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# 1

# Capitalism, the sustainability crisis, and the limitations of current business governance

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## 1 Impetus for a new direction

This book investigates the limitations of corporate governance and some related business laws, and their potential reform in furthering environmentally sustainable development, or 'sustainability', as this term is more conveniently known. The central idea is that promoting sustainability cannot be left solely to corporate volunteerism, but also requires enabling legal frameworks that go beyond conventional environmental regulation to ensconce within company law the necessary standards and procedures. While the book is strongly motivated by the threat of global climate change, which challenges the traditional assumptions and purpose of business enterprise over the long term, along with many other domains of human endeavour, a range of other environmental problems such as the loss of biodiversity also suggests that a different approach to business activity is needed. Arising from the work of the Sustainable Companies Project, led by Professor Beate Sjåfjell at the University of Oslo,[1] this volume offers multi-jurisdictional perspectives from scholars of business and environmental law. Over eight chapters, a mosaic of analyses, spanning company law, accounting standards, and financial markets regulation, identify both the barriers to and the opportunities to promote sustainability in the context of corporations and their financial investors. The book concludes with some ideas to further 'sustainable companies', a phrase intended to capture the ideal of corporations and other business entities acting within environmentally sustainable parameters. The focus of the book is to deepen our understanding of the barriers to creating sustainable companies, rather than outlining a blueprint for reform. The

[1] See jus.uio.no/companies under Projects. The project received funding from the Research Council of Norway. The project's broad international scope was made possible through the academic contributions of the large team of scholars from all around the world, to whom we express our gratitude and whose work we hereby recognise.



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path to reform largely hinges on better understanding of the source and nature of the problems, and recognition that the tools and strategies for such reform will vary somewhat across societies and jurisdictions.

Creating sustainable companies has never been more urgent in a world beset by the intertwined crises afflicting global financial markets and the planetary environment. The Global Financial Crisis (GFC) that erupted in 2008 revealed profound weaknesses in the conventional paradigm of market finance, and the need to rethink its fundamental tenets and purpose. Another emerging crisis stems from humankind's degradation of life-sustaining natural resources with an intensity and speed that threaten the livelihoods and prosperity not only of future generations, but also of those alive today. Climate change looms large as the most ominous such threat. The GFC and environmental crises stem from a different aetiology but they also share the problem of how short-sighted economic activity can lead to dangerous long-term problems.

To promote sustainability, it is not sufficient simply to have more environmentally efficient businesses, in the sense that companies use fewer natural resources or emit less pollution relative to their economic activity. An efficiency standard fails to ensure sustainability when the economy continues to grow and the human population is increasing. The 'efficiency' paradigm also avoids addressing the significant social injustices in contemporary environmental decision-making. Putting the economy on a sustainable path requires a more comprehensive and fundamental strategy that includes rethinking the very purpose and nature of economic activity, including that of the dominant business organisation: the corporation.

This book proceeds from the position that sustainable business should not be a discretionary preference, to follow only if corporate leaders perceive an economic benefit for their company. All economic activity must avoid depleting non-substitutable natural capital or creating environmental externalities. It must invest more in clean, low-carbon technologies, climate adaptation projects, ecosystem rehabilitation and improvement, and other ways to build sustainability.[2] Economic activity that has public costs should be accountable for such impacts.

Presently, business enterprise and the wider capitalist system in which it functions still have a long way to go before it might fulfil this vision. The movement for corporate social responsibility (CSR) and its offshoot,

[2] T. Jackson, *Prosperity Without Growth: Economics for a Finite Planet* (Earthscan, 2009), 138–9.

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socially responsible investing (SRI), have captured only a relatively small group of committed converts. CSR has a long history in the context of industrial capitalism, dating back to the nineteenth century in the first movement for improved labour conditions.[3] Its influence has generally been episodic and fleeting. It has more recently regained prominence as modernist economic virtues such as efficiency, profits, and maximum growth have waned in an increasingly cynical world plagued by social and environmental problems.[4] Rejecting the unbridled free market doctrines of previous years,[5] the World Business Council for Sustainable Development (WBCSD) explains: 'Corporate social responsibility is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large.'[6]

However, while many investors and business leaders today distance themselves from the hyperbole of Milton Friedman, who once admonished CSR as one of the '[f]ew trends [that] could so thoroughly undermine the very foundations of our free society',[7] most are unwilling to sacrifice profits for environmental gains. The minority of firms and investors that have embraced CSR have tended to recast it in a new business paradigm that views environmental and social issues instrumentally for potential financial advantage.[8] But even this restrictive version of business responsibility has struggled to attract many followers, partly because of problems in organisational cultures and difficulties in financially quantifying the business value of improved environmental performance. Rather

[3] J.J. Asongu, 'The history of corporate social responsibility' (2007) 1(2) *Journal of Business and Public Policy* 1.

[4] E. Garriga and D. Mele, 'Corporate social responsibility theories: mapping the territory' (2004) 53 *Journal of Business Ethics* 51. D. Birch, 'Corporate social responsibility: some key theoretical issues and concepts for new ways of doing business' (2003) 1(1) *Journal of New Business Ideas and Trends* 1.

[5] On financial and corporate management attitudes in the 1980s, see A. Smith, *The Roaring '80s* (Viking Press, 1988).

[6] WBCSD, *Corporate Social Responsibility: Meeting Changing Expectations* (WBCSD, 1999), 3. Among important CSR literature of recent years, see D. Crowther and L. Rayman-Bacchus (eds.), *Perspectives on Corporate Social Responsibility* (Ashgate, 2004); D. Vogel, *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility* (Brookings Institution Press, 2005).

[7] M. Friedman, *Capitalism and Freedom* (University of Chicago Press, 1962), 133–4.

[8] H. Jemel-Fornetty, C. Louche, and D. Bourghelle, 'Changing the dominant convention: the role of emerging initiatives in mainstreaming ESG', in W. Sun, C. Louche, and R. Pérez (eds.), *Finance and Sustainability: Towards a New Paradigm? A Post-Crisis Agenda* (Emerald Group, 2011), 85.

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than ask how business might contribute to sustainability, today's corporate managers are more likely to self-servingly question how sustainability might contribute to their firms' profitability. There is nothing intrinsically objectionable from benefitting financially from sustainable business practices; the problem arises when the financial rationale becomes the only rationale for acting, given that this logic can also work the other way to encourage environmentally unscrupulous development.

The prevalence of a myopic, single-value approach to commerce and investment may thus marginalise CSR strategies that cannot be commuted into the language of financial risk or profitability. The prevailing belief in the CSR movement that companies' ability to manage environmental risks and opportunities is increasingly relevant to business competitiveness, profitability, and organisational competence, while valid, does not provide a comprehensive framework for sustainable business. Missing from this perspective is acceptance of an ethical responsibility to act for environmental well-being, regardless of immediate financial returns. Dominant global CSR and SRI standards, such as the United Nations Principles for Responsible Investment (UNPRI)[9] and the UN Global Compact (UNGC),[10] lack explicit sustainability performance benchmarks. If fund managers or business leaders rely only on narrow grounds to act responsibly, then by their own reasoning they would be justified in making an exception if ignoring those 'extraneous' values would be more profitable. Any commitment to CSR thus remains fragile.

Unsustainable business practices are also attributable to failures of the legal system. Corporate law is an obstacle, especially its problematic tendency to view business enterprises as private institutions despite their often public-like characteristics and social impacts. Under prevailing legal understandings, this book reveals in Chapter 2 by Millon, and Chapter 3 by Sjåfjell and others, that business managers cannot easily accommodate sustainability considerations if they lack economic benefits for the firm or its shareholders, unless the firm is explicitly established as a non-profit or mixed-purpose corporation. The legal duties of senior managers and directors of companies to act to benefit their company's economic prosperity are perceived to exclude consideration of social and environmental issues unless they can offer financial benefits to the business. There is a cognate assumption that environmental standards are preferably quarantined in separate external regulation as opposed to being incorporated

[9] See www.unpri.org. [10] See www.unglobalcompact.org.

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into corporate governance. But as will be explained shortly, modern environmental law has had limited success, despite the sincere efforts of many regulators, judges, and other actors dedicated to the long-term well-being of the planet.[11]

While smarter and more discrete 'external' environmental regulation of companies and financial institutions may help promote sustainability, we also need to incorporate such legal measures into economic institutions. We need to embed environmental standards in the governance of economic institutions in order to minimise the tensions their managers face between reconciling expectations that they act in the public interest while serving their private constituencies. Fund managers, business managers, and other economic decision-makers are expected to prioritise profits or maximise returns to shareholders – goals that create powerful incentives to avoid paying for environmental externalities. Conversely, environmental regulation seeks to communicate responsibility for such externalities and thereby constrain profit-making. By reconciling such mixed messages, environmental protection could be internalised as a fundamental norm for investment and business. It should also thereby help improve compliance with external environmental regulation.

The following section examines the global economic and ecological predicaments that require that this challenge be addressed urgently.

## 2 The global economic and ecological crises

Politicians and corporate executives frequently remind us that our well-being depends on growing the economy.[12] Despite its unsustainable burden on the biosphere, economic growth remains the foremost goal of nations worldwide. The historic economic trends are truly staggering. Worldwide consumer expenditure during the last century rose from US$1.5 trillion in 1900 to US$24 trillion in 1998.[13] Likewise, international trade in goods and services soared from US$50 billion in 1870 to US$8043

[11] For example, S. Wood, G. Tanner, and B.J. Richardson, 'Whatever happened to Canadian environmental law?' (2011) 37(4) *Ecology Law Quarterly* 981.

[12] For example, 'Flaherty raises economic growth forecast', *CBC News*, 2 February 2010, www.cbc.ca/news/business/flaherty-raises-economic-growth-forecast-1.954083; L.P. Bloomfield Jr, 'Corporate investments can help accelerate economic growth in the developing world', *International Business Times*, 19 November 2013, www.ibtimes.com.

[13] United Nations Development Programme (UNDP), *Human Development Report 1998* (UNDP, 1998), 1.

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billion in 2005.[14] Both trends vastly outstripped even the extraordinary surge in human population from some 1.6 billion in 1900 to 7 billion in 2011. In recent decades, a further economic impetus has come from the financial sector. The assets of the world's 1000 largest banks surged from US$23 trillion in 1990 to approximately US$101 trillion by mid-2010, despite the headwinds from the GFC.[15] In late 2010, the global financial economy was valued at approximately US$212 trillion.[16] Such majestic statistics suggest we live in an age of great prosperity that has raised living standards and lifted billions out of poverty.

Apart from the rising economic and social inequalities for some people that have accompanied such growth, one uncomfortable consequence is that the global economy has become very large compared to the ecosystems that sustain it. Natural systems provide innumerable economic and life-support benefits,[17] yet humanity acts brazenly as though Earth's natural bounty is infinitely abundant and free.[18] In *The Cancer Stage of Capitalism*, John McMurtry metaphorically depicts this economic plundering as a malignant tumour.[19] As ecological economists have more academically put it, infinite economic and population growth in a physically finite world is impossible.[20] The debate about such 'limits' is not recent; Thomas Malthus raised it in his influential *Essay on Population*, published in 1778, and since the early 1970s, numerous scientists have warned against rampant growth that devours nature.[21] Resource scarcities

[14] *World Trade Organization (WTO)*, World Trade Report 2007 (WTO, 2007), 244 (expressed in constant 1990 dollar values); see also W. Bernstein, *A Splendid Exchange: How Trade Shaped the World* (Atlantic Monthly Press, 2008).

[15] International Financial Services London (IFSL, now known as TheCityUK), 'Worldwide assets of the banking industry', see also TheCityUK 'Banking: May 2012, financial markets series', available at: www.thecityuk.com/research/our-work/reports-list/.

[16] C. Boxburgh, S. Lund, and J. Piotrowski, *Mapping Global Capital Markets 2011* (McKinsey Global Institute, 2011), 2.

[17] See G.C. Daily, *Nature's Services: Societal Dependence on Natural Ecosystems* (Island Press, 1997); Y. Baskin and P.R. Ehrlich, *The Work of Nature: How the Diversity of Life Sustains Us* (Island Press, 1998); T. Prugh, *et al.*, *Natural Capital and Human Economic Survival* (CRC Press, 1999).

[18] Its economic value is undoubtedly staggering, and was quantified by one notorious study in 1997 at somewhere between US$16–54 trillion annually, dwarfing a then annual global gross economic product of about US$18 trillion: R. Costanza, *et al.*, 'The value of the world's ecosystem services and natural capital' (1997) 389 *Nature* 253.

[19] J. McMurtry, *The Cancer Stage of Capitalism* (Pluto Press, 1999).

[20] H. Daly and J.B. Cobb, Jr., *For the Common Good* (Beacon Press, 1989); H. Daly, *Ecological Economics and the Ecology of Economics* (Edward Elgar, 1999); P. Victor, *Managing Without Growth* (Edward Elgar, 2008).

[21] D.H. Meadows, *et al.*, *The Limits to Growth* (Universe Books, 1972).

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are only part of the problem. There are also limits to the capacity of environmental 'sinks', which serve to assimilate the pollution and other by-products of economic activity. Climate change is the most severe of these emerging sink problems.

Soaring ecological problems provoked the UN's Millennium Ecosystem Assessment in 2005 to warn that 'human activity is putting such strain on the natural functions of the Earth that the ability of the planet's ecosystems to sustain future generations can no longer be taken for granted'.[22] Many other international studies echo this view.[23] In 2012, scientists spoke of the risk of 'threshold-induced state shifts' in the Earth's biosphere that could trigger myriad, unforeseen, devastating consequences for all life.[24] With emerging economies such as China and India rapidly industrialising, and thereby intensifying the global environmental burden, grave ecological tipping points may be irreparably passed soon.

These trends are not simply an expression of some carnal human urge for greater material prosperity – though they do have deep cultural and biological roots[25] – but substantially reflect prevailing economic and political systems. The market economy is particularly influential. Some economists laud the market as crucial to human welfare and a tool to solve our environmental problems, such as by unleashing competitive pressures to pioneer innovative green technologies, efficiently using scarce resources, and pricing pollution risks.[26] Geoffrey Heal optimistically contends, 'This poor [environmental] record is not intrinsic to markets. They can be reoriented in a positive direction, in which case their potential for good is immense.'[27] Similarly, through dematerialisation, new technologies, better management systems, and investment in a knowledge-based economy, Paul Hawken and others champion a benevolent 'natural

[22] Millennium Ecosystem Assessment, *Living Beyond Our Means: Natural Assets and Human Well-Being, Statement from the Board* (Millennium Ecosystem Assessment, 2005) at 5.

[23] United Nations Environment Programme (UNEP), *Global Environment Outlook GEO-5* (UNEP, 2012); Worldwatch Institute, *State of the World 2012: Moving Toward Sustainable Prosperity* (Island Press, 2012).

[24] A.D. Barnosky, *et al.*, 'Approaching a state shift in Earth's biosphere' (2012) 486 *Nature*, 52 at 52.

[25] S. Boyden, *Western Civilization in Biological Perspective: Patterns in Biohistory* (Oxford University Press, 1987).

[26] See generally K. Midgley and R. Burns, *The Capital Market: Its Nature and Significance* (Macmillan, 1977).

[27] G. Heal, 'Markets and sustainability', in R.L. Revesz, P. Sands, and R.B. Stewart (eds.), *Environmental Law, the Economy and Sustainable Development* (Cambridge University Press, 2000), 410 at 427.

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capitalism' that respects the critical interdependency between the economy and nature.[28] Ecological economists recommend more fundamental changes that go beyond improved 'efficiency' of resource use to actually limit economic growth.[29] They highlight how the market suffers from several environmental blind-spots, including fugitive pollution 'externalities',[30] degradation of 'public goods' such as the atmosphere and oceans,[31] undervaluation of ecological services and amenities such as biodiversity,[32] and myopic decision-making that ignores posterity's interests.[33]

Equally troubling, the cornucopia of material wealth gained from this growth binge does not necessarily equate with heightened prosperity. Empirical research suggests that once basic human needs are satiated, further economic growth yields a diminishing marginal return to human happiness.[34] Economic indicators such as Gross Domestic Product (GDP) undervalue the contribution of nature to overall well-being.[35] Moreover, much of this growth has delivered uneven benefits, with just a fifth of humanity earning about 2 per cent of global wealth.[36] Some economists have pioneered alternative measures of economic vitality and satisfaction, suggesting that the seemingly most prosperous nations do not necessarily enjoy the highest contentment.[37]

[28] P. Hawken, L.H. Lovins, and A. Lovins, *Natural Capitalism: Creating the Next Industrial Revolution* (Earthscan, 2000).

[29] See, e.g. M. Common and C. Perrings, 'Towards an ecological economics of sustainability' (1991) 6 *Ecological Economics* 7; A.M. Jansson, *et al.* (eds.), *Investing in Natural Capital: The Ecological Economics Approach to Sustainability* (Island Press, 1994); Jackson, *Prosperity Without Growth*, 5.

[30] A.A. John and R A. Pecchenino, 'International and intergenerational environmental externalities' (1997) 99(3) *Scandinavian Journal of Economics* 371.

[31] T. Cowen, *Public Goods and Market Failures: A Critical Examination* (Transaction Publishers, 1991).

[32] M. Common, *Environmental and Resource Economics: An Introduction* (2nd edn, Longman, 1996), 330–5.

[33] Common, *Environmental and Resource Economics.*

[34] William Rees documents that recent increases in per capital expenditures on US healthcare have not improved the overall health of its population: W.E. Rees, 'The end (of growth) is nigh', paper presented at Ecological Integrity and Sustainable Society Conference (Dalhousie University, 23–7 June 2007).

[35] R. Eisler, *The Real Wealth of Nations: Creating a Caring Economics* (Berrett-Koehler Publishers, 2007).

[36] Jackson, *Prosperity Without Growth*, 5.

[37] H. Henderson, *Ethical Markets; Growing the Green Economy* (Chelsea Green Publishing, 2007). Consider alternative measures of prosperity, such as the 'Index of Sustainable Economic Welfare', www.neweconomics.org, or the 'Happy Planet Index', www.happyplanetindex.org.

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Another crisis, in global financial markets, has recently attracted greater attention from policy-makers and business leaders, yet its causes are partly associated with the same processes fuelling the planetary ecological crisis – namely, excessive risk-taking, failure to incorporate all social costs in the pricing of financial assets, and the short-term orientation of the market. Although some commentators believe '[t]here is nothing inherent in the structure of the financial system which necessarily leads to environmental destruction',[38] such an assumption is largely only plausible at a theoretical level because it ignores problems such as imperfect information, the culture of financial organisations, and collective action problems in the financial industry. The fall-out from the GFC that began in 2008 illustrates how excessive risk-taking by financiers can precipitate wide-ranging economic and social devastation. We are tied to an interconnected global financial system 'in which money traverses national capital markets with dramatic speed and callous scrutiny, bringing with it both the ability to enhance local economic opportunities or break an economy at its very core'.[39] These impacts are also the product of governance gaps and weaknesses, as a growing preference since the 1970s for market deregulation has led to diminished state oversight and control of the financial economy.

The separation of capital and the control of business, the hallmark of corporate capitalism, has also leveraged the separation between investment and social responsibility.[40] Ease of access to capital through financial markets removes corporate financing constraints that might otherwise curb economic growth and thus its environmental consequences. Passive investors also tend to be physically distant from the activities that directly impact the environment, thus weakening their sense of responsibility for taking corrective action. Further fraying the ties between those who manage companies and those who contribute capital, investors tend to own tiny fractional stakes in a multitude of companies in their portfolio, and the ease of selling corporate securities helps diminish the perceived importance of being a shareholder or creditor to the company. The result of so many intermediaries is the diminution of the sense of moral agency of investors for the activities of the companies they fund.

[38] M.A. White, 'Environmental finance: value and risk in an age of ecology' (1996) 5 *Business Strategy and the Environment* 198, at 200.

[39] C.J. Mailander, 'Financial innovation, domestic regulation and the international marketplace' (1997–98) 31(3) *George Washington Journal of International Law and Economics* 341, at 378.

[40] See B.J. Richardson, 'Putting ethics into environmental law: fiduciary duties for ethical investment' (2008) 46(2) *Osgoode Hall Law Journal* 243.

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Whatever environmental sensitivities investors may have, they function within a financial system whose aim is to mobilise capital through loans and investments in order for it to deliver a profit (or 'return' as investors call it). Such returns are unlikely to accrue from investing in firms that do not expand or innovate. Shareholders' and financiers' desire for returns in turn creates pressure on corporations to be profitable in order to repay creditors or generate returns for shareholders. The recent rise in financial capital and the decline in natural capital are thus surely not merely coincidental.

In addition to squandering natural capital, the markets' contribution to material prosperity is reproachable. Although investing has the generic purpose of sacrificing current value and use of existing capital in order to obtain greater future benefit, the financial system is prone to speculative, ephemeral, and short-term tactics that can undermine long-term social and economic well-being.[41] The dominant paradigm of the finance system that arose after the 1950s is grounded on several models, particularly the efficient market hypothesis, the capital asset pricing model for the trade-off between risk and return, the modern portfolio theory of diversification of investment, and arbitrage pricing theory.[42] Over-reliance on these models, which suffer from some unrealistically simple assumptions about financial risk and investor behaviour, coupled with regulatory lacunae and lax market supervision, has created vulnerabilities in the financial economy that metamorphosed into the GFC in 2008. Financial crises are not new, however: a World Bank study identified 112 systemic financial crises in 93 countries between the late 1970s and 2000.[43] The 2008 crisis, however, was of historic breadth and depth, partly because financial markets have become much more integrated than was the case in earlier decades. The crisis led to financial bailouts of US$4.89 trillion between 2007 and 2009 in the United States and the European Union (EU), equivalent to 6 per cent of GDP in each country/region.[44] By contrast, no commensurate sense of urgency and commitment of financial resources have been offered to address global ecological problems.

[41] F. Jameson, 'Culture and finance capitalism' (1997) 24(1) *Critical Inquiry* 246, at 247; A. Harmes, *Unseen Power: How Mutual Funds Threaten the Political and Economic Wealth of Nations* (Stoddard, 2001) at 76.

[42] C.F. Lee and A.C. Lee (eds.), *Encyclopedia of Finance* (Springer, 2006).

[43] World Bank, *Finance for Growth: Policy Choices in a Volatile World* (World Bank, 2001).

[44] J. Black, *Restructuring Global and EU Financial Regulation: Capacities, Coordination and Learning*, Law, Society and Economy Working Paper 18/2010 (London School of Economics, 2010), 8.

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