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The important role that UK business has to play in wider society is being reflected in their updated corporate governance arrangements, explain Paul Ellerman, Caroline Rae, Gareth Sykes and Ben Ward of Herbert Smith Freehills

In most major jurisdictions there has been a considerable increase in focus on corporate governance issues in recent years. In particular, additional requirements have been introduced, or are being proposed, to the corporate governance landscape that seek to further widen social and stakeholder goals. This reflects an acknowledgement of the important role played by businesses both domestically and internationally.

In the UK this trend has manifested itself in a renewed focus on the role of business in society. This has been driven, at least in part, by a number of actual or perceived corporate failures. Much of the discussion has focused on corporate purpose and how companies should take into account the interests of their wider stakeholders (including the workforce, customers and suppliers), rather than simply be run in a way that is perceived to favour only shareholders.

A good example of this trend is the statement on the purpose of a corporation published by the US Business Roundtable organisation, which comprises the chief executive officers of leading US companies, in August 2019. The statement was signed by 181 CEOs who committed to lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders.

What is the legislative framework in the UK in relation to the consideration of stakeholder interests by company directors?

The core duty of company directors in the Companies Act 2006 (the Companies Act) is the duty contained in s172 that a director must act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, having regard to the list of factors specified in s172(1). Those factors are: the likely consequences of any decision in the long term; the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment; the desirability of the company maintaining a reputation for high standards of business conduct; and the need to act fairly as between members of the company. During the passage of the legislation, the government made it clear that this list of factors is not exhaustive, but highlights areas of particular importance reflecting wider expectations of responsible business behaviour.

The wording of s172 reflects a compromise between two different philosophical positions:

- the shareholder primacy approach, which would require directors to make decisions in such a manner as purely to maximise the interests of shareholders, rather than being required to take into account the interest of any other stakeholder group; and

- the pluralist approach, which would require directors to have a wider vision beyond profit maximisation for shareholders and instead oblige them to act in the interests of a wider group of constituents with a stake or interest in the company and its business.

The compromise embodied in the Companies Act is commonly referred to as 'enlightened shareholder value'. This means that a director's duty is ultimately still owed solely to the company but in order to promote the success of the company, directors should also have regard to the interests of certain stakeholder groups and other principles.

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> **Ben Ward, partner, Herbert Smith Freehills**

How does consideration of the s172 duty and stakeholder issues work in practice?

The s172 duty applies across the full spectrum of a director's role. This includes setting strategy, business plans and budgets; defining the company's values and culture; setting policies and procedures; and making day-to-day business decisions. There is no one-size-fits-all approach and different boards of directors may reasonably decide to pursue different outcomes, depending on their own experiences, judgements and views, and on the company's circumstances.

It is not appropriate for directors to try to 'score' or prioritise different stakeholder matters as part of the board decision-making process. The role of the director is not to balance the interests of the company and stakeholders. Instead, after weighing up all of the relevant factors, a director should consider the impact of a decision on stakeholders and which course of action best leads to the success of the company, having regard to the long term. This can sometimes mean that certain stakeholders are adversely affected, but that fact alone does not invalidate the decision.

How are companies required to demonstrate their regard to stakeholder issues?

In terms of reporting on stakeholder issues, many UK companies are required to prepare a strategic report as part of their annual report and accounts, the purpose of which is to demonstrate how the directors have performed their duty under s172. The strategic report requirements oblige public companies and large private companies to make certain stakeholder-related disclosures, for example, analysis using key performance indicators relating to environmental and employee matters where appropriate. Quoted companies are also required to provide information about environmental, social, community and human rights issues. Those quoted company disclosures were further enhanced in 2017 as a result of implementation of the EU Non-Financial Reporting Directive.

A number of separate reporting requirements that are focused on societal issues and responsible business practices have also been introduced recently. These include reporting on modern slavery issues, workforce gender pay gaps and the timely payment of company suppliers. These have been largely welcomed for bringing focus and transparency in these areas, and allowing companies to demonstrate responsible business practices and good governance.

How is the corporate governance landscape changing so as to ensure that company directors are taking account of wider stakeholder interests?

Pressure from wider society, the media and politicians, and increasingly institutional investors, has led to a number of developments that seek to encourage directors to more carefully consider, and articulate how they have considered, stakeholder matters as part of their business decisions.

Consideration of stakeholder, employee and supplier matters is a key theme in The Companies (Miscellaneous Reporting) Regulations 2018 which apply for financial years beginning on or after 1 January 2019 (the Reporting Regulations). They introduce requirements for companies which are large for accounting purposes (and certain other companies), to publish a statement explaining how their directors have performed their duty under s172 of the Companies Act to have regard to the various stakeholder factors listed in s172(1). In addition, companies that have more than 250 UK employees have to explain how the directors

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have engaged with employees and how the directors have had regard to UK employee interests, and the effect of that regard, including on the principal decisions taken by the company during the financial year. Large companies must also explain how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others, and the effect of that regard, including on the principal decisions taken by the company during the year.

The 2018 edition of the UK Corporate Governance Code (the Governance Code), which applies to companies with a premium listing on the UK stock market, also focuses much more on stakeholder issues than its prior editions. It contains a range of new requirements for both corporate behaviour and reporting, including in relation to company purpose, culture and values, and engagement and regard to stakeholder interests. In particular, a new principle has been introduced referring to a company's responsibilities to shareholders and stakeholders, stating that the board should ensure effective engagement with, and encourage participation from, these parties. This is supported by a provision which states that the board should understand the views of the company's key stakeholders and describe in the annual report how their interests, and the matters set out in s172 of the Companies Act have been considered in board discussions and decision-making.

For large privately-owned companies, there is a similar focus on stakeholders in the Wates Corporate Governance Principles for Large Private Companies (the Wates Principles), which are intended to provide a framework for corporate governance best practice for large privately-held UK companies given their importance to the economy and society at large. The Wates Principles state that directors should foster effective stakeholder relationships aligned to the company's purpose. It also states that the board is responsible for overseeing meaningful engagement with stakeholders, including the workforce, and having regard to their views when taking decisions.

These new requirements do not prescribe a particular approach to consideration of stakeholder matters. As such, companies will need to consider carefully their corporate governance arrangements, what is appropriate to their individual circumstances, and how to articulate this through their reporting.

What are companies doing in practice to meet this challenge?

In practice, many companies are already undertaking a variety of initiatives to ensure that their boards are appropriately and properly taking into account stakeholder views and interests as part of the decision making process. As such the new requirements have for the most part resulted in a review of these initiatives, ensuring that they remain fit for purpose.

The issues of company culture, values and purpose are very much interconnected with the issues of workforce and stakeholder engagement. As a result of the new corporate governance landscape, and in a move similar to the US Business Roundtable, many companies are revisiting their purpose, looking to articulate a purpose that incorporates references to a wider purpose, based on benefits to society as a whole. Many companies have also focussed on their culture, and in particular their values, undertaking a process to refresh or update their values statements. There is also increased focus on ensuring that the desired culture permeates throughout the corporate group and the supply chain, as far as practicable.

Many companies have undertaken, or refreshed, a stakeholder mapping exercise to ensure that key stakeholders are identified and their views considered. The workforce, customers and suppliers are likely to be universal stakeholders, however the list of stakeholders could extend, for example, to communities, regulators and pension schemes.

Companies have also sought to improve their board processes to better ensure that the s172 issues were better reflected in board papers and therefore in board discussions and decisions. While many companies have typically referred to the impact on stakeholders when preparing board papers in connection with decisions in relation to M&A and other significant corporate matters, references to stakeholders are not necessarily systematically incorporated when preparing board papers on other matters. One approach to deal with this is to require all of those preparing board papers to complete a checklist that refers to each of the matters listed in s172 and to confirm that the impact on all relevant stakeholders has been properly articulated in the paper.

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Workforce engagement is a particular focus of the new governance landscape. Most well-run businesses acknowledge the importance of the workforce as a source of insight into the well-being of a company and utilise a variety of engagements tools. Typical ways in which boards have gained workforce insights have been through employee panel meetings, town hall meetings and question and answer sessions, as well as receipt of detailed data on employee turnover rates and exit interviews and reports from whistleblowing hotlines. Some companies have extended these tools to other stakeholders, for example, holding supplier meetings or town halls.

The Governance Code states that one or a combination of the following methods should be used for engagement with the workforce: (i) a director appointed from the workforce; (ii) a formal workforce advisory panel; or (iii) a designated non-executive director. However, another engagement method (or methods) can be adopted if the directors consider that it allows effective engagement to take place. Engagement mechanisms will need to be reviewed regularly and should develop and adapt year on year to ensure that they remain appropriate and effective.

What impact have wider stakeholder considerations had on executive remuneration?

Against a backdrop of concerns that rising levels of executive pay at listed companies have contributed to public mistrust in business and concerns that incentives schemes are often too complex, the Governance Code included a range of new requirements including a new principle that remuneration policies and practices should be designed to support a company's strategy and promote its long-term sustainable success and that executive remuneration should be aligned to a company's purpose and values and be clearly linked to the successful delivery of the company's long-term strategy. The Governance Code has also expanded the remuneration committee's remit to review workforce remuneration and related policies, and to take these into account when setting executive pay levels with the board having overall responsibility for workforce policies and practices.

Remuneration committees have therefore become much more sensitive to issues of fairness and the broader workforce picture and indeed recent changes to reporting requirements will require all companies with more than 250 UK employees to show the ratio of the CEO's latest single total figure of pay versus UK full-time equivalent employees' remuneration at the median, upper and lower quartiles. The issue of fairness also lies behind the push, particularly by the Investment Association, for remuneration committees to set out a credible action plan to reduce pension contributions for directors to the level of the majority of the workforce by the end of 2022 or otherwise face being 'red-topped'. In addition, remuneration reports should now set out the pension contribution rate that a company considers to be given to the majority of its workforce, and an explanation of how the rate was determined.

Concern for wider stakeholder issues has also led to more focus on environmental, social and governance (ESG) considerations that are of increasing importance to managers of investment funds. Investors are now using ESG as an investment criterion and expect ESG to be part of the performance criteria for short and long-term executive remuneration.

Finally, an interesting call has been made by the Business, Energy and Industrial Strategy Parliamentary select committee for performance criteria to include sustainability matters such as a company's levels and serviceability of debt which, if implemented by remuneration committees, would be an important acknowledgement of the potential impact that remuneration schemes can have for wider stakeholders such as employees and society generally in the event of a significant corporate failure.

What does the future hold?

There appears to be only one direction of travel in this area, and that is for further focus on stakeholder interests and issues and ensuring that these are properly considered by boards of directors. Discussion and debate in this area will likely intensify again as companies start to comply with the new requirements introduced by Reporting Regulations and the Governance Code. For those outside of the UK, it seems highly likely that this trend will continue and be picked up in other markets. ■