reviewed the performance of 22 industry sectors on sustainability issues since the 1992 Rio Earth Summit. UNEP concluded that:

There is a growing gap between the efforts of business and industry to reduce their impact on the environment and the worsening state of the planet . . . due to the fact that in most industry sectors, only a small number of companies are actively striving for sustainability, that is, actively integrating social and environmental factors into business decisions . . . the majority of companies are still doing business as usual. (UNEP, 2002b)

Those companies that are engaged in CSR are primarily those that have previously been on the receiving end of boycotts, campaigns by civil society groups, media exposés and/or are operating in particularly controversial industry sectors, such as BP, Shell, British American Tobacco, Rio Tinto and BAE Systems.

The argument is put that as long as NGOs continue in their 'enforcer' role, the uptake of CSR will continue. But, there will never be enough NGO capacity to police the corporate world and run effective, inspiring campaigns to counter every type of corporate wrongdoing. The public, let alone the media, will never have the time or appetite for that number of campaigns. And what about those countless companies that are not brand sensitive, either because they are too specialist, or because they sell their products and services to other

businesses, rather than to the public? What about those companies that see CSR as just another type of public relations?<sup>2</sup>

An alternative suggestion is that NGOs like Friends of the Earth should put less effort into confrontational campaigns and instead engage in constructive dialogue with corporations and participate in relevant multi-stakeholder voluntary initiatives. But to do this would require them to focus exclusively on a fraction of companies at the expense of monitoring the corporate sector as a whole.

Furthermore, many NGOs have become increasingly frustrated at the failure of many corporations to deliver on the promises that they make when joining voluntary initiatives. In 1995, for example, the British supermarket Tesco joined the WWF 95+ Group and in so doing promised to ensure its timber products were certified as sustainable by the FSC. In 2003, Friends of the Earth found Tesco selling garden furniture made from illegally felled tropical hardwood. The broken promise meant that the precious resources injected into the initiative by several NGOs were wasted.

Although voluntary initiatives are held up by politicians and business alike as the preferred method of CSR delivery, the evidence of their effectiveness is not good. In 2003, the Organisation for Economic Cooperation and Development (OECD) reviewed the performance of a range of voluntary initiatives across a range of industry sectors. Given the NGO, governmental and commercial resources that have been put into such initiatives, the report's conclusions were damning: 'there are only a few cases where [voluntary initiatives] have contributed to environmental improvements significantly different from what would have happened anyway' (OECD, 2003: 14).

As with ethical consumerism, CSR and voluntary initiatives have a role to play but it is a fallacy to believe that they will bring about the kind of widespread change in the corporate sector that is needed.

### **The rise of corporate power**

But the real limits of ethical consumerism, CSR and voluntary initiatives go far beyond their practical inadequacies. Such initiatives fundamentally fail to challenge the spectre that is causing growing unease in several sections of society: the rise of corporate power. This rise has been the subject of a succession of best-selling books over the last decade, most notably Korten (1995), Klein (2000), Monbiot (2000) and Bakan (2004) – the last also related to a general-release film documentary about corporate power. Protests in Seattle in 1999 and later in Genoa were important for the fact that the world's mainstream corporate media – 40 per cent of the world's media is controlled by five TNCs (Simms et al., 2000) – gave them extensive coverage and branded them as 'anti-corporate' (Bendell, 2004).

Hornblow (2004) has noted how Hollywood is now tapping into this unease by making the corporation its new 'bad guy':

In films from Jonathan Demme's remake of *The Manchurian Candidate* to *I, Robot*, *The Bourne Supremacy*, *Spider-Man 2*, and even *Catwoman*, the movie industry's new villain is, to varying degrees, the corporation. . . . Whether narrative or documentary, the celluloid portrait of the corporation is uniformly unflattering. Corporations are depicted as outsized, profit-driven, unprincipled and potentially murderous, all of which makes Big Business the perfect Public Enemy No. 1. . . . Creating a list of films in which corporations are viewed in a more flattering light is nearly impossible. This points to two things: The first is that the corporation is easily demonized. But the second is more telling: The steady rise in the number of superheroes and Average Joes doing battle with Big Business on the big screen suggests the American population is angry with corporate malfeasance and executive skulduggery. . . . Hollywood has always functioned as a Dream Factory, and right now Americans seem to be dreaming that corporate hegemony can be brought to its knees.

Corporations have gained their power for two principle reasons that have evolved out of the process of 'incorporation' or the establishment of a separate legal identity. First, the corporate 'legal person' has gained some civil and legal rights, such as freedom of speech, which – in turn – has allowed them to influence political processes. Second, it can limit liability (that is, protect those who run it from some of the responsibilities of their actions). As noted by Bendell (2004, p. 8), '[t]hese two aspects of corporations mean that they could acquire significant power, which they could exercise with limited accountability'.

Part of the growing frustration among NGOs, activists and communities with ethical consumerism, CSR and voluntary initiatives is that they fail to challenge this power dynamic. No matter how much a sizeable minority of consumers may ask for more ethically sourced products, the majority of companies will only stop producing damaging products or start producing ethical products if it suits their business interests. No matter how much 'stakeholder dialogue' a corporation may undertake with a local community over their plans for a major construction project in their neighbourhood, the company is still driven by its business interests and that is what will determine the final decision. No matter how much effort NGOs and government may put into a voluntary initiative, there are no penalties if a company pulls out or blatantly disregards the commitments it has made. And it should be remembered that for the NGOs, the only reason for being involved in such a process is if it is going to make a real difference in the way a company behaves.

Even worse, rather than challenging corporate power, CSR has been used to reinforce it. Despite the questionable efficacy of voluntary initiatives and partnerships, these have been adopted by governments as a justification for inaction and by corporate lobby groups as 'proof' that regulatory frameworks are not needed.

Nowhere was this clearer than at the 2002 World Summit on Sustainable

Development (WSSD) in Johannesburg where over 200 agreements were announced as official ‘Type 2’ outcomes of the ‘Earth Summit’. This was the first time that agreements between non-state actors had been endorsed at an intergovernmental conference and the development was used by some western countries and lobby groups such as Business Action for Sustainable Development and the International Chamber of Commerce as evidence that legally-binding measures on business need not be agreed. As Bendell has put it: ‘[a]s partnerships and voluntary corporate responsibility morphed from a methodology to an ideology, it became clear that some participants in and commentators on partnerships were using them to pursue a neo-liberal political agenda’ (Bendell, 2004: 31).

But leaving the market to decide on social and environmental standards means that they will become a minority pursuit, leaving the majority of companies to ignore such standards and continue with business as normal.

For all the talk by politicians and business leaders about corporate responsibility and ways in which to promote it, there is a deafening silence when it comes to corporate irresponsibility. What happens to the companies who do not voluntarily chose to adopt responsible environmental and social standards? Few governments have yet put forward any means of addressing this.

### **The emergence of a corporate accountability movement**

Bendell (2004) has provided a thorough analysis of the emergence of what he terms a ‘corporate accountability movement’. He defines corporate accountability as ‘the ability of those affected by a corporation to regulate the activities of that corporation’ and the corporate accountability movement as ‘those who work toward this outcome, knowingly or not, in specific circumstances or in general’ (ibid.: 19).

The concept of corporate accountability raises questions about the desired relative role of corporations, governments and society. It highlights that society has provided corporations with a licence to operate and asks whether they should have to operate in the public interest if they are to maintain that licence.

From a corporate accountability perspective, ethical consumerism and voluntary CSR places a focus on the consumer and on the individual company (all too often located in the global north) and ignores the real issues of social and environmental justice for communities (often located in the global south).

Is it right for workers on banana plantations to suffer if, actually, the majority of western consumers decide that having a cheap banana is more important to them than to have a fairly traded banana? Is it right for western governments to sit back and do nothing when indigenous communities get pushed off their land and rainforests cleared to produce cheap palm oil for British supermarkets? Is it right for social and environmental concerns to be ignored in circumstances where addressing them does not make short-term business sense? Is it

right for governments to surrender their responsibilities to govern, and rely instead on NGOs and the free market?

When our society decided that it was time to mainstream common standards on health and safety, employee or consumer protection, it was done through changes to the legal framework in which companies operate. Company directors were given new legal duties, and employees and consumers were given rights that would allow them to hold companies and directors to account if they failed to uphold those duties.

If we, as a society, are serious about sustainable development, social and environmental justice, the time has surely come to mainstream common standards on social and environmental performance. The way to do it is through equivalent changes to the legal framework that would allow people to hold corporations to account for social and environmental wrongdoing; in short, corporate accountability.

These changes are already being called for at international, EU and UK levels. These campaigns differ in one crucial respect from those that have preceded them. Whereas, in the past, the corporations were the target of the campaigners' strategies, the targets now are politicians and governments. This is because only politicians and governments can bring about the kind of legal changes required.

### **International frameworks for corporate accountability and liability**

There has been a stream of proposals for mechanisms to deliver corporate accountability over the last five years, recently summarised by the United Nations Research Institute for Social Development (UNRISD, 2004):

The emerging corporate accountability agenda includes proposals to establish institutional mechanisms that hold corporations to account, rather than simply urging companies to improve standards or to report voluntarily. Corporate accountability initiatives promote complaints procedures, independent monitoring, compliance with national and international law and other agreed standards, mandatory reporting and redress for malpractice . . . The corporate accountability movement has put the spotlight on certain issues that have not figured prominently, if at all, in the mainstream CSR agenda but which are fundamental to the role of TNCs in governance and development: corporate power; perverse fiscal, financial and pricing practices; and corporate lobbying for macroeconomic policies that can have negative developmental impacts.

Some of these focus on specific sectors, such as the Framework Convention on Tobacco Control. Others focus on specific aspects of corporate accountability, such as the International Right to Know Campaign's call for disclosure and transparency. While sector-specific mechanisms will undoubtedly play a crucial role in delivering corporate accountability, there is a danger that they will be developed for only a handful of sectors.

In the run-up to the 2002 WSSD (frequently referred to as the 'Johannesburg

Earth Summit'), Friends of the Earth International (FOEI) published proposals for a new international legally binding convention on corporate accountability and liability that sought to address problems common to the corporate sector as a whole (FOEI, 2002b). FOEI is the world's largest grassroots environmental organisation, with member groups in 71 countries around the world. The proposal, developed with the involvement of groups based in the global north, south, east and west, stipulates the following requirements for signatory governments:

- (i) *Duties*: Impose duties on publicly traded companies, their directors and board level officers to:
  - (a) report fully on their social and environmental impacts, on significant risks and on breaches of relevant standards (with such reports to be independently verified);
  - (b) ensure effective prior consultations with affected communities, including the preparation of environmental impact assessments (EIAs) for significant activities and full public access to all relevant documentation; and
  - (c) take the negative social and environmental impacts of their activities fully into account in their corporate decision-making.
- (ii) *Liability*: Extend legal liability to directors for corporate breaches of national social and environmental laws, and to directors and corporations of corporate breaches of international law or agreements.
- (iii) *Rights of redress*: Guarantee legal rights of redress for citizens and communities adversely affected by corporate activities, including:
  - (a) access for affected people anywhere in the world to pursue litigation where parent corporations claim a 'home', are domiciled, or listed;
  - (b) provision for legal challenge to company decisions by those with an interest;
  - (c) a legal aid mechanism to provide public funds to support such challenges.
- (iv) *Rights to resources*: Establish human and community rights of access to and control over the resources needed to enjoy a healthy and sustainable life, including rights:
  - (a) over common property resources and global commons such as forests, water, fisheries, genetic resources and minerals for indigenous peoples and local communities;
  - (b) to prior consultation and veto over corporate projects with a view to preventing displacement;
  - (c) to compensation or reparation for resources expropriated by or for corporations.

- (v) *Standards*: Establish (and enforce) high minimum social, environmental, labour and human rights standards for corporate activities based, for example, on existing international agreements and reflecting the desirability of special and differential treatment for developing countries.
- (vi) *Introduce sanctions*: Establish national legal provision for suitable sanctions for companies in breach of these new duties, rights and liabilities (wherever breaches occur) such as:
  - (a) suspending national stock exchange listing;
  - (b) withholding access for such companies to public subsidies, guarantees, loans or procurement contracts; and
  - (c) in extreme cases the withdrawal of limited liability status.
- (vii) *Extend the role of the International Criminal Court* to try directors and corporations for social, environmental and human rights crimes, perhaps involving a special tribunal for environmental abuses.
- (viii) *Improve international monopoly controls* over mergers and monopolistic behaviour by corporations.
- (ix) *Implementation mechanism*: Establish a continuing structure and process to monitor and review the implementation and effectiveness of the convention (FOEI, 2002b).

FOEI did not expect the Johannesburg Summit to result in a clear agreement to develop an international convention, let alone agree on its content. While the position paper contained some detail on how such a proposal would work in practice, it was not a draft convention.

The purpose of the proposal was to provoke debate around the possible solutions to corporate wrongdoing, to promote a southern agenda around community rights, as opposed to a northern corporate agenda on voluntary codes of conduct, and to reverse the pendulum swing away from corporate voluntarism towards corporate accountability.

The call for corporate accountability became a rallying call for environmental, human rights, development and labour organisations in the run-up to Johannesburg. Governments took note and a clear commitment was made at the meeting to develop new frameworks and mechanisms. This was summarised in the Final Plan of Implementation document which noted that 'urgent action' was required 'at all levels' to:

Actively promote corporate responsibility and accountability, based on the Rio Principles, including through the full development and effective implementation of intergovernmental agreements and measures, international initiatives and public-private partnerships, and appropriate national regulations, and support continuous improvement in corporate practices in all countries. (WSSD, 2002)

Inevitably, different governments have differing opinions as to the meaning of this text. Governments from the G77 group of developing countries have consistently expressed their view that it calls for the development of new international frameworks. In contrast, the closing session of the Johannesburg Summit saw the United States declaring a formal 'reservation' with respect to the paragraph in which they noted their belief that it only referred to the development of 'existing agreements', even though the word 'existing' was specifically dropped from the draft text during the negotiations.

The realisation of an International Convention on Corporate Accountability and Liability is still some way off, but a long and slow process towards that eventuality may have begun. An international framework represents the ultimate solution for many in the corporate accountability movement and one that many campaign groups continue to work towards.

### **EU legislation for corporate accountability and liability**

The European Union is the world's largest single market and home to many of the world's largest corporations. If economic union is the *raison d'être* for the EU, then surely this needs to be paralleled with the development of mechanisms that ensure that the economic benefits are also to the benefit of people and the environment, allowing stakeholders to hold EU-based corporations to account?

Over the last couple of years the Green 8 group of NGOs (the coalition of leading environmental groups engaged in the EU policy process<sup>3</sup>) participated in a two-year multi-stakeholder process on CSR, facilitated by the European Commission, which concluded in June 2004. At the end of this process, the Green 8 issued a dissenting statement noting that the bias in the final report towards voluntary CSR was the result of a process which had been dominated by business interests.

They called on the European Commission, the Council and the Parliament to work together to develop a regulatory framework that ensures:

- (i) Mandatory corporate transparency on environmental and social performance and impacts;
- (ii) Enforceable stakeholder rights to information, participation and accountability;
- (iii) Public procurement and investment rules that discriminate in favour of companies whose responsible performance can be independently verified;
- (iv) Clear standards and practices for the independent verification of corporate performance;
- (v) Tax reforms to internalise the environmental and social costs.



Such legislation could be introduced into EU legislation through an EU Corporate Accountability and Liability Directive.

### **UK legislation for corporate accountability and liability**

International conventions and EU directives would have to be transposed into the domestic legislation of signatory/member states to come into force. To examine how such frameworks might work in a practical sense, it is necessary to explore in greater detail the technical and legal mechanisms that would facilitate their translation into national law.

In the UK, a coalition of NGOs, trade unions and think tanks known as the Corporate Responsibility Coalition (CORE)<sup>4</sup> has been developing proposals on how company law could be changed to hold UK companies to account. These proposals can be grouped under three headings.

#### *Mandatory reporting and access to information*

Legal requirements on companies to report annually on their financial performance form the basis of company law in most jurisdictions. A similar requirement on UK companies to report annually on their social and environmental performance is needed to form the basis of UK legislation for corporate accountability.

CORE wants to see a new legal duty placed on companies (or their directors) requiring them to report annually on the *significant* (see Box 21.1) negative social and environmental impacts of their business operations, products, policies and procedures. There should be a requirement for these reports to be independently audited and for a range of key performance indicators (KPIs) to be developed to facilitate comparisons between companies and sectors.

#### *New legal duties on company directors*

UK company law relies on legal duties on directors to ensure certain aspects of their behaviour. The fiduciary duty was defined in the classic quotation of Lord Cransworth in *Aberdeen Railway Co v Vaikie Bros* (1854) 1 Macq 461:

The Directors are a body to whom is delegated the duty of managing the general affairs of the Company . . . Such agents have duties . . . of a fiduciary nature . . . And it is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which may possibly conflict, with the interests of those whom he is bound to protect. (Quoted in Macintyre, 2005: 515)

There are considered to be two separate aspects of the fiduciary duty owed by directors: (i) the directors must exercise their powers *bona fide* for the benefit of the company as a whole and (ii) there must be no conflict between the directors' interests and the interests of the company.

Over time, the common law fiduciary duty has been added to and counterbalanced by a number of non-fiduciary duties defined in statute. For example, Section 309 of the Companies Act 1985 provides that directors should have regard to the interests of the company's employees as well as to the interests of the members (shareholders). Section 2(1) of the Health and Safety at Work Act 1974 states that it shall be the duty of every employer to ensure, so far as is reasonably practicable, the health, safety and welfare at work of all their employees and sets out five matters to which the duty particularly extends (for example, providing information, instruction and training, and providing an overall safe working environment for employees). The law does not prescribe exactly how to do this and the duties are not absolute; the employer only has a duty to comply with them so far as it is reasonably practicable. If it is practicable, however, and he or she fails to carry it out then they will be liable (Macintyre, 2005).

The fiduciary duty should be counterbalanced with new statutory duties requiring directors to take *reasonable* steps to reduce the *significant* (see Box 21.1) negative social and environmental impacts of their business operations, products, policies and procedures, which have been identified through the mandatory reporting requirements. This new duty could be referred to as a 'duty of care' to people and the environment.

#### *New provisions for liability, including foreign direct liability*

Individuals or communities who suffer significant negative impacts because of the failure of UK companies (and directors) to have proper regard to these new duties, should be given the legal right to seek redress in a UK court, with legal aid. This would include negative impacts such as human rights and environmental abuses resulting directly from the operations, policies, products and procurement practices of UK companies or their overseas subsidiaries.

Under the approach adopted, it would be left for an aggrieved party or a prosecuting body to make a case in court that a company had failed to report on the 'significant' negative impact of its business policies, products, operations and procedures, or had failed to take 'reasonable' steps to reduce their negative impacts. The claimant would most likely point to evidence such as: more progressive behaviour being practised by a company's competitors; established and effective voluntary initiatives that the company had failed to participate in; expert witnesses; widely distributed research and materials meaning the company should have been aware of a particular issue and impact; correspondence between interested, expert or affected parties; and so on.

The legal issues around foreign direct liability are complex and outside the scope of this chapter, but a fuller description has been offered by Ward (2002, 2003). It is worth noting that a major review by the Royal Institute of

International Affairs of options for action by governments on how to follow up the WSSD commitments on CSR recommended that 'enabling communities to get redress when business flout norms' should be an area of priority (Calder, 2005, p. 10).

### BOX 21.1 SO WHAT IS 'REASONABLE' AND WHAT IS 'SIGNIFICANT'?

Corporate accountability legislation in the UK would be able to utilise the flexibility that is inherent in the British system of common law whereby it can be left to courts to interpret, on a case-by-case basis, the meaning of legislative words such as 'significant' and 'reasonable'.

It is an approach that is used effectively in a number of torts, such as the tort of negligence. The duty which an occupier owes to his lawful visitors, for example, is defined by the Occupiers' Liability Act 1957, 2(2) as 'a duty to take such care as in all the circumstances of the case is reasonable to see that the visitor will be reasonably safe in using the premises for the purpose for which he is invited or permitted by the occupier to be there'.

In deciding whether or not an occupier's duty has been breached, a court will consider all the circumstances of the case and will assess the reasonableness or otherwise of a defendant's conduct by assessing how 'the man in the street', 'the man of ordinary prudence' and, most famously, 'the man on the Clapham omnibus' would have behaved in the same circumstances and how these mythical bodies would have defined words such as 'safe' or 'significant'.

Negligence is then defined as 'the omission to do something which a reasonable man guided upon those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do' (Alderson B in *Blyth v Birmingham Waterworks Co* 1856).

Legislation to deliver corporate accountability could take a similar approach whereby the concept of the 'reasonable man' would be used to define what social and environmental impacts were 'significant' enough to be subject to reporting requirements and what remedial steps would be considered 'reasonable' enough that a company would be expected to undertake them when having regard to their new duty of care to society and the environment.

*Why not define more precisely?*

An alternative approach would be to try and codify (perhaps through lists or legal guidance) precisely what social and environmental impacts the legislation pertains to and exactly what remedial steps a company would be expected to take. Such an approach is rightly adopted for environmental regulations pertaining to very specific areas of commercial performance (for example, emissions of dangerous chemicals, where regulations may specify the exact parts per million limit that is considered reasonable).

Such an approach would be inappropriate for broad framework legislation designed to improve the social and environmental performance of the corporate sector as a whole because:

- It would not be possible to foresee and list every possible form of negative social and environmental impact that could possibly be carried out by any company at any time (now and in the future), let alone then specify the precise nature of the remedial action necessary;
- It is reasonable to expect that a particular 'impact' may vary in its significance according to commercial sector, company size, geographical location and so on;
- It would be over-prescriptive and might place a bureaucratic burden on business, one that would also create a 'tick-a-box' culture of compliance rather than one of innovation and striving for constant improvement;
- It would miss the point of broad corporate accountability legislation, which is not to 'catch' well performing companies for making small errors when trying to improve their social and environmental performance – or even those merely acting 'reasonably' – but rather to 'catch' those companies that are failing to take even the most basic steps to reduce their negative social and environmental impacts.

Of course, there will always be a role for regulations that prescribe specific levels of performance for particular sectors. It would also be appropriate for legislative guidance to set common approaches for mandatory social and environmental reporting (for example determining certain KPIs).

But the foundation for corporate accountability legislation must be as broad as possible if it is really going to change the behaviour of the corporate sector as a whole. Broad duties requiring *reasonable* actions would represent such a broad foundation.

### **What difference would this make?**

Business lobby groups argue that regulating CSR would create a culture of compliance rather than innovation and tie business up in red tape. But logically, this seems to represent the standard knee-jerk reaction of big business to anything resembling regulation.

The reality is that corporate accountability is not about ‘red tape’; it is about fundamentally changing the legal framework in which companies operate to enable the people affected by their operations to ensure they are operating in the interests of people and the environment. It does not prescribe exactly how a company should go about improving its social and environmental performance, merely that it should. Corporate accountability would also provide a means of redress for affected communities in the most extreme cases where companies fail to consider and mitigate their negative impacts.

In the vast majority of circumstances, the way in which a company would show that it has ‘had regard’ to the circumstances is through genuine CSR programme (including stakeholder dialogue), joining the relevant voluntary initiatives (and taking them seriously) and having regard to agreed and well-established norms of corporate behaviour.

In some circumstances, governments may consider it appropriate to specify, through guidance, what these norms are or what voluntary initiatives would help companies to meet them. In 2002, the Johannesburg Stock Exchange, for example, became the first stock exchange in the world to require publicly listed companies to report to the standards set by the Voluntary Global Reporting Initiative.

In other circumstances, it might be that a court would conclude that it was reasonable to expect that a company should have had regard to well-established and defined norms, such as the OECD Guidelines, or the UN Human Rights Norms for business (see further, Amnesty International, 2004).

Either way, this interaction between legal expectations and codes of conduct would provide a much-needed ‘statutory foundation’ and degree of enforcement to voluntary initiatives – without losing the benefits associated with the voluntary approach (that is, being able to evolve and amend codes without recourse to government).

Over time, it could be expected that common and ‘reasonable’ standards of corporate behaviour would go through a continual cycle of improvement bringing benefits to all stakeholders and allowing best-of-sector companies to define future norms of behaviour.

### **Conclusion**

Calls for mechanisms to deliver corporate accountability will continue to grow as the evidence mounts that voluntary CSR is failing to deliver the changes

that are needed to deliver sustainable development as well as social and environmental justice.

The corporate accountability movement does not claim to have all the answers, but it has come a long way in a short time. Over the next few years, the debate and the campaigns will intensify. It is time for political parties, politicians and governments to join this debate and help develop the policies and mechanisms that will make corporations fit for the twenty-first century.

What is clear is that we urgently need to shift our priorities in recognition of the social and environmental damage that is being done. Despite years of civilisation, as we move into the twenty-first century, our world is divided and damaged, our future uncertain. It is time that corporations recognised that they should be the servants of society, rather than the masters, and to join the calls for corporate accountability. As such, they might start to become part of the solution rather than the problem.

### Notes

1. Stephen Timms, the-then UK Government Minister for Corporate Social Responsibility, in a speech to a World Wide Fund for Nature 'fringe' meeting during the 2002 Labour Party Conference.
2. A recent job advert for a CSR post at Virgin Group specified that knowledge and experience of marketing and public relations was 'essential'. In contrast, knowledge of social and environmental issues was not even mentioned (advertisement issued March 2004).
3. The Green 8 consists of: Birdlife International, Climate Action Network Europe, European Environment Bureau, Friends of the Earth Europe, Friends of Nature, Greenpeace European Unit, Transport and Environment, and WWF European Policy Office.
4. CORE is a broad grouping of over 100 UK-based environment, human rights and development organisations, think-tanks and trade unions including Action Aid, Amicus, Amnesty International (UK), CAFOD, Christian Aid, Friends of the Earth, Save the Children, New Economics Foundation (NEF), T&G Union, Traidcraft, Unison and Unity Trust Bank.

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## 22 International aspects of corporate liability and corruption

*Gemma Aiolfi and Mark Pieth*

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### **Introduction**

In September 2003 the shares of Statoil, the Norwegian oil company, took a beating: over a three-week period the value of the shares fell by 11 per cent, whereas the crude oil price had declined by only 2 per cent in the same time span. The cause of this unexpected price drop was the revelation that the company was possibly implicated in bribery in its international business dealings. The news reports allege that Statoil had signed a contract for advisory services with an Iranian intermediary, named M.H. Rafsanjani, the son of the former Iranian president. The contract provided for a \$15 million fee to be paid over an 11-year period. The Norwegian financial crime police announced that a payment of \$5.2 million of Statoil money had wound up in an account in the Turks and Caicos Islands belonging to a consulting company registered in the UK (Horton Investment) and which appears to have been used in the transaction. The services that the Iranian consultant was supposed to render included supplying information on social developments in Iran, but the whistle was blown by internal audit staff at Statoil, with the resulting furor in the world press. Within two weeks the chief executive officer of Statoil, the chairman, and the head of exploration, all resigned from their posts. It would appear that once this had happened, the share price began to recover, although it took until mid-December 2003 for the price to regain its September level. During that same period oil prices had gained 11.6 per cent.<sup>1</sup> At the time of writing in November 2004, the Norwegian and US stockmarket authorities (Securities and Exchange Commission) are still investigating, and no charges against the company or any of its personnel have been brought.

The Statoil story serves to illustrate some of the issues associated with corporate liability and corruption. Perhaps most striking were the immediate financial repercussions felt by the company: the share price slid until the resignations took effect, indicating that a company's reputation really is its most valuable and fragile asset. The facts also illustrate the importance of protection for whistleblowers and the dilemmas faced by staff as to who to turn to when confronted with a serious problem (the question of whistleblower protection is an important and relevant aspect of this subject but will not be

addressed here). The question also arises what might constitute suitable sanctions for a company found liable for bribe payments. We shall return to the issue of sanctions and their corollary of preventive measures later on.

Although Statoil has not been indicted, the facts do provide a useful example that highlights where ‘corporate liability’ might attach in connection with acts of bribery. First, with respect to the consulting company mentioned above – a small company in a major financial centre with an account located offshore to facilitate the collection of funds for later disbursement. The risk of corporate vehicles, such as international business corporations, foundations, and trusts and so on, being misused for illegal purposes is well known (OECD, 2001). Second, corporate liability might attach to the intermediaries executing the transactions involved in paying the bribes, such as banks or other financial intermediaries which may act as conduits, enabling illicit funds to flow.<sup>2</sup> In the Statoil case, investigations are also being conducted by Swiss authorities into the role played by certain banks, according to media reports.<sup>3</sup> Under some circumstances, these financial intermediaries may be accused of complicity in these transactions, rendering them liable to charges of money laundering.<sup>4</sup> Third, companies engaged in international trade which may engage in illicit payments to foreign public officials in order to obtain or retain business. This last group is the subject matter of this chapter. The following questions will be addressed. When may a legal entity be held liable for bribery of a foreign public official when the offence is committed by its officers or employees? What sanctions should be imposed and what preventive measures might be appropriate for multinational enterprises competing for business globally? Before considering these issues, the legal and historical context of the development of international anti-corruption law will be briefly outlined, followed by an overview of the main relevant international instruments.

### **From Watergate to the world**

All of the industrialised countries and many in the developing world passed laws in the nineteenth and early twentieth centuries that made the bribery of public officials illegal. For example, England enacted the Corrupt Practices Act in 1883 and the Public Bodies Corrupt Act in 1889, and current laws date back to 1906. Countries like Canada, Denmark, France (as early as 1810), Germany, Italy, the Netherlands, Spain and Switzerland similarly adopted provisions in their criminal codes to address this issue. The USA passed the Federal Practices Act in 1910 (repealed in 1972 and replaced by the Federal Election Campaign Act). All these laws were restricted to the bribery of domestic (that is national) officials (Timothy Martin, 1999). It was not until the Watergate scandal in the 1970s revealed the widespread practice of US companies paying bribes when engaging in contracts abroad that the extra-territorial leap was made by the USA. The payment of bribes to foreign public

officials by natural and legal persons was subsequently criminalised. The Foreign Corrupt Practices Act<sup>5</sup> was later to become the catalyst for change at the international level, although not before early attempts to address the question at the UN failed (Brademas and Heimann, 1999). The motivation for American companies to push for an international approach was the recognition that they were at a competitive disadvantage compared to their foreign competitors, who not only could pay with impunity but could also invariably deduct these payments for tax purposes (Hines, 1995; US Department of Commerce, 1995).

Renewed efforts for a multilateral approach were made by the USA in 1993 under the Clinton administration. The conclusion of the Cold War prompted the USA to focus its attention on global economics, and the problem of the so-called 'supply side' of bribery by corporate entities was given high priority. The organisation chosen to pursue this multilateral approach was the Organisation for Economic Cooperation and Development (OECD), which had been working on the topic since 1989. Other organisations had also been tackling this problem for quite some time. The Rules of Conduct on Extortion and Bribery in International Business Transaction of the International Chamber of Commerce (ICC) were first published in 1977 and updated in 1996. These rules prohibit extortion and bribery as such, and are not just confined to bribery to obtain or retain business (the scope of the OECD Convention).<sup>6</sup> The anti-corruption non-governmental organisation (NGO) Transparency International, founded in 1993, has attained a high profile and developed a worldwide network of chapters. It seeks to prevent and eradicate corruption through dialogue and partnerships with business and governments.<sup>7</sup> International financial institutions such as the World Bank also began to take up the issue by acknowledging that corruption was not solely a political problem but also an economic one that had to be tackled through a multi-pronged approach (World Bank, 1997). It introduced a policy that permits investigating complaints of corruption and where sufficient grounds exist, companies and governments risk being blacklisted. Evidence of corruption could mean that the World Bank would cancel financing and/or prevent a company from taking part in contracts financed by the bank.<sup>8</sup> The confluence of these political and civil society developments indicate the extent to which the climate had changed, and provide the backdrop for what had been brewing at the OECD since 1989.

The OECD deliberations resulted in a recommendation in May 1994, a 'soft law' document that outlined the issues for the future.<sup>9</sup> The next few years saw the participants address the issues in more detail and the outcome was a further 'soft law' instrument with more prescriptive language. This revised recommendation of May 1997 provided for monitoring the implementation of the recommendation by member states. It was soon followed by the

Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (hereafter the OECD Convention).<sup>10</sup> As at June 2004, 35 countries had signed and ratified the convention, almost all had undergone a first phase of monitoring their implementing legislation, and 13 have been submitted to the second phase to assess the efficacy of their legislation in practice. The rapidity with which the OECD Convention was ratified and implemented is unprecedented in international law.

The EU and the Council of Europe have developed regional instruments which include provisions for dealing with the question of corporate legal liability for corrupt practices. The UN Convention Against Corruption, signed in December 2003 and entering into force after ratification by 30 states, also includes an article on the liability of legal persons.<sup>11</sup>

### **An overview of the provisions of the international instruments**

The aforementioned regional and international instruments establish the liability of legal persons engaging in corrupt practices. This liability may be criminal, administrative and/or civil in nature. The European instruments are relatively more detailed on the standard of liability and also identify the range of entities covered. The relevant provisions are:

1. *OECD Convention*: Article 2 on the liability of legal persons and Article 3 concerning sanctions.
2. The *European Union Second Protocol* of 19 June 1997 is drawn up on the basis of article K.3(2)(c) of the Treaty on European Union on the Fight Against Corruption Involving Officials of the European Communities or Officials of member states of the European Union (26 July 1995) to the Convention on the Protection of European Communities' Financial Interests (26 May 1997). This convention does not itself provide for the liability of legal persons but provides for criminal liability for heads of businesses. The relevant provisions of the EU 2nd Protocol are Article 1 on the definition of legal persons, Article 3 on their liability and Article 4 on sanctions (*Official Journal* C 221, 19 July 1997).
3. The *Council of Europe Criminal Law Convention on Corruption* (hereinafter CoE Convention) of 27 June 1999: Article 1 concerns the definition of legal persons, Article 18 their liability and Article 19 on sanctions.
4. The *UN Convention Against Corruption*: Article 26 defines the liability of legal persons.

#### *The definition of legal persons*

The UN Convention, the main text of the OECD Convention and its commentaries<sup>12</sup> do not include a definition of 'legal persons'. The EU 2nd Protocol and

the CoE Convention provide for the same definition and put the onus upon domestic legislation to clarify the point: ‘“Legal person” shall mean any entity having such status under the applicable national law, except for States or other public bodies in the exercise of State authority and for public international organizations’.

*Private entities* Parties to the OECD Convention<sup>13</sup> as well as EU countries include private incorporated companies as legal persons liable for bribery.

*Public entities* The exclusion of public entities in the EU and CoE instruments is clarified in the latter’s explanatory report.<sup>14</sup> ‘State or other public bodies exercising State authority, such as ministries or local government bodies as well as public international organizations such as the Council of Europe’ are expressly excluded from the scope of the definition of legal persons potentially liable for bribery. Furthermore, ‘the exception refers to the different levels of government: State, Regional or local entities exercising public powers’. This exemption is included in the legislation of most EU and other OECD countries (for example: Belgium, Greece, Italy, Mexico – which excludes all public authorities – and the USA. In France the liability is not applicable to the state but can be applied to local authorities).

The report states the rationale in the following terms:

The reason is that the responsibilities of public entities are subject to specific regulations or agreements/treaties, and in the case of public international organization, are usually embodied in administrative law. . . . A contracting State may, however, go further as to allow the imposition of criminal law or administrative law sanctions on public bodies as well.

In relation to the question of how to treat state-owned and state-controlled enterprises, the report states that the exclusion of public entities ‘is not aimed at excluding responsibility of public enterprises’. It does not, however, define a public enterprise.

#### *Standard of liability*

The OECD and UN Conventions are similar in their approaches. Article 26 of the UN Convention provides that:

1. Each State Party shall adopt such measures as may be necessary, consistent with its legal principles, to establish the liability of legal persons for participation in the offences established in accordance with this Convention.

Article 2 of the OECD Convention provides that:

Each Party shall take such measures as may be necessary, in accordance with its legal principles, to establish the liability of legal persons for the bribery of a foreign public official.

The European provisions develop a more comprehensive approach to the required standard, and there is no significant difference between Article 18 of the CoE Convention and Article 3 of the EU 2nd Protocol, which reads as follows:

1. Each Member State shall take the necessary measures to ensure that legal persons can be held liable for fraud, active corruption and money laundering committed for their benefit by any person, acting either individually or as part of an organ of the legal person, who has a leading position within the legal person, based on
  - a power of representation of the legal person, or
  - an authority to take decisions on behalf of the legal person, or
  - an authority to exercise control within the legal person,
 as well as for involvement as accessories or instigators in such fraud, active corruption or money laundering or the attempted commission of such fraud.
2. Apart from the cases already provided for in paragraph 1, each Member State shall take the necessary measures to ensure that a legal person can be held liable where the lack of supervision or control by a person referred to in paragraph 1 has made the commission of a fraud or an act of active corruption or money laundering for the benefit of that legal person by a person under its authority.
3. Liability of a legal person under paragraphs 1 and 2 shall not exclude criminal proceedings against natural persons who are perpetrators, instigators or accessories in the fraud, active corruption or money laundering.

*The ‘for the benefit of the legal person’ criterion* According to the EU and CoE provisions, and in contrast to the OECD Convention, there are certain criteria to be met in order for a legal person to be held liable for bribery offences. There are three interpretations of these criteria at the national level. The first refers to the objective of the act: committed for the benefit of, or on behalf of the legal person. The second criterion is either used cumulatively with the first, or alternatively, requires that the act be ‘in connection/relative to the business’ of the legal person. Third, in some jurisdictions the narrower criterion of the infringement of duties by the perpetrator is used. Each of these interpretations will be examined below.

1. *Of benefit to the legal person:* This is a common requirement in many jurisdictions (such as the USA, Iceland, Italy and Canada where the phrase has been interpreted to mean ‘by design, or result partly for the benefit of’). German law states that the ‘legal entity . . . has gained, or was supposed to have gained, a profit’. Other countries like Belgium, France, Norway and Poland use the term ‘on behalf of’, drawing on the language

of the CoE explanatory report. Under French law, criminal responsibility will be incurred if the acts have been committed on behalf of the company in the broadest sense, namely in the course of activities intended to advance the organisation, operation or objectives of the legal person, even where there is no resultant benefit or advantage. Greece, on the other hand, requires clear proof that the benefit is actually realised. Several States (Belgium, France, Italy, Norway and the USA) justify this causal link to differentiate the situation where the natural person is acting purely in his/her own interest or even against the interest of the legal person.

2. *In connection/relation to the business of the legal person* This requirement is found in some national laws either as an alternative (in Japan, Korea and the UK) or in addition (Canada, USA) to the benefit to the legal person mentioned above. In the UK, the criterion finds expression in case law that states that the offence be committed 'in connection with the business of the legal person' and 'within the scope of the authority of the representative'. Mexico adds the requirement that the offence must have been committed in the name or on behalf of the legal entity using means provided by the entity itself.

The distinction between (1) and (2) above is not always clear. For example, Finnish law provides that the offence has to be committed 'in [the legal person's] operations', referring to the sphere in which the crime has to occur. This is further defined such that the 'offence shall be deemed to have been committed in the operation of a corporation if the offender has acted on behalf of, or for the benefit of the corporation': in other words, back to the aim of the offence.

3. *Infringement of duties* An additional criterion in some countries (Germany, Italy, Sweden) is the requirement of infringement of duties. German law states, as an alternative to acts committed on behalf of the legal person, that 'legal entities can be liable for fines, if a "person" has committed a crime or an administrative offence by means of which duties incumbent upon the legal entity or association have been violated'. Italy refers to 'duties connected with the functions of the responsible person'. Finally, Swedish law provides that the illegal act committed when carrying out business activities 'entailed gross disregard for the special obligations associated with the business activities or to be otherwise of a serious kind'.

*The 'leading person' criterion* The 'identification' doctrine underwent most of its development within the Anglo-Saxon tradition in a series of cases reported in 1944 (*D.P.P. v. Kent & Sussex Contractors, Ltd* (1944); *R. v I.C.R.*

*Haulage Co Ltd* (1944); *Moore v I. Bresler Ltd* (1944)). The process was first set in motion by a civil liability decision of the House of Lords in 1915 in *Lennard's Carrying Co. Ltd v Asiatic Petroleum Co.* (1915). The law in the UK up until the 1940s dealt with the criminal responsibility of corporations on the basis of vicarious liability. In contrast to strict liability offences (where the company was liable for the conduct of its employees without proof of any criminal state of mind) the courts began to extend vicarious liability to cover offences where some mental element was required. The culmination of the doctrine in *Tesco Supermarkets Ltd v Natrass* (1972) established that the principle of identification applied to all offences not based on vicarious liability. The House of Lords held that a corporation could be convicted of a non-regulatory offence requiring proof of *mens rea* if the natural person who had committed the *actus reus* of the offence could be identified with the company.

This criterion has been picked up in both civil and common law systems (for example, by France and Canada). The triggering of corporate liability requires that a relationship exist between the natural and the legal person. This can include the natural person him/herself or a person under his/her authority. Where the latter case arises, the acts of the subordinate must have been made possible by 'the lack of supervision or control by a person having a leading position'. Some national laws provide a standard of liability that is based on both the EU and CoE instruments and draws together the acts committed or condoned by management and personalised management failure, originally an approach of French law (for example, Australia, Finland, France, Germany, Greece, Italy and Poland). Canada and the UK confine themselves to the 'directing mind' definition, although the Canadian approach is relatively broader since it includes the board of directors, the superintendent, the manager, or anyone else to whom the board has delegated the governing executive authority of the corporation. Canada is reportedly also considering the case where these senior company officers were aware of or wilfully blind to criminal behaviour by their subordinates.<sup>15</sup>

Many countries accept that the misdeeds of any employee can trigger corporate liability. In some instances, agents or other parties are explicitly included (for example, Denmark, Iceland, Korea, Switzerland and the USA). Whereas the USA employs a strict liability approach such that participation, acquiescence, knowledge or authorisation by higher-level employees or officers is relevant to determining the sanction, other states such as Finland, Korea, Japan, Switzerland and Sweden require that a standard of objective corporate liability be met. In Japan and Korea, this has resulted in the burden of proof for the absence of negligence being put onto the corporation. Thus in Japan the principle is based on the premise that the company did not exercise due care in the supervision or selection of an officer or employee to prevent the criminal act.



The identification concepts within corporate liability have been criticised for being overly focused on the behaviour of senior officials (Fisse, 1983a; Wells, 2001). Given the complexity of corporate structures and different modes of organisation in today's multinational enterprises, the rather simplistic 'chain of command' model based on anatomical analogy is no longer a realistic metaphor. Decision-making may be more diffuse both geographically and/or functionally, making it more realistic to use an aggregation model that looks at combined and cumulative behaviour for the purposes of corporate criminal liability (Ferguson, 1998: 14).

The critique of the identification doctrine may be particularly apposite for acts of bribery by a company. The collective and cumulative behaviour of a range of employees may provide the corporate climate in which the payment of bribes may occur. Dispersing managerial responsibilities (such as authorising purchases and payments, opening bank accounts, advising on tax arrangements, selecting and employing intermediaries as well as using under-regulated financial centres to effect payments to third parties) may make it difficult to pin the blame on a single directing mind.<sup>16</sup> For complex industries such as defence, it is not unusual to find that the buyer of the weapons system (usually a government) has insisted upon a wholly separate set of terms and conditions that are unrelated to the subject matter of the main contract. These so-called 'offset agreements' may require specialised brokers to facilitate the performance of these secondary agreements since their subject matter is outside the core business of the defence company. This scenario, with its reliance on external parties for a contract that is a *sine qua non* to the main sales agreement, creates a risk situation vulnerable to bribery. For example, a major European manufacturer of military equipment related to the authors how a (government) customer insisted upon an offset agreement involving the purchase of a large number of pork bellies. This agreement required the services of a specialised broker since it was a business area in which the company had neither knowledge nor interest, other than being a condition for an agreement being made alongside the main contract (the purchase of military equipment). In executing the offset agreement the defence company had only limited control over the specialised broker and the variety of third parties involved in this agreement. Although there were no indications of any wrongdoing by any of the parties in that particular instance, this type of agreement is neither uncommon nor unusual and may be open to misuse.

In contrast to the 'alter ego' concepts, some jurisdictions have moved towards an objective focus on the fault of the corporation itself. Under the 1995 Australian Criminal Code, a corporation can be held responsible for the acts of an agent, employee or officer, where, for crimes requiring a mental element, the 'fault element must be attributed to a body corporate that expressly, tacitly or impliedly authorised or permitted the commission of the

offence'. Authorisation or permission can be fulfilled in three ways: (a) the traditional identification liability; (b) by extending the imputation to acts and omissions of 'high managerial agents'; or (c) a 'corporate culture . . . that directed, encouraged, tolerated or led to non-compliance with the relevant provisions'. Swiss law also provides a clear example of an objective approach in its law of 1 October 2003, which states that the crime has to be as a result of 'the lack of reasonable organisational measures'.<sup>17</sup>

*The link between proceedings against natural and legal persons* The UN Convention as well as the EU and CoE instruments address the link between legal proceedings against the natural person and the legal entity. The UN Convention under Article 26 provides that: 'Such liability shall be without prejudice to the criminal liability of the natural persons who have committed the offences'. On this point the CoE is similar to the EU 2nd Protocol and states that:

3. Liability of a legal person under paragraphs 1 and 2 shall not exclude criminal proceedings against natural persons who are perpetrators, instigators of, or accessories to, the criminal offence mentioned in paragraph 1.

Both the EU and CoE explanatory reports examine only one side of this equation (the consequences of the prosecution of the legal person on the prosecution of the natural person) but not vice versa. According to the EU explanatory report, measures taken against an entity for whose benefit a fraud has been committed by a manager, shall not exclude criminal prosecution of that manager. The CoE explanatory report provides that:

In a concrete case, different spheres of liability may be established at the same time, for example the responsibility of an organ etc. separately from the liability of the legal person as a whole. Individual liability may be combined with any of these categories of liability.

The OECD Convention is silent on this issue. However, if corporate liability is meant to be 'effective, proportionate and dissuasive' it would be hard to see how national laws could permit anything less than the UN or European instruments. In fact most of the OECD Convention members do not require the conviction of the natural person in order to prosecute or convict the legal person (Canada, Denmark, Finland, France, Greece, Germany, Iceland, Italy, Japan, Korea, the Netherlands, Sweden and the UK). The OECD has criticised two countries that require the conviction of an individual before proceedings against a corporation can commence.<sup>18</sup> The conviction of a natural person is a requirement to establish the liability of a legal person in Mexico, and in Poland a final judgment against a natural person is a prerequisite to start proceedings against the legal person.

In several countries the culpability of the legal person does not preclude the individual responsibility of the natural person who intended to commit the bribery (Denmark, France (explicitly), and Greece, Japan and Mexico (implicitly)). Under Finnish law, the prosecution of the legal person may be waived if the offender is a member of the management of the legal person and has already been sentenced (subject to the size of the corporation and the share held by the offender). A similar provision exists in Norway where the proximity between the natural and legal person is such that it may not be necessary to fine the company.

### **Sanctions**

The debate about whether civil or criminal liability is appropriate for corporate misdeeds has provoked large amounts of academic literature, particularly on the subject of the range, appropriateness and effectiveness of sanctions (Coffee, 1991). The controversy relates back to philosophical notions of the aims of criminal law, the nature of criminal punishment generally, the specific sanctions available for companies, and whether blurring the distinctions between offences in torts (civil law) and criminal law somehow diminishes either field of law. In the USA, corporations themselves have engaged in efforts to influence the development of laws that would hold them accountable.<sup>19</sup>

Criminal liability is but one means of regulating corporations. Civil law, self-regulation or a combination thereof offers a panoply of possible sanctions. Traditionally, a fine is the most common sentence imposed on companies, but probation, restitution, forfeiture, confiscation and dissolution are all sentencing options that are currently available in many jurisdictions. Civil sanctions may take the form of a declaration, injunction, community service order, compensation order or a pecuniary penalty. Administrative sanctions may include infringement notices, financial penalties, publicity orders, restricting rights and revoking licences. It is also conceivable for sanctions to involve some form of arbitration or conciliation process.

The advantage of criminal sanctions most often cited is that it expresses social condemnation of the behaviour in question. Such censure may result in the loss of corporate reputation which in turn causes financial damage which is arguably the most powerful sanction that can be imposed on a corporation (Fisse, 1983b). It is of course usually the case that criminal penalties are more severe than civil penalties and fines tend to be higher. The loss of reputation for the company, and the deprivation of liberty for corporate management means that criminal penalties are perceived as harsher.

Several commentators have identified the disadvantages of criminal sanctions for corporations: companies cannot be incarcerated and fines are 'water off a duck's back' with few consequences for management (Coffee, 1981).

The ‘deterrence trap’ means that the fine is limited by the wealth of the corporate offender: if a corporation is made bankrupt or is already so then fines are meaningless (*ibid.*: 407). Members of the OECD Convention who have employed this approach have been criticised. Poland, for example, makes sentencing dependent on the last year’s tax return, which immediately benefits poor earners and newcomers.<sup>20</sup> Denmark and Portugal have adopted the ‘day fine system’ which may be a more effective way of fining a company.

Moral condemnation cannot attach to an inanimate object like a company. The rehabilitative effect of criminal sanctions is also lost – sending management to prison may not necessarily contribute to changes in corporate structure to prevent future repetition of the illegal behaviour. Criminal sanctions which focus on punishment rather than cooperation promotes disharmony that deters self-regulation and puts enforcement agencies and businesses on an adversarial footing.

The EU instrument provision on sanctions is set out in Article 4 and in relation to legal entities states:

1. Each member state shall take the necessary measures to ensure that a legal person held liable pursuant to Article 3(1) is punishable by effective, proportionate and dissuasive sanctions, which shall include criminal or non-criminal fines and may include other sanctions such as:
  - (a) exclusion from entitlement to public benefits or aid;
  - (b) temporary or permanent disqualification from the practice of commercial activities;
  - (c) placing under judicial supervision;
  - (d) a judicial winding-up order.

The CoE instrument and the UN Convention do not identify the alternative sanctions listed above but in identical language mandate for ‘effective, proportionate and dissuasive criminal or non-criminal sanctions, including monetary sanctions’.

The OECD Convention has also adopted this phrase. However, Article 3(1) applicable to both natural and legal persons envisages criminal penalties whereas Article 3(2) allows for the possible substitution of non-criminal sanctions against corporations. Confiscation and seizure are foreseen for both legal and natural persons in Article 3(3). Finally, Article 3(4) considers the ‘imposition of additional civil or administrative sanctions’ for both natural and legal persons. The OECD Commentary refers to the list of EU sanctions listed above as examples of sanctions beyond fines.

Countries have taken a mix of approaches in applying these standards at the national level. France, Italy (in para-criminal form) and Portugal served as models for the European instruments<sup>21</sup> and therefore have similar sanctions. Many others have followed suit with respect to exclusion from public procurement (the aforementioned countries as well as Austria, Belgium, Brazil,

France, Germany (partially), Hungary, Poland, Spain, Switzerland and the USA). Several countries have attempted to address the issue of restitution (for example, the Netherlands), although the USA has taken the position that fines act as a stronger deterrent than seizure and that the former should take precedence. Italy's law has a built-in incentive with the possibility of substantially reduced fines if credible rehabilitative efforts are made within the company.

The notion of rewarding conduct is an approach promulgated by the US Sentencing Guidelines. The guidelines envisage a three-stage process by which courts set fines for convicted corporate offenders. The basis of the fine reflects the gravity of the offence. Seriousness is assessed against the pecuniary gain to the offender; the pecuniary loss to the victim (and whether it was caused intentionally, knowingly or recklessly); and the intrinsic wrongfulness of the offence according to a statutory table. The court will then multiply the fine by a numerical factor that reflects culpability. This gives a recommended fine range from which the court will determine the amount due unless departure therefrom is justifiable. In calculating 'culpability' the court will have regard to factors that affect the position negatively and positively. The most important mitigating factor is establishing a generally effective compliance programme to prevent and detect violations and reporting possible offences to appropriate authorities before they learn of it from another source. Developing internal codes of compliance to address anti-corruption issues are gaining currency, and not only in the USA. Once this initial step has been taken, companies may develop the courage to address the issue more widely with their competitors.

### **Alternative measures**

Corporations are an omnipresent feature of society, several wield more power than states (Jorgensen, 2000: 174), and the continuing technological revolution keeps them globally active. It is not unreasonable to 'impute to corporations social duties including the duty not to offend all relevant parts of the criminal law'.<sup>22</sup> Notions of corporate responsibility continue to develop. The UN Global Compact,<sup>23</sup> originally conceived as a means for global businesses to address human rights, labour and environmental issues, has recently added a new tenth principle stating that 'business should work against corruption in all its forms, including extortion and bribery'. The UN noted the importance of 'developing sectoral initiatives' in its report on the consultation process. Certain industry groups have already embarked upon this course in recognition that this could be a useful way to 'level the playing field' when competing for international business.

### *Developing industry standards*

The Engineering and Construction Industry Anti-Bribery Principles<sup>24</sup> were concluded under the auspices of the World Economic Forum with the Basel

Institute on Governance and Transparency International acting as joint facilitators. This is an example of what can be achieved by rival companies who want to take a proactive approach in tackling transnational bribery. The methodology used to develop these principles built upon that developed by 12 major private banks known as the Wolfsberg Group. Their Principles on Anti-Money Laundering<sup>25</sup> stand out as an example of what can be achieved by major players who are normally rivals in a highly competitive market. They were developed by the banks together with civil society over a relatively short period of time. Continually refined and added to, their website contains a range of statements and guidance documents that this group has agreed to implement on a global basis. Interestingly, the principles have been adopted by other banks that are not formally members of the Wolfsberg Group and used for compliance training purposes. Unlike the engineering and construction industry principles, the Wolfsberg Principles do not deal with the issues of bribery and corruption directly. The integrity standards developed by the International Federation of Consulting Engineers (FIDIC)<sup>26</sup> directed at reducing corruption in aid-funded public procurement from the private sector are a similarly dynamic set of principles that commit the industry to a standard of behaviour from which it is difficult to deviate.

Industry standards are gradually gaining ground with new efforts discernible in various sectors, such as oil and gas and its supply chain, power, mining and defence. All are either contemplating the idea of collaboration or in the process of discussing the consequences of revealing their innermost secrets regarding the issue of bribery in international business transactions. Developing a common solution to commercially sensitive issues such as agents' contracts might prevent the use of agents as a conduit for bribery. Their motivation is the changing international legal framework, the costs of competitive advantage obtained through corruption and the attendant risks to corporate reputation in the event of exposure. Self-regulation through industry standards will be increasingly deployed in a variety of industries in the future.

#### *Methodology of industry standards*

The obstacles to bringing together rival companies to address these issues are significant. The whole process is very delicate if subsisting bribery exists within the particular industry. It is essential that the composition of the group is of the right balance – this means major companies in the sector in question that have a significant world market share, are active internationally and for whom the importance of a level playing field and preserving reputations are of economic significance. Timing is also of the essence: recognising and seizing the moment when an individual company has taken – or is well on the way to taking – the decision to confront the problem of corruption directly.

The way forward is a frank and forthright approach. The optimal size of the

group is in the region of 10–12 companies represented by the top echelons of management, thereby maximising their decision-making capacity. This lends momentum and weight to the whole process and is of crucial importance to the procedure. Since this process is undoubtedly a novel experience for most of the participants and may be outside their usual business experience, the use of external facilitators nurturing the process can be invaluable. How to control and monitor the implementation of the resulting standards needs to be considered for the longer term, either by adapting the peer review principle or through external agencies. After having formulated an industry standard the participants might either want to keep it ‘secret’ and monitor each other or they may want to make their document public, promote its implementation and encourage the participation of others. The latter may involve other companies directly (by ‘subscription’ as the Wolfsberg process was in the initial phase) or indirectly via regulators (its current state). When and how other companies within industry can join the ‘club’ must also be considered.

The advantages of industry standards are the speed and flexibility with which they can be created and their adaptation to specific aspects of corruption facing any given sector of industry. The acknowledgement by major companies that they are confronting issues related to bribery will, in turn, bolster government efforts to tackle the issues, making it harder for anyone to avoid their judicial, legislative or legal responsibilities. The disadvantage of industry standards relates to monitoring and how best to achieve it. Deferring this question affects the credibility of the process. This question falls to regulators for the Wolfsberg Group and remains unresolved for the engineering and construction group as a self-regulatory tool industry standards act as a dynamic spur to policy-makers and can achieve a complementary status to existing legislation.

## **Conclusion**

The behaviour of corporations affects all our lives. The degree of economic and political influence they wield varies according to several factors, not least size and whether they engage in international activities. Those companies that operate on a transnational basis may have been less easily held to account for corruption in the past. This position has changed over the last two decades, and not only in legal terms. Corporations can no longer regard bribery as a legitimate, tax deductible means to oil the wheels of business. Corruption carries a risk that is explicit in legal provisions and implicit in economic terms through potential damage to reputation (adverse publicity, boycotting and blacklisting) as well as criminal and civil sanctions. These developments have occurred at voluntary and regulatory levels – through compliance codes which aim to moderate corporate behaviour both internally and more broadly through industry-wide initiatives and international and domestic legal changes which affect

the operating landscape. Both of these approaches put pressures on business, but is one route preferable or can they be reconciled?

Although companies may currently be wrestling with the question as to where the boundaries of, for example, their human rights obligations should be set,<sup>27</sup> there seems to be a steady momentum to ensure that corporate social responsibility will continue to expand. This has been clearly demonstrated in relation to corruption with the UN Global Compact. Self-regulatory approaches are traditionally regarded as being business orientated, risk based, flexible and adaptable to the complexities of the organisational structures of modern transnational corporations. On the other hand, the legal implications of voluntary initiatives can be problematic in some jurisdictions, most notably the USA.

On the regulatory side, the Phase Two country reviews of the implementation of anti-bribery laws under the OECD Convention are currently being conducted by the OECD Working Group on Bribery. The effectiveness of policies and procedures with respect to the prosecution of corporations suspected of paying bribes to obtain or retain business in their international transactions are being carefully assessed. The adequacy of sanctions, the degree of prosecutorial discretion and the vigour of preventive measures are taken into account before the country assessment is published on the internet. An international standard is emerging which may prompt the OECD Working Group to revisit the issue of 'effective, proportionate and dissuasive' sanctions. The working group will continue to use 'peer pressure' to raise the standards of corporate behaviour to ensure a more level playing field for all companies competing in the global market. These developments will continue to gain momentum with the entry into force of the UN Convention, which will subsequently harmonise laws and bring new challenges for legal entities with respect to asset recovery.

Can the regulatory and voluntary approaches be reconciled when considering corporate liability for corruption? A cumulative approach is called for if the aim of making corporations liable for corruption is to deter and reduce bribery within a larger effort to tackle the pernicious effects of corruption in 'southern' countries' governments, international organisations, civil society and business need to act in a concerted manner. In practice this means not just waving the stick of criminal law sanctions but also producing the carrots to bring about real changes in corporate behaviour on a voluntary basis. Hence codes of practice constitute a valuable output. Business is calling for a credible and effective form of international 'helpline' to which they can turn for guidance on how to proceed when confronted with extortive demands. Although this idea was initially mooted by the ICC several years ago, it has gained new currency and would be a welcome addition to the array of approaches that are needed to make inroads into the problem of corruption.



## Notes

1. Press reports on Statoil by Kambiz Foroohar on [www.Bloomberg.com](http://www.Bloomberg.com). The authors thank him and Karina A. Litvack of ISIS Asset Management for information and interpretation of the Statoil share price.
2. For the 'red flags' that alert a company to risks when engaging an agent, see Davies (2003).
3. See Iranian news reports from Shargh quoted on [www.Bloomberg.com](http://www.Bloomberg.com), 8 April 2004, by Kambiz Foroohar and Marc Wolfsberger.
4. For the initiatives of financial intermediaries, see the statements and principles issued by the Wolfsberg Group of private banks: [www.Wolfsberg-Principles.com](http://www.Wolfsberg-Principles.com), and Chaim Even-Zohar, *Diamond Industry Strategies to Combat Money Laundering and the Financing of Terrorism* (ABN-Amro, The Hague, 2004).
5. Foreign Corrupt Practices Act 1977 (US) amended 1988, USC Title 15, chap. 2B.
6. See [www.iccwbo.org](http://www.iccwbo.org).
7. See [www.transparency.org](http://www.transparency.org).
8. See, for example, the current case of the Canadian company Acres International, found guilty by a national court in 2002 of paying bribes to a public official in relation to the Lesotho Highland Water Project.
9. Recommendation of the Council on Bribery in *International Business Transactions*, 27 May 1994.
10. OECD Convention on Combating Bribery of Foreign Public Officials in *International Business Transactions* 17 December 1997 (signed December 1997 and entered into force 15 February 1999), [www.oecd.org/document/21/0,2340,en\\_2649\\_37447\\_2017813\\_1\\_1\\_1\\_37447,00.html](http://www.oecd.org/document/21/0,2340,en_2649_37447_2017813_1_1_1_37447,00.html).
11. Over 100 countries have signed the UN Convention, and at May 2004, two countries had deposited their ratification documents (Kenya and Sri Lanka).
12. See further the Commentaries on the OECD Convention on Combating Bribery of Foreign Public Officials in *International Business Transactions*.
13. Membership of the OECD Convention includes non-OECD countries: Argentina, Brazil, Bulgaria, Chile, Estonia and Slovenia.
14. The Explanatory Report is located at *Official Journal C* 091, 31 March 1999.
15. See the Phase 1 and Phase 2 Reports on Canada conducted by the OECD Working Group on Bribery, [www.oecd.org/dataoecd/20/51/31643074.pdf](http://www.oecd.org/dataoecd/20/51/31643074.pdf).
16. See OECD Working Group on Bribery Phase 2 Review of Bulgaria at p. 26, [www.oecd.org/dataoecd/8/19/2790505.pdf](http://www.oecd.org/dataoecd/8/19/2790505.pdf).
17. Pieth (2003). See also Phase 1 examination of Switzerland by the OECD Working Group on Bribery, [www.oecd.org/dataoecd/16/45/2390117.pdf](http://www.oecd.org/dataoecd/16/45/2390117.pdf).
18. See OECD Working Group on Bribery Phase 1 reports, [www.oecd.org/dataoecd/15/30/2388858.pdf](http://www.oecd.org/dataoecd/15/30/2388858.pdf) and [www.oecd.org/dataoecd/39/45/2020928.pdf](http://www.oecd.org/dataoecd/39/45/2020928.pdf). The critique was upheld by the Working Group in the Phase 2 evaluation in June 2004.
19. See Dobbin (1998: 43) for an account of the steps taken by General Electric to 'derail' the US corporate Sentencing Guidelines.
20. OECD Working Group on Bribery Phase 1 Review of Poland, [www.oecd.org/dataoecd/39/45/2020928.pdf](http://www.oecd.org/dataoecd/39/45/2020928.pdf).
21. Council of Europe Committee of Ministers Recd. (88) 18 adopted 20 October 1988.
22. Per Turner J. in *P&O European Ferries (Dover) Ltd* (1991) 72, 83, quoted in Pinto and Evans (2003: 5).
23. See further, [www.unglobalcompact.org/](http://www.unglobalcompact.org/).
24. Business Principles for Countering Bribery in the Engineering & Construction Industry, [www.skanska.com/files/EC%20Principles%202012.23.03.pdf](http://www.skanska.com/files/EC%20Principles%202012.23.03.pdf). See also Aiolfi (2004).
25. See [www.wolfsberg-principles.com/](http://www.wolfsberg-principles.com/).
26. See [www.fidic.org](http://www.fidic.org).
27. See [www.novartisfoundation.com/en/articles/human/symposium\\_human\\_rights/speeches/speech\\_vasella.htm](http://www.novartisfoundation.com/en/articles/human/symposium_human_rights/speeches/speech_vasella.htm).

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# Index

---

- A7D brake fraud 184–5  
*A.-G.’s Reference (No. 2 of 1999)* 197, 199, 207  
Abbott, C.C. 161  
*Abdullahi v Pfizer Inc* 139  
*Abebe-Ira & Ors v Negewo* 133  
Abeltshauser, T.E. 65  
*Aberdeen Railway Co v Blaikie Bros* 78, 79, 387  
accountability 149  
AccountAbility 241, 244, 245, 249  
Acquaah-Gaisie, G. 127  
*actus reus* 126, 140, 195, 201  
*Adams v Cape Industries plc* 111, 132  
Addo, M. 290  
agency approach 114  
agency costs 13  
agency problems, and company law 106–7  
agency relationships 35  
Agent Orange 169  
aggregation 153  
Ahn, B. 28  
*Airbus Industries GIE v Patel et al.* 131  
Aitken, B. 324  
*Al-Adsani v Kuwait* 135  
*Al-Adsani v UK* 135  
Alcock, A. 88  
Alien Tort Claims Act 133–41  
*Atomang v Freeport McMoRan Inc* 139  
Alsop, R. 172  
alter ego concept 151–2, 403  
American Law Institute 165  
    Model Penal Code (MPC) 164  
American Sugar Refining Company 163  
*amicus curiae* 135, 136, 137  
Amnesty International 288, 289, 290, 295, 391  
*The Amoco Cadiz* 128  
Anderson, M. 143  
Anderson, S. 375  
Annan, K. 379  
‘anomie’ 178, 180  
anthropomorphic approach 151  
apartheid 140  
*Aquinda v Texaco Inc* 139  
Arbouw, J. 30  
Argentinian Public Offers of Securities Act 64  
Arrowsmith, S. 113, 114  
Arthur Anderson 167–9  
asset partitioning 13  
association theory 11  
*Attorney General for Hong Kong v Reid* 80  
attribution  
    doctrine of 194–214  
        Canada 199–205  
        history 194–5  
        UK, common law 195–9  
Australia 132  
    CLERP 9 26  
    corporate governance developments 44–7  
    ecological sustainable development (ESD) 216  
    employees 126  
    *forum non conveniens* 142  
    HIH report, and corporate governance 46  
    HIH Royal Commission 26  
    negligence 126  
    Parliamentary Inquiry into the Code of Conduct Bill 293  
    Ramsay Report 26  
Australian Criminal Code Act 153, 154, 403  
Australian Institute of Company Directors 22  
Australian Securities and Investments Commission (ASIC) 36  
Australian Stock Exchange (ASX) Corporate Governance Council (CGC) corporate principles 26, 46–7  
autonomy 149

- autopoietic analysis 13–14  
 Awareness and Preparedness for  
     Emergencies at the Local Level  
     (APELL), UNEP 367–8  
 Ayres, I. 172
- Baade, H.W. 329  
 Bakan, J. 43, 235, 380  
 balancing of interests test 142  
*Banco Nacional de Cuba v Sabbatino* 129  
 Bank of New England 165  
*Bano v Union Carbide Corp* 139  
 Barlow, D.E. 165  
 Baron, P. 28  
 Barstow, G. 167  
 Bartos, S. 28  
 Batteries Directive, European Union  
     (EU) 219  
 Bauman, Z. 182, 183  
 Baxt, B. 43–4  
*Bazley v Curry* 127  
 Beale, H.G. 110  
 Belgium, social report 330  
*Bell v Lever Brothers Ltd* 81  
 Bendell, J. 380, 381, 382  
 Benner, K.-D. 166  
*Berea College v Kentucky* 163  
 Bergkamp, L. 336, 339, 346, 347  
 Bergman, D. 178, 187, 188, 191  
 Berle, A.A. 5, 12, 74  
 Berman, J. 331  
 Berns, S. 28  
 Betlem, G. 129, 337, 339  
 B.F. Goodrich Co 184–5  
 Bhopal disaster 254  
 BHP-Billiton 27  
*Bhullar v Bhullar* 79  
*Bi v Union Carbide Chemicals &  
     Plastics Co* 131  
*Bigio v Coca-Cola Co.* 134  
 Bill C-45, Canada 195, 197, 201, 202–5,  
     210  
 biodiversity 336, 374  
 Black, D.S. 63, 64  
 Black, J. 273  
 Blair, M. 20, 37, 39, 75  
 Blair, T. 237  
 blame  
     concepts of 148–50  
     and fault 149–50
- Blumberg, P.I. 128, 162  
*Blyth v Birmingham Waterworks Co* 389  
 board effectiveness 32–3  
 board structure 30–31, 35, 36–7  
*Boardman & Anor v Phipps* 79  
 Boardman Jr., F.W. 163  
 boardroom analysis 29  
*Bodner v Banque Paribas* 143  
 BOVESPA (Brazilian Stock Exchange)  
     249  
*Bowoto v Chevron* 134  
 Box, S. 177, 178, 179, 180, 182  
 Boyd, C. 188, 189  
 Brademas, J. 397  
 Bradley, M. 22, 30, 36, 37, 59  
*Brady & Anor v Brady & Anor* 75, 117  
 Braithwaite, J. 28, 152, 172  
 Brandeis, L. 162  
 BRASS 223  
 Bratton, W.W. 12  
*Brazilian Rubber Plantations and  
     Estates Ltd* 82  
 Brett, B. 325  
 Brickey, K.F. 164, 166  
*Briggs v James Hardie & Co* 128  
*British Midland Tool Ltd v Midland  
     International Tooling Ltd* 81  
 Brock, J. 263  
 Brown & Root 254  
 Brundtland Report 216  
 Bruno, K. 379  
 Brussels Convention on Jurisdiction and  
     the Enforcement of Judgments in  
     Civil and Commercial Matters 129  
 ‘brute reality’ 5, 6  
 Buffett, W. 171  
 Bunn, I. 329  
*Burland v Earle* 83  
*Bushell v Faith* 114  
 business case, boundaries 362–4  
 business decisions 66  
 Business and Human Rights Resource  
     Centre 289  
 business judgement rule 67  
*Business Week* 328
- Caldecote, Viscount 195, 197  
 Calder, F. 389  
 Calfee, J.E. 58  
 Campbell, R. 134

- Canada  
 attribution, doctrine of 199–205  
 Bill C-45 195, 197, 201, 202–5, 210  
   and crimes of negligence 204  
   definition of ‘senior officer’ 205–6  
   and positive change 205–9  
 corporate liability rules 154  
 ‘directing mind’ 198  
 Westray mine disaster 202  
*Canadian Aero Service v O’Malley* 79  
*Canadian Dredge & Dock Co. v The Queen* 196, 198, 200, 201, 202, 204, 205, 206  
*Carmichael v United Technologies Corp* 140  
 Carroll, B. 228  
 Carter, C. 29, 30  
*Case 21/76 Handelskwekerij GJ Bier BV v Mines de potasse d’Alsace SA* 130  
*Case concerning the Arrest Warrant of 11 April 2002 (Democratic Republic of Congo v Belgium)* 136  
 Cavanagh, J. 375  
 Centre for Corporate Accountability (CCA) 189  
*Certain Phosphate Lands in Nauru (Nauru v Australia)* 132  
 Chalmers, D.M. 162  
 Chandler, G. 288, 290  
 Chapman, B. 59  
*Charan Lal Sahu & Ors v Union of India* 131  
 Cheffins, B.R. 105  
 children  
   and codes of conduct 305–7  
   employment of 286, 287, 310  
   in the textile industry 302–15  
 Chile 320  
 China, and the WTO 29  
 City Code on Takeovers and Mergers 76  
 civil liability 127  
 Clark, G.A. 162  
 Clay, T.R. 167  
 cleaner production strategy 351–2, 353  
 CLERP 9, Australia 26  
 climate change 374–5  
 Coase, R. 12, 14  
 codes of conduct 304–9, 327  
   and children 305–7  
   and women 307–9  
 Coffee, J.C. 155, 160, 405  
 Cohen Committee Report 115  
 Cole, S. 23, 25, 35  
 Colley Jr., J. 28  
 Combined Code on Corporate Governance 76, 250  
 Combined Code of the Financial Reporting Council, UK 26  
*Commission of the European Communities v Portugal, France, Belgium* 114  
 Commission on Human Rights 295  
 companies, structure of 73–4, 75  
 Companies Act 1980 (Aus) 92  
 Companies Act 1985 (UK) 75, 78, 83, 89, 91, 92, 94, 96, 100, 110–11, 388  
*Companies (Tables A to F) Regulations, 1985* 82  
 company 8  
   definition of 7  
   as a term for real entity 10  
 company culture theory 150  
 Company Directors Disqualification Act 1986 (UK) 84, 118, 119  
 Company Law Reform White Paper 101  
 Company Law Review, UK 8, 73, 75, 88, 238  
   and employees 93–5  
 Comprehensive Environmental Response Compensation and Liability Act, US 127  
 concession theory 11, 14, 74  
 Confederation of British Industry (CBI) 191, 373  
 Conger, J. 29  
*Connelly v RTZ Corp plc* 132  
 contractual theory 11  
 Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, OECD 398  
 Convention of the Council of Europe on the Protection of the Environment through Criminal Law 340–42  
*Cook v Deeks* 79  
 Cooper, K. 299  
 Cooter, R. 64  
 Corbett, G. 191

- corporate accountability
  - definition 372
  - emergence of movement 382–3
  - EU legislation 386–7
  - foreign direct liability 388–9
  - international frameworks 383–6
  - and NGOs 372–94
  - UK legislation 287–90
  - and whistleblowers 254–70
- corporate capacity 114–15
- corporate citizenship, and the Global Compact 355–7
- corporate collapses 20–21, 25–6, 48
- corporate criminal liability, in the United States 159–76
  - corporate corruption, Enron/Anderson case 167–9
  - due diligence cases 165
  - enforcement patterns 163–6
  - penalties 166
  - railroads 162–3
  - respondeat superior* standard 164–5
  - Sarbanes–Oxley Act 169–71
- corporate criminal responsibility 147–58
  - accountability principle 149
  - aggregation 153
  - alter ego (identification theory) 151–2
  - autonomy 149
  - common law jurisdiction 154
  - concepts of blame 148–50
  - holistic theories 152–3
  - manslaughter 154–5
  - punishing corporations 156–7
  - rationality 149
  - reactive fault 153–4
  - responsibility attribution 150–54
  - systems theory 153
  - vicarious liability 150–51, 152
- corporate deviance 179
- corporate environmental liability, EU 334–48
- corporate environmental responsibility 350–55
- corporate environmental and social responsibility (CESR) 349
- corporate governance
  - and alignment 25
  - Anglo-Saxon model 36
  - Australian developments 44–7
  - and Australian HIH report 46
  - concept of 21–2, 40
  - contemporary literature 28–35
  - and corporate performance 34–5
  - definition of 23
  - dimensions of 23
  - European model 36
  - formal and informal factors 33
  - models 29–30, 35–8
  - in the private sector 22
  - risk management in 24–5
  - roles and responsibilities in 24
  - transnational regulatory issues 27–8, 30
- Corporate Governance International 44
- corporate governance reforms 20–21, 25–8
  - Australia 26
  - USA 26
- corporate groups, rules on 111
- ‘corporate killing’ 199
- corporate law, as standard terms 13
- corporate law theory 3
  - and corporate social responsibility 16–17
- corporate liability, and corruption 395–412
  - ‘for the benefit of the legal person’ criterion 400–401
  - industry standards 407–9
  - ‘leading person’ criterion 401–2
  - sanctions 405–9
- corporate manslaughter 154–5, 177–93
  - directors’ safety responsibilities 191
  - duty of care 190
  - ‘identification’ doctrine 185, 187
  - legal position in England and Wales 185–9
  - and moral indifference 181–5
  - policy reform in England and Wales 189–91
  - political economy of 178–81
  - UK 154–5
- Corporate Manslaughter Bill, US 155
- corporate ownership, and corporate responsibility 35
- corporate performance 20, 21
  - and corporate governance 34–5
  - non-financial 42–3
- corporate personality approach 111

- corporate power
  - and the media 380–81
  - rise of 380–82
- corporate punishment 156–7
- corporate reporting, and corporate responsibility 239–40
- corporate responsibility
  - civil regulation 248
  - and corporate ownership 35
  - and corporate reporting 239–40
  - and globalisation 246–7
  - international agreements and legally binding regulation 250–51
  - and James Hardie Industries 44–5
  - and legal responsibility 235–53
  - peer-based norms 248–9
  - ‘principle based’ 245–6
  - and shareholders 241
  - ‘single issue’ 242–3
  - towards shareholders and stakeholders 38–44
  - under the law of torts 125–46
  - and United Nations Environmental Programme 349–71
  - USA 236
- Corporate Responsibility Coalition (CORE) 239
  - proposals on corporate accountability 387–9
- corporate social responsibility 41–3, 226, 227, 319, 326–7, 331, 349, 355, 363, 373
  - and corporate law theory 16–17
  - and voluntary initiatives 378–80
  - within the EU 345–7
- corporation 3, 10–11
  - ‘directing mind’ 195–6
  - as fiction 10–11
  - as a gestalt entity 12
  - meaning of 5
  - theories of 10–16
  - use of term 10
- corporations
  - application of international legal standards to 142
  - and criminal law 147–8
- Corrupt Practices Act 1883 396
- corruption, and corporate liability 167–9, 395–412
- Council of Europe 335
- Criminal Law Convention on Corruption 398
- Council Framework Decision on the Protection of Environmental Law through Criminal Law 344–5
- Cox, E. 40
- Coyle, M. 143
- Crainger, S. 188
- Cranworth, Lord 78
- Craswell, R. 58
- criminal law, and corporations 147–8
- Criterion Properties plc v Stratford Properties LLC* 78
- Crown Prosecution Service 178
- cross-channel ferries 188–9
- Cullen, F.T. 163
- cultural attitudes 229–30
- Curragh Resources Inc. 292
- Currency Transaction Report Act 165
- Dagi & Ors v BHP Minerals Pty and Ok Tedi Mining Ltd* 129
- Dalton, D.R. 4, 16
- Daniels v Daniels* 84
- Dartmouth College v Woodward* 7, 162
- Davies, K.G. 159
- Davies, P.L. 94
- Davis, C. 191
- De Bow, M.E. 88
- Deakin, S. 42
- Dean, J. 101
- ‘defensive asset partitioning’ 108
- delegated management 35
- demandable diligence standard 66
- Demsetz, H. 59
- Denning, Lord Justice 185, 196
- Department for Environment, Food and Rural Affairs (DEFRA) 21, 217, 221
- Department of Trade and Industry 330, 377
- Dershowitz, A.M. 159
- Deutsch v Turner Corp* 134
- Dewey, J. 12
- DHN Food Distributors Ltd v Tower Hamlets London Borough Council* 111
- Dicey, A.V. 4–5
- Dickerson, C.M. 307
- Dilhorne, Viscount 185, 196

- Diller, J. 324, 327  
 DiMento, J.F.C. 164, 171, 173  
 Dine, J. 73  
 Diokno-Pascual, M.T. 299  
 Diplock, Lord 200  
 ‘directing mind’, of the corporation 195–6, 198, 202, 208  
*Director of Public Prosecutions v Kent and Sussex Contractors Limited* 195  
 directors, independence of 28, 31, 67  
 directors’ duties 54–72  
   bribes 80  
   competing directorships 80–81  
   content of 82  
   delegation 82  
   duty of care 54, 57, 59, 388  
   duty of diligence 55, 59  
   ‘duty of independence’ 67  
   duty of loyalty 54, 55, 57, 60–61, 62–3, 95  
     implications for employees 95–6  
   duty not to fetter discretion 77  
   duty to act in good faith 77, 79  
   duty to exercise care and skill 81, 84  
   duty to exercise power for a proper purpose 78  
   duty of transparency 63–4  
   enforcing 82–4  
   fiduciary duties 76, 77, 83–4, 116  
   historical evolution 76  
   no conflict rule 78–81, 83  
   obligations to employees 89–90  
   reforms to law 84–5  
   ‘shareholder argument’ 73  
   ‘stakeholder argument’ 73  
   and supplier protection 115–17  
   UK 73–87  
 directors’ liability 54–72, 56–9  
   breach incentives 6–7  
   and error risk 58–9  
   excesses of litigation 68  
   excesses of sanction 68–9  
   exemption clauses 61  
   and firm’s value 56  
   joint and several liability rule 68  
   liability for disloyalty 59–65  
   for negligence 65–9  
   and over-compliance 59  
   personal liability 43–4  
     safety responsibilities 191  
     subjective extension of liability 62  
     and uncertainty 58–9  
 Dirk, W. 324  
 Disability Discrimination Act 242  
 disclosure requirements 110  
 disgorgement 64–5  
 disloyalty 60  
   burden of proof for 64  
   liability for 59–65  
 Dodd, E.M. 88  
 Dodd Jr., E.M. 74  
*Doe v Islamic Salvation Front* 137  
 domicile approach 130  
 Donaldson, T. 29, 42  
*Dovey v Cory* 82  
*Dow Chemical Co v Castro Alfaro* 131, 134  
 Dow Chemical Company 169  
*D.P.P. v Kent & Sussex Contractors, Ltd* 401  
*Draft Companies Bill* 73, 76, 77, 80, 81, 82  
 Drahos, P. 28  
*Drincqbier v Wood* 82  
 Drury, R.R. 110  
 Dugdale, A. 110  
 Dunfee, T. 29, 42  
 Dunlop, I. 22  
 Durkheim, E. 178  
 Dutch Corporate Governance Code (Tabaksblat Code) 271–85  
   aims of 278–9  
   compliance and enforcement 279  
   history 276–7  
   as interactive legislation 281–3  
   as self-regulation 280–81  
 Eade, D. 299  
 Earthrights International 139  
 Easterbrook, F.H. 57, 61, 64  
*Eastman Kodak Company v Kavlin* 140  
 EC Regulation 44/2001 129  
 ecological sustainable development (ESD), Australia 216  
 Economic and Social Council Resolution 1985/72 141  
 Economic and Social Research Council (ESRC) 216  
 Edwards, G.E. 140



- Edwards v Halliwell* 83  
 Eisenberg, M.A. 14, 66  
 Elkington, J. 29, 41, 350  
 Elkins Act 163  
 employees 14, 75, 267, 402  
     Australia 126  
     and Company Law Review, UK 93–5  
     death toll 177  
     and the duty of loyalty 95–6  
     UK 88–104  
 enforcement substitutability 57–8  
 Engels 180  
 Engineering and Construction Industry  
     Anti-Bribery Principles 407–8  
 English Court of Appeal (Criminal  
     Division) 199  
 ‘enlightened shareholder value’ approach  
     75, 94, 98  
 Enron/Anderson case 167–9  
 enterprise 3–4, 5–6, 9, 15  
     and legal entity 7  
 entities *see* legal entity; real entity  
 Environment Act 1995 219  
 Environment Agency 229  
     National Waste Production Survey  
     (1998) 217–18  
 Environment Protection Act 1990 219  
 environmental campaigning 243  
 environmental criminal liability 340–45  
     Convention of the Council of Europe  
     on the Protection of the  
     Environment through Criminal  
     Law 340–42  
     Council Framework Decision on the  
     Protection of Environmental Law  
     through Criminal Law 344–5  
     European Commission proposal for a  
     directive on protection of the  
     environment through criminal law  
     342–4  
 environmental harm, liability for 362–3  
 environmental legislation, and SMEs  
     229  
 environmental liability directive  
     defences 338–9  
     EU 334–6  
     liability rules 338  
     nature of regime and temporal  
     application 339  
     scope and purpose 336–7  
 Environmental Protection Act 1990  
     (EPA) 215  
 environmental uncertainty 179  
 Ermann, D.M. 163  
*Estate of Rodriguez v Drummond Co.*  
     134  
 Estey, Justice 200, 204  
 ethical consumerism 376–8  
*Ethical Consumerism Report* 376  
 Ethical Trading Initiative (ETI) 241,  
     248, 307  
 European Commission 336, 342, 346  
     proposal for a directive on protection  
     of the environment through  
     criminal law 342–4  
     sanctions and corporate liability  
     344  
 European Communities Act 1972 220  
 European Community, Sixth  
     Environmental Action Programme  
     334  
 European Council 344  
 European Court of Justice 114, 130  
 European Framework for Corporate  
     Social Responsibility (Green paper)  
     346  
 European Parliament 346  
 European Union (EU) 148  
     Batteries Directive 219  
     corporate environmental liability  
     334–48  
     corporate social responsibility 345–7  
     Directive on Integrated Pollution  
     Prevention and Control 219  
     Directive on Waste Electrical and  
     Electronic Equipment 219  
     environmental liability directive  
     334–6  
     Landfill Directive 219  
     legislation on corporate accountability  
     386–7  
     Packaging Directive 219  
     Second Protocol 398  
     Sixth Environmental Action  
     Programme 217  
     Waste Framework Directive 218  
     Waste Incineration Directive 219  
 European Waste Catalogue (EWC) 221  
 Evans, G. 288  
*Evans v Brunner, Mond & Co. Ltd* 116

- executive remuneration 27  
 external outcomes 4, 5  
 Extractive Industries Transparency Initiative 297, 298
- Facia Footwear (in administration) v Hincliffe* 117  
 Factory Acts 180  
*Fairtrade* 376  
 False Claims Act 259–60  
 Farrar, J. 28  
 Farrell, R. 180  
 Fatino, J.F. 165  
 fault, and blame 149–50  
 Faure, M. 343  
 Federal Court Claims Act 135  
 Federal Election Campaign Act, US 396  
 feminist theory 74  
 Ferguson, G. 403  
 fiction, corporation/firm as 10–11, 14  
 Fien, C.M. 197  
*Filartiga v Pena-Irala* 133, 138, 139  
 financial services 365  
*Financial Times* 249, 358  
 Finkelstein, S. 29  
 Fischel, D.R. 57, 59, 61, 64, 66  
 Fishel, D. 28, 29  
 Fisse, B. 126, 152, 403, 405  
 Fleming, J.G. 126  
*Flores v Southern Peru Copper Corporation* 139  
 food industry 375  
 Ford Motor Company, Pinto model 163, 180  
 Foreign Corrupt Practices Act 397  
 foreign direct liability 388–9  
 Foreign Sovereign Immunity Act (US) 136  
 Forest Stewardship Council 377  
 Forti, G. 173  
*Forti v Suarez-Mason* 138  
*forum non conveniens* 125, 129–33, 138, 139  
     Australia 142  
*Foss v Harbottle* 90, 115  
 Fox, L. 167  
 France  
     limited liability 159  
     social report 330  
 Frankental, P. 289, 291  
 fraud 55, 58, 62, 254  
     volume of sanctions 64  
 ‘free-riders’ 297  
 Freedman, B.J. 64  
 Freedman, J. 108  
 Freeman, B. 292  
 Freeman, M. 290, 298  
 Freeman, R. 107  
 French, P. 153  
 Friedman, M. 21, 226, 327  
 Friends of the Earth International 292, 329, 372–3, 374, 375, 384  
     proposals for convention on corporate accountability 384–5  
 Frostell, K. 311  
*Fulham Football Club Ltd & Ors v Cabra Estates plc* 77, 91  
 Fussler, C. 357
- Gamble, J. 288, 292  
 Garratt, B. 28, 29  
 Geis, G. 160, 164, 167  
*General Slocum* (steamboat) 164  
 German Government Panel on Corporate Governance 63  
 gestalt entity, corporation as 12  
 Gilles, J 31  
 Glasback, H. 169  
 Global Compact, UN 246, 292–3, 297, 328, 347, 350, 351, 360, 379, 407, 410  
     and corporate citizenship 355–7  
     Performance Model 357  
     Resource package 356  
 global e-sustainability initiative 357  
 global markets 30  
 Global Reporting Initiative 241, 242, 243–4, 245, 358, 360–61  
     Boundaries Protocol 363  
 globalisation 246–7, 375  
 Goddard, R. 81, 84  
 golden shares 113–14  
 governance, concept of 21  
 governance mechanisms 57–8  
 government procurement 112–13  
 Government of Wales Act 1998 215, 219  
 Grabosky, P. 359  
 Graham, C. 113  
 Grantham, R. 28, 126

- Graymore, D. 329  
 Greenfield, K. 268  
 Gribben, R. 377  
 Griffiths, J. 272, 273  
 Griffiths, N. 379  
 Gross, E. 180, 183  
*Group Josi Reinsurance Co SA v Universal General Insurance Co* 129  
 groups, organised and unorganised 4–5  
*The Guardian* 191, 243, 251  
 Guillen, M. 30  
*Guinness v Saunders plc & Anor* 79  
 Gunningham, N. 359  
*Gwyer v London Wharf (Limehouse) Ltd* 117  
  
 Hager, M. 12  
 Hague Conference on Private International Law 130  
 Haldane, Viscount 151, 195  
*Hale v Henkel* 163  
 Hamilton, R.W. 166  
 Hamilton, V.L. 160  
 Hanford Joint Council for Resolving Employee Concerns 263–4, 270  
*Hanley v Automotive, Food, Metals, Engineering, Printing & Kindred Industries Union* 126  
 Hansmann, H. 13, 30, 35, 106, 107, 108, 110, 112, 114  
 harmonisation, transnational and international 148  
 Hart, O. 13  
 Hart, S. 366  
 Hartt Interactive 172  
*Harvard Business Review on Corporate Ethics* 29  
*Harvard Business Review on Corporate Governance* 28  
*Harvard Business Review on Corporate Responsibility* 29  
*Harvard Business Review on Measuring Corporate Performance* 29  
 Hatfield train disaster 191  
 Haufler, V. 327  
 Haward, D. 163  
 Hawkins, K. 166  
 Health and Safety at Work Act 1974 (UK) 150, 388  
 Health and Safety Executive (HSE) 177, 178  
 Heimann, F. 397  
*Hely-Hutchinson v Brayhead Ltd & Anor* 79  
*Henderson v Bank of Australia* 116  
 Hennes & Mauritz (H&M) code 307, 308  
 Henning, P.J. 163  
 Hepple, B. 326  
 Hernandez-Uriz, G. 292  
*Heron International Ltd. v Lord Grade* 116  
 Herz, R.L. 140  
 Hicks, A. 119  
*Hilao v Estate of Marcos* 139  
 Hilton Hotel chain 165  
 Hines Jr., J.R. 397  
 Hinkley, R. 43  
*H.L. Bolton (Engineering) Co. Ltd v T.J. Graham & Sons* 185, 196  
 Hoffman, Lord 5  
*Hogg v Cramphorn Ltd & Ors* 78  
 holistic theories 152–3  
*Hollis v Vabu Pty Ltd (the Bicycle Couriers case)* 126  
 ‘Holy Grail syndrome’ 14  
 Home Office 189, 190  
*Hopu and Bessert v France* 132  
 Hornblow, D. 380  
 Horrigan, B. 28  
 Horwitz, M.J. 12  
 House 289  
 House of Commons Environment, Food and Rural Affairs Committee 220  
 House, F. 289  
*Howard Smith Ltd v Ampol Petroleum Ltd.* 78  
 Howard, T. 126  
*Hudson River case* 163  
 Hufbauer, G.C. 136  
 human rights 242, 286–301  
     and foreign direct investment 286–8  
     NGOs’ publications 289  
     voluntary codes 302  
     voluntary obligations and international law 309–12  
 Human Rights Watch 288  
*Hutton v West Cork Railway Company (1883)* 77, 88  
 Hutton, W. 107

- Iacobucci, Justice 196, 200  
*ICI Ltd v Commission of the EC (Dyestuffs Case)* 128  
*IDC v Cooley* 80  
 identification doctrine 19, 196, 198–9, 401, 403  
 identification liability 152  
 ILO 133, 148, 291, 303, 304, 305, 310, 321–6, 324, 327, 356  
   decisions of Governing Body 324–5  
   declaration on multinational enterprises 319–33  
*In Plus Group Ltd v Pyke* 81  
*In re 'Agent Orange' Product Liability Litigation* 139  
*In re Austrian and German Holocaust Litigation* 134  
*In re South African Apartheid Litigation* 140  
*In re Union Carbide Corporation Gas Plant Disaster at Bhopal, India* 131  
*In re World War Two Era Japanese Forced Labour Litigation* 134  
 incentive-setting strategies 117–19  
 'incorporated', meaning of 8  
 India, Union Carbide Disaster 131  
 individual responsibility 75  
 Industrial and Provident Societies Act 1965 (UK) 112  
 industry standards 407–9  
 insider control and influence 36  
 insolvency 76, 84, 116–17  
 Insolvency Act 1986 (UK) 81, 84, 117, 118  
 insolvency practitioners 119  
 Institute for Labour Studies 324  
 institutional investors 268  
 institutional theory 11  
 interactive legislation 273–5  
 intergovernmental organisations (IGOs) 246, 247  
 intermediary accountability 240–41  
 internal outcomes 4, 5  
 Internal Revenue Service (IRS) 173  
 International Chamber of Commerce (ICC) 294, 359, 397  
 International Convention on the Suppression and Punishment of the Crime of Apartheid 141  
 International Council on Human Rights Policy 287, 330  
 International Court of Justice 132  
 International Declaration on Cleaner Products 351  
 International Federation of Consulting Engineers (FIDIC) 408  
 International Labour Organisation *see* ILO  
 International Organisation of Employers (IOE) 294  
 investor ownership 35  
 involuntary manslaughter 186, 189  
 Ireland, P. 108  
*Island Export Finance Ltd v Umunna* 80  
*Iwanowa v Ford Motor Co* 134  
 Jackall, R. 4  
 Jackson, D. 44  
 Jacobs, A. 306, 310  
 Jacobs, M. 217  
 Jalley, E.M. 173  
*Jama v Immigration and Naturalization Service* 134  
 James Hardie Industries 44–5  
 Japan, corporate criminal liability 160  
 Jenkins, R. 290  
 Jensen, M.C. 14  
 Jochnick, C. 287  
 Johannesburg Summit *see* World Summit on Sustainable Development (WSSD)  
*John Doe & Ors v Exxon Mobil Corp & Ors* 137  
*John Doe I v Unocal Corp* 135  
 Johnston, J.S. 12  
 joint and several liability rule 68  
 Joint Stock Companies Act 1844 (UK) 108  
 joint-stock companies 159  
 Jones, D. 378  
 Jorgensen, N.H.B. 407  
*Jota v Texaco Inc* 139  
*jus standi* 125  
*Kadic v Karadzic* 13  
 Kagan, R.A. 166  
 Kamminga, M.T. 128  
 Karlinger, J. 379  
*Kasky v Nike* 330

- Kay, J. 108  
 Kearney, N. 325  
 Keay, A. 116  
 Kelly, G. 107  
 Kelly, M. 39  
 Keong Low, C. 28  
*Keshub Mahindra v State of Madhya Pradesh* 131  
 Khair, S. 307  
 Khana, V.S. 166  
*Khulumani v Barclays* 140  
 Kiel, G. 25, 29  
 Kimberley Process Certification Scheme 249  
 Klein, N. 313, 380  
 Knott, D. 37  
 Koh, H.H. 137  
 Koh, P. 78  
 Kohn, S.N. 257, 258  
 Korten, D. 380  
 Kraakman, R. 13, 28, 30, 35, 106, 108, 110, 114  
 Kramer, E.W. 166  
*Kregor v Hollins* 77  
 Ku, C. 288, 292  
 Kuwait 135  
*Kuwait Asia Bank EC v National Mutual Life Nominees Ltd.* 116  
  
 La Porta, R. 55  
 labour standards 291  
 Lacey, N. 187  
 Laffont, J.J. 14  
 Lagan, A. 43  
*Lampf v Gilbertson* 170  
 landfill 218, 219  
     hazardous waste 221  
     UK legislation on 220  
 Landfill Directive, EU 219  
 landfill tax 220–21  
 Latin America  
     law reform 54–72  
     Peruvian General Company Act 60  
 Laufer, W.S. 126, 165  
 Law Commission 189  
 ‘law of nations’ 138, 140  
 Lawler, E. 28, 34  
 Lawrence, A. 288  
 Leblanc, R. 31  
 Lee, D.R. 88  
  
 Lee, M.T. 163  
 legal entity 3, 6–7, 7, 8, 16  
     assets 13  
     development of idea 9–10  
     and enterprise 7  
 legal personality 9, 11, 12, 147  
 ‘legal persons’, definition of 398–9  
 legal responsibility, and corporate responsibility 235–53  
*Lennard’s Carrying Company, Limited v Asiatic Petroleum Company, Limited* 152, 195, 402  
 Levi-Strauss, code of conduct 304  
 Lewis, O. 163  
*lex artis* 59  
*lex loci actus* 128  
*lex loci delicti* 128  
 Liebot Majo, J.O. 65  
 limited liability 108  
     France 159  
 liquidation 76, 84, 92  
*Liquidator of West Mercia Safetywear v Dodd* 75, 117  
 Litman, D.S. 162  
 Litman, R.C. 162  
 Liubicic, R.J. 109  
 Lizée, M. 4  
 local development 366–9  
*London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* 81  
*Lonrho v Shell* 116  
 Lorsch, J. 29, 30  
*Louis K. Leggett Co. v Lee* 162  
*Lubbe & Ors v Cape plc* 132  
 Luck, K. 30  
 Luhmann, N. 14  
 Lyme Bay canoe incident 187  
  
 McAuley, I. 42  
 McConough, J. 165  
 Machado Plazas, J. 68  
 McIntosh, M. 41, 360  
 Macintyre, E. 387, 388  
 McKinsey, Global Investor Opinion survey 42  
 Macneil, I.R. 110  
 McSweeny, T. 170  
 Magnan, I. 41  
 Maine, H. 161

- Maitland, F.W. 252  
Mallin, C. 28  
Malmö Declaration 354  
*Mannesmann Anlagenbau Austria AG v Strohal Rorationsdruck GesmbH* 114  
Marine Stewardship Council 377  
Mark, G.A. 12  
Marshall, C.J. 5–6  
Marshall, J. 162  
Martimort, D. 14  
Martinex Machuca, P. 55  
Marx, K. 180  
Materiality Report, UNEP 365  
Matten, D. 355  
Matthews, R.C.O. 56  
May, L. 16  
Mayson 98  
Means, G. 12  
Means, G.C. 74  
Meckling, W.H. 14  
Meeran, R. 132  
*Mendonca v Tidewater Inc* 139  
*mens rea* 126, 140, 200, 402  
of involuntary manslaughter 186  
*Meridian Global Funds Management Asia Ltd. v Securities Commission* 154, 198, 199, 200, 209  
Merme, M. 244  
Merton, R.K. 178, 179  
*Meterlogic Inc v Copier Solutions Inc* 128  
Metzger, M.B. 4, 16  
Micklethwait, J. 235  
Miguel, A. 62  
Millon, D. 73, 75  
Mills, M. 25  
mineral resource extractions 134  
Minow, N. 28, 30  
Mitrokostas, N.K. 136  
Model Penal Code, US 150  
Modern Company Law: the Strategic Framework 94  
Modern Company Law, Final Report 2001 89, 94, 97, 99  
*Modernising Company Law* 73, 76, 77, 80, 81, 82, 89, 97, 99, 238  
*Modernity and the Holocaust* 182  
Moeves case 166–7  
Monbiot, G. 380  
money laundering 396  
Monks, R. 28, 30  
Monoghan, P. 239  
Moodie, G. 126  
Moore, S. 273  
*Moore v I. Bresler Ltd.* 197, 402  
moral fault 148  
moral indifference 181–5  
*Morphitis v Bernasconi and Others* 117  
Morris, Lord 196  
Morrisey, O. 324  
*Movitex Ltd v Bulfield & Ors* 78  
Muchlinski, P. 130, 131, 294, 297  
Mueller, G.O.W. 164  
Muirhead, S.A. 236  
Mukherjee, A. 322  
Multilateral Agreement on Investment, OECD 292  
multinational enterprises  
compliance with transnational regulatory standards 27, 30  
and human rights 330  
ILO declaration 319–33  
multilateral regulation instruments 328–30  
multistakeholder initiatives 328  
private sector initiatives 326–30  
reporting requirements 330  
‘social labelling’ 327–8  
Murphy, D.E. 165  
Myanmar 133  
Nader, R. 74  
Nadler, D. 28  
Namibia 140–41  
*National Coalition Gov’t of the Union of Burma v Unocal Inc* 135  
National Waste Production Survey (1998), Environment Agency 217  
natural and legal persons 404–5  
Needleman, C. 179  
Needleman, M. 179  
negligence 55, 57, 59, 65–9  
and disloyalty 59  
liability for 65–9  
Nelson, J. 236, 358  
Netherlands  
corporate governance 275–6  
Dutch Corporate Governance Code 271–85

- Peters Report 275, 276, 278  
 Social Economic Council report 275  
 New Balance Code 308  
*New York Central & Hudson River  
 Railroad Co. v United States* 163  
 nexus of contracts 14, 15, 74  
 NGOs 94, 137, 227, 237–8, 241,  
 286–301  
   and business campaigns 288–91  
   campaigns for extraterritorial  
     legislation 293  
   and corporate accountability 372–94  
   and corporate policies 291  
   effectiveness of campaigning 295–8  
   Green 8 group 386  
   and international law and policy 292–3  
   publications on human rights 289  
 Nicholson, G. 29  
*Nicholson v Permakraft (NZ) Ltd.* 116  
 Nigeria, Shell in 288  
 Nike 250, 306, 308  
 no conflict rule 78–81, 83  
 non-financial corporate performance  
   42–3  
*Norman v Theodore Goddard* 81  
*North-West Transportation Co Ltd v  
 Beatty* 83  
 Norwitz, T.S. 88  
*Ntsebeza et al. v Citigroup et al.* 141  
  
 objective culpability 186  
*The Observer* 190  
 occupational danger, Moeves case  
   166–7  
 Occupational Safety and Health  
   Administration (OSHA) 166, 167  
 Occupiers' Liability Act 1957 389  
 O'Connor, M.A. 268  
 O'Donnell, E.T. 164  
 OECD 148, 246, 248, 305, 309, 320,  
   380, 396, 397  
   Convention on Combating Bribery of  
     Foreign Public Officials in  
     International Business Transactions  
     398  
   Multilateral Agreement on Investment  
     292  
   working group on bribery 410  
 Office of the High Commissioner for  
   Human Rights (OHCHR) 356  
  
*Official Journal (EC)* 335, 345, 398  
 Olivencia report 55  
 O'Neill, T.R. 74  
 Ong, D. 224  
 operating and financial review (OFR)  
   97–100, 101–2, 238–9, 330  
*Osuwu v Jackson & Ors* 130  
*Our Common Future* 216  
 outcomes 6  
   external and internal 4, 5  
 outsider control and influence 36  
 ownership interests 39  
 Oxfam International 303, 304  
  
 P&O 187–9  
*P v P&O European Ferries* 186  
 Page, R. 173  
*parens patriae* 131  
 Parker, C. 28  
 Parkinson, J. 94, 107  
 Parry, R. 84  
 Parsons, T. 5  
 Passas, N. 179, 183  
 Paul, J.R. 138  
*Pavlidis v Jensen* 84  
 Pax Christi 288  
 Paz-Ares, C. 65, 67  
 Pearce, F. 178, 181  
 penal clauses 65  
*Percival v Wright* 116  
 Perdices Cueto, A. 62  
 person, concept of 9  
 persons, natural and legal 404–5  
 Peruvian General Company Act 60  
 Peters, J.L. 133  
 Peters Report, Netherlands 275  
 Philippines 324  
 Phillips, M.J. 10, 12  
 pluralist approach 73, 74, 75–6, 88  
 Ponzi schemes 168  
 Posner, R.A. 13, 40, 57  
 poverty 374  
*Practice Note, 1966* 209  
 Prahalad, C.K. 366  
 Pratt, R. 40  
*Prentice and Others* 186, 187  
*Presbyterian Church of Sudan et al. v  
 Talisman Energy Inc & the  
 Republic of Sudan* 134  
*Prestige* oil tanker disaster 334, 367

- Prince, P. 132  
 Principles on Anti-Money Laundering 408  
 private entities 399  
 property, and corporations 13  
 property rights 13  
 Prosser, T. 113  
 Public Accounting Oversight Board 170–71  
 Public Bodies Corrupt Act 1889 396  
 public entities 399  
 public governance 21  
 punishing corporations 156–7  
 punitive damages 65  
*Punt v Symons & Co Ltd* 78
- R v Adomako* 187  
*R v British Steel* 154  
*R v Caldwell* 186  
*R v H.M. Coroner for East Kent* 187  
*R v ICR Haulage Ltd* 195, 402  
*R v Kite and Others* 187  
*R v Lawrence* 186  
 Raaijmakers, M.J.G.C. 283  
 Ralston, D. 41  
 Ramsay Report, Australia 26  
 Ramsey, I. 45, 126  
 Ramsey, M.D. 136  
 rationality 149  
 Raynard, P. 237  
*Re Barings Bank plc (No. 5)* 82  
*Re City Equitable Fire Insurance Co Ltd* 81, 82  
*Re a Company ex parte Burr* 92  
*Re Continental Assurance plc* 82  
*Re D'Jan of London Ltd* 81  
*Re Floor Fourteen Ltd* 84  
*Re Horsley & Weight Ltd.* 117  
*Re Lee Behrens & Co.* 116  
*Re Peppermint Park Ltd* 82  
*Re Produce Marketing Consortium (In Liquidation)* 118  
*Re Saul D Harrison & Sons plc* 91, 92  
*Re Sevenoaks Stationers (Retail) Ltd.* 118  
*Re Smith & Fawcett* 78, 89  
*Re Swift 736 Ltd.* 119  
*Re W. & M. Roith Ltd.* 77, 116  
*Re Welfab Engineers Ltd* 91  
 reactive fault 153–4  
 real entity 5, 9  
   company as a term for 10  
   and enterprises 3–4  
   and legal entities 3–8  
 realist theory 74  
*Recherches Internationales Quebec v Cambior Inc* 130  
 Redress for Torture Bill (UK) 136  
*Regal Hastings v Gulliver* 79  
*Regie National des Usines Renault SA v Zhang* 132  
 Reid, Lord 196  
 reification 5, 15, 16  
 Reiman, J. 182  
 Reingold, J. 168  
 relational transacting 109–10  
 Reputation Institute 172  
 reputation risk 354  
*respondeat superior* 150  
 responsibility attribution 150–54  
*The Rhône v The Peter A.B. Widener* 196, 200  
 Richard, K.P. 202  
 Richter, J. 288  
 Rickett, C. 28  
 RING Alliance 367  
 Rio Earth summit 352, 379  
 Roberts, J. 28  
 Robertson, D.W. 131  
 Robins, N. 253  
 Rodriguez, L.J. 165  
 Roef, D. 343  
 ‘Roman privilege’ 66  
 Rosencranz, A. 134  
 Rosoff, S.N. 168  
 Royal Institute of International Affairs 389  
 Rubin, R.L. 163  
 Ruggie, J.G. 355, 358  
 Ryngaert, C. 135
- Salacuse, J. 30  
 Salinger, L.S. 160  
 Salmond, J.W. 162  
*Salomon v A. Salomon & Company Ltd.* 10, 111  
*Santa Clara County v Southern Pacific Railroad* 163  
 Sarbanes–Oxley Act 26, 28, 169–71, 194, 236, 250, 254, 257



- anonymous reporting procedures  
     265–6  
 cost–benefit analysis of 29  
 whistleblower provisions 257–8,  
     260–61, 264–5  
*Sarei v Rio Tinto plc* 137  
 Saul, J.R. 29  
 Scholz, J.T. 166  
 Schuck, P.H. 169  
 Schultheiss, M. 62  
 Schwartz, M. 167  
 Scott, K.E. 57, 62  
 Scott, W.R. 108  
 Sealy, L.S. 76  
*Secretary of State For Trade and  
     Industry v Collins and Others* 119  
 ‘selection bias’ 59  
 self-dealing transactions 39  
 self-regulation 271–3  
     definition of 272–3  
     Dutch Corporate Governance Code  
     (Tabaksblat Code) as 280–81  
     interactive legislation 273–5  
     semi-autonomous social field (SASF)  
     273  
*Sequihua v Texaco Inc* 139  
 Shannon, H.A. 159  
 ‘shareholder argument’ 73  
 ‘shareholder primacy’ 38, 39, 43,  
     100–101, 116, 267–8  
 shareholders 20, 21, 22, 35, 96, 267  
     and corporate responsibility 241  
     corporate responsibility towards  
     38–44  
     and director liability action 63  
     and executive remuneration 26  
     rights 55  
     and stakeholders 36, 42  
 Shaughnessy, M. 109  
 Sheen inquiry 188–9  
 Sheinin, M. 311  
 Shell, in Nigeria 288  
 Shleifer, A. 62  
*Shorter Oxford English Dictionary* 5, 7,  
     11  
 Shultz, S. 29  
 Silberson, A. 108  
 Sillanpaa, M. 237  
*Simmonds v Heffer* 115  
 Simms, A. 375, 380  
*Sinaltranal v Coca-Cola Co.* 134  
 Singer, P. 39  
*Sithole & Ors v Thor Chemical Holdings  
     Ltd* 132  
 Sixth Environmental Action Programme,  
     European Community 334  
 Slapper, G.J. 177, 178, 180, 181, 183,  
     187  
 SMEs  
     and environmental legislation 229  
     and UNEP 368  
 Smith, C.H. 322  
 Snider, L. 181  
 ‘social audits’ 237  
 social capital 40  
 Social Economic Council Report,  
     Netherlands 275  
 Social Investment Forum 328  
 ‘social labelling’ 327–8  
 social norms 13  
 ‘social partnership’ 236  
 socially responsible investment 328  
 Sonnenfeld, J. 28  
*Sosa v Alvarez-Machain et al.* 135, 137,  
     138, 139, 140, 142, 143  
 South Africa 132  
     vicarious liability 150  
 South Sea Bubble Act 159  
 Southall tragedy 199  
 Spain 55, 65  
     Provincial Court in Cordova 66  
 Spanish Commercial Code 66  
 Special Commission on Jurisdiction,  
     Recognition and Enforcement of  
     Foreign Judgements in Civil and  
     Commercial Matters 130  
*Spilada Maritime Corporation v  
     Cansulex Ltd* 131–2  
 Squires, S.E. 168  
 ‘stakeholder argument’ 73  
 stakeholder model in law 114–19  
 stakeholders 40, 74, 98  
     and British company law 238–9  
     definitions of 237–8, 278  
     and shareholders 36, 42  
     suppliers as 107–8  
 Stamhuis, J.N. 274  
 State Immunity Act 1978 (UK) 136  
*State v The Olivers* 160  
 Statoil 395–6

- statutory informational rights 110
- Stock Exchange Listing Rules 76
- Stout, L. 20, 37, 39
- strict liability 149
- Stuart, D. 200
- Sullivan, R. 289, 290, 291, 296
- supplier protection
  - and company law 105–8
  - and directors' duties 115–17
  - formal company law protections 114–19
  - golden shares 113–14
  - government procurement 112–13
  - gratuitous transactions 115
  - historical development 108–9
  - incentive-setting strategies 117–19
  - legal regulation 110–11
  - purchasers' self-regulation 109
  - relational transacting 109–10
  - structuring the parties to the transaction 111–14
- suppliers, as stakeholders 107–8
- suppliers' cooperatives 112
- SustainAbility 362, 364
- sustainability reporting 359–61
- 'sustainable consumption and production' 353
- sustainable development 215
  - and waste 216–18
- sustainable waste management, Wales 215–31
- Sweeney, J.M. 138
- Swigert, V. 180
- systems theory 153
  
- Tabaksblat Code *see* Dutch Corporate Governance Code
- Taekema, S. 274
- Taylor, Lord 186
- Taylor v Walker* 80
- team production model 13, 37–8
- Tel-Oren v Libyan Arab Republic* 137
- tertium genus* 67
- Tesco Supermarkets Ltd v Natrass* 152, 185, 195, 196, 198, 200, 201, 209, 402
- Teubner, G. 14
- textile industry
  - codes of conduct 305
  - gender segregation 311–12
  - women and children in 302–15
- theory, use of term 10
- Thomas, R. 360
- Tiger Nominees Pty Ltd v State Pollution Control Commission* 126
- Time* magazine 256
- Timms, S. 378
- Timothy Martin, A. 396
- Toffler, B.L. 168
- Tombs, S. 177, 178, 179, 180, 181, 183, 187, 190
- Tomkinson v South-Eastern Railway Co.* 116
- tort law 125–46
  - litigation against transnational corporations 127–8
  - as a mechanism for corporate responsibility 125–9
- torture 140
- Torture Victim Protection Act 137
- Tour Operators' Initiative for Sustainable Development 357
- tourism 375
- Toxic Release Act, US 250
- Toxic Substances Control Act, US 127
- trade unions 94
- transaction costs 12
- transnational corporations 27–8, 30, 375
  - and human rights 286–8, 290, 299, 312–13
  - tort litigation against 127–9
- Transparency International 397
- Transvaal Lands Co v New Belgium Dev Co* 84
- Treaty of the European Community 345
- Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, historical background 319–21, 322–6
- Trustees of Dartmouth v Woodward* 7, 162
- Tsang, D. 42
  
- UK
  - Combined Code of the Financial Reporting Council 26
  - common law on attribution 195–9
  - company law, and stakeholders 238–9

- Company Law Review 8, 73, 75, 88, 93–5, 238
- directors' duties 73–87
- employees 88–104
- legislation, corporate accountability 287–90
- manslaughter 154
- supplier protection 105–22
- UK Law Commission 154
- ultra vires* 115, 116
- UN 248, 322
  - Commission on Transnational Corporations 329
  - Conference on Environment and Development (UNCED) 350
  - Convention against Corruption 398
  - Convention on the Law of the Sea 137
  - Economic and Social Council (ECOSOC) 320
  - General Assembly Resolution 37/233A 1141
  - Human Rights Committee 132, 311
  - Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights 293–5, 297
  - Office on Drugs and Crime 356
  - see also* Global Compact
- UNCTAD 379
- UNCTC 141
- UNEP 34
  - Advertising and Communication Forum 357
  - and corporate responsibility 349–71
  - Finance Initiative 58
  - Mobility Forum 357–8
- Union Carbide Disaster, India 131
- United States Supreme Court 163
- United States v Bank of New England* 165
- United States v Bestfoods* 127
- United States v Hilton Hotels Corp.* 165
- United States v Van Schaick* 164
- Universal Declaration of Human Rights 290
- Unocal 134–5
- UNRISD (United Nations Research Institute for Social Development) 383
- Urminsky, M. 327, 330
- US
  - Child Labor Deterrence Act 1993 (Harkin Bill) 307
  - Comprehensive Environmental Response Compensation and Liability Act 127
  - corporate criminal liability 159–76
  - corporate governance reforms 26
  - Corporate Manslaughter Bill 155
  - corporate responsibility 236
  - Department of Commerce 397
  - Sentencing Commission 165
  - sentencing guidelines 407
  - Toxic Release Act 250
  - Toxic Substances Control Act 127
  - vicarious liability 150
- Utting, P. 299
- Vaighan & Sons Inc. v State* 166
- Van der Burg, W. 274
- Van der Lugt, C. 360
- Van Klink, B. 274
- Vandivier, K. 184–5
- Veasey, E. 26
- vicarious liability 126–7, 150–51, 152
- Vishny, R.W. 62
- 'voluntarism' 248
- voluntary codes, on human rights 302
- voluntary initiatives 357–9
  - and CSR 378–80
- Voluntary Principles and Security Rights 292
- Voth v Manildra Flour Mills* 132
- Waddams, S.M. 197
- Waldron, J. 275, 282
- Wales
  - Bosch Limited case study 225, 228
  - commercial and industrial waste arising survey 223–7
  - commercial and industrial waste targets 222
  - Dolgarrog Aluminium case study 222, 228
  - hazardous landfill 221
  - Panasonic case study 224, 227, 228
  - sustainable waste management 215–31

- Walker v Secretary of State for Trade and Industry* 118  
*Walker v Wimborne* 116  
 Walter, C. 40  
 Ward, H. 143, 250, 367, 388  
 Warhurst, A. 299  
 Waste Framework Directive, EU 218  
 Waste Incineration Directive, EU 219  
 waste legislation 218–22  
*Waste Strategy for England and Wales*, DEFRA 21  
 Watgate scandal 396–7  
 Watkins, S. 167  
 WBCSD 351  
 WCED 216  
 Webb, T. 331  
 Wedderburn, K.W. 88, 101, 110  
 Weiser, J. 378  
 Weisman, J. 173  
 Wells, C. 403  
 Wells, J.T. 168  
 Welsh Assembly Government (WAG)  
     215, 216  
     funding for business support organisations 229  
     *Sustainable Development Action Plan of the Welsh Assembly Government* 216–17  
     *Wise About Waste* 215, 217  
*West Mercia Safetywear v Dodd* 75, 117  
 Westbrook, J.L. 131  
 Westerman, P. 274  
 Westpac Banking Corporation 42  
 Westray mine disaster, Canada 202  
 Wheeler, D. 237  
 Wheeler, S. 29  
 Whincop, M. 28, 29  
 whistleblowers  
     and corporate accountability 254–70  
     False Claims Act 259–60, 262  
     federal statutes 259  
     Hanford Joint Council for Resolving Employee Concerns 263–4  
     origin of term 256  
     protection laws 255, 395–6  
     retaliation 259, 260–61, 263–6  
     Sarbanes–Oxley Act 257–8, 260–61, 264–6  
     ‘wrongful discharge’ 258  
 White, T.J. 136  
 Whyte, D. 187, 190  
 Willetts, P. 296  
 Williams, G. 151, 164, 194, 197  
 Williamson, J. 94, 96, 98  
 Winch, P. 273  
*Winkworth v Edward Baron Developments Co. Ltd.* 117  
 Witteveen, W. 274  
*Wiwa v Royal Dutch Petroleum Company* 134  
 Wolf, M. 235  
 Wolfsberg Group 408  
 women  
     and codes of conduct 307–9  
     non-discrimination principle 310–12  
     in the textile industry 302–15  
 Woodsome Jr., E.V. 136  
 Wooldridge, A. 235  
*Woolfson v Strathclyde Regional Council* 111  
*Woon Tan Kan v Asian Rare Earth* 130  
 Worker Rights Consortium Model Code of Conduct 308  
 World Bank 305, 308, 397  
 World Federation of the Sporting Goods Industry 306  
 World Summit on Sustainable Development (WSSD) 292, 296, 352–3, 381–2, 383–4, 385  
 ‘wrongful discharge’ 258  
 wrongful trading 118  
 WTO 250  
     and China 29  
 Wyndham, H. 289  
  
*Xuncax v Gramago* 133  
  
*Yukong Line Ltd. of Korea v Rendsburg Investments Corpn* 117  
  
 Zadek, S. 41, 236, 244, 378  
 Zappala, G. 41  
 Zeebrugge ferry disaster 147, 153, 177, 187–9  
 Zelitzer, E.G. 170