CORPORATE PURPOSE AND THE IMPACT ON EQUITABLE REMEDIES, ECONOMIC GROWTH AND DEMOCRACY

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Section 131(5) of the Companies Act 1993 permits a director, as part of the duty to act in the best interests of the company, to "consider matters other than the maximisation of profit (for example, environmental, social, and governance matters)".

This article suggests that the section is problematic in that it appears to suggest that ESG factors can override the pursuit of shareholder wealth. That in turn gives rise to three concerns.

First, the section creates added complexity for how to assess whether directors' actions amount to a breach of the fiduciary duty to act in the best interests of the company. That is problematic when the duty gives rise to equitable remedies, such as rescission of contracts, and therefore detracts from commercial certainty. Secondly, the section, by distracting directors from a focus on company and shareholder wealth enhancement, lessens the benefit of the corporate form as an engine for economic growth. Thirdly, an approach that favours ESG matters over shareholder interests is undemocratic, as directors are expected to make judgements on whether actions are socially and environmentally desirable when that should be the function of a democratically elected Parliament.

The article suggests that the current Government was right to suggest that s 131(5) should be repealed.

I INTRODUCTION

Section 131(5) of the New Zealand Companies Act 1993 currently provides that "in considering the best interests of a company … a director may consider matters other than the maximisation of profit (for example, environmental, social, and governance matters)".

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Depending on its interpretation, this is a provision that either has no real consequence or very significant consequences. The incorporation of "environmental, social, and governance" (ESG) factors into s 131 makes no difference if those factors are being considered as part of the desire of the board to enhance long-term company and shareholder value. Such matters can already be considered for that purpose. However, if the section suggests that ESG factors can be considered, even where that is not profitable for a company, then that is a fundamental shift.

This article will consider whether such a shift is consistent with the nature of a director's fiduciary duty and gives rise to concerns given the special remedies that apply for a breach of fiduciary duty under the law of equity. It will also consider whether such a shift impacts the benefit of the corporate form as an engine for economic growth. Finally, it will consider whether an approach that favours ESG matters over the enhancement of shareholder value raises democratic concerns, as directors are expected to make judgements on whether actions are socially and environmentally desirable.

II SECTION 131 AND THE RELEVANCE OF ESG

Section 131 of the Companies Act sets out the duty that has been described as the "core fiduciary duty" of directors, the duty to act in good faith in the best interests of the company.[1] Section 131(1) provides:

> Subject to this section, a director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company.

Traditionally, the interests of the "company" have been associated with the interests of the shareholders as a whole.[2]

Historically, the rationale for this was that it was shareholders who entrusted their moneys with the directors, and it was shareholders who determined the constitutional provisions that defined the powers of the directors. By taking on the position of director, a director undertook to exercise the powers that shareholders agreed they should have. As a result, the shareholders necessarily reposed trust and confidence in the directors.[3]

It was also because shareholders reposed trust and confidence in directors that the courts traditionally provided that directors could only be released from their fiduciary obligations (or

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1 *Yan v Mainzeal Property and Construction Ltd (in liq)* [2023] NZSC 113, [2023] 1 NZLR 296 at [117] per Winkelmann CJ and William Young J.

2 *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, [2024] AC 211 at [19] per Lord Reed.

3 Francis Dawson "Acting in the Best Interests of the Company—For Whom Are Directors 'Trustees'?" (1984) 11 NZULR 68 at 78. Now under the Companies Act 1993, directors' powers are conferred in the first instance by s 128. However, shareholders still have control over the extent of powers conferred on directors through their control over the form of a company's constitution, and shareholders also have the default right (subject to the constitution) to appoint and remove directors (under ss 153 and 156).

permitted to retain profits made in the course of their office) if they obtained the consent of the intended "beneficiaries" of those obligations, being the shareholders. In the recent United Kingdom Supreme Court decision in *BTI 2014 LLC v Sequana SA* (*Sequana*), this principle of shareholder ratification of breaches of directors' duties was described as being "nearly as old as company law itself".[4]

The *Sequana* decision suggests, however, that the justification for equating the interests of a company with those of its shareholders has changed. The modern justification is that the shareholders have an economic interest in the company's assets based on their entitlement to its residual assets on liquidation.[5] However, that changed rationalisation also meant that once a company became insolvent (or insolvency was imminent), the directors were required to take into account the interests of creditors. Once a company was insolvent, it was not clear whether the residual claimants to a company's assets were in fact shareholders or creditors, and so there should be a balancing of shareholder and creditor interests.[6]

The members of the Court in *Sequana* were heavily influenced by the judgment of Street CJ in the New South Wales Court of Appeal decision in *Kinsela v Russell Kinsela Pty Ltd*.[7] In *Kinsela*, Street CJ also took an approach to the duty to act in the best interests of the company based on the expected rights to the residual assets of the company, noting that the party with the potential interest in the residual assets of the company changed once a company became insolvent.

The New Zealand Supreme Court has yet to consider *Sequana* in a s 131 case. However, in *Yan v Mainzeal Property and Construction Ltd*, it did note a requirement to have regard to the interests of shareholders in a solvent company and to have regard to the interests of creditors in an insolvent company.[8]

An alternative approach taken by some commentators is to view the duty to act in the best interests of the company as one to sustain and maximise the value of the corporate fund.[9]

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4 *BTI 2014 LLC v Sequana SA*, above n 2, at [196] per Lord Briggs.

5 At [45] and [47] per Lord Reed.

6 At [47]–[48] and [56] per Lord Reed and [130] and [147] per Lord Briggs. Only Lady Arden would have taken a wider approach to the interests in a company than shareholders and creditors: see [293]–[294].

7 *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (NSWCA) at 730.

8 *Yan v Mainzeal Property and Construction Ltd*, above n 1, at [142] per Winkelmann CJ and William Young J.

9 Susan Watson "What More can a Poor Board Do? Entity Primacy in the 21st Century" (2017) 23 NZBLQ 142 at 153–154.

How then does the introduction of s 131(5), with effect from 4 August 2023, impact the approach to the best interests duty?

A *The Introduction of s 131(5)*

Section 131(5) provides:

> To avoid doubt, in considering the best interests of a company or holding company for the purposes of this section, a director may consider matters other than the maximisation of profit (for example, environmental, social, and governance matters).

A supplementary order paper which would have amended "may" in s 131(5) to "must" failed to pass.[10]

The wording finally enacted replaced the wording originally proposed in the Companies (Directors Duties) Amendment Bill 2021, which would have allowed directors to take into account "recognised environmental, social and governance factors", with a list of five factors being expressly mentioned, including "reducing adverse environmental impacts" and "recognising the interests of the wider community".[11]

The wording of s 131(5) as finally passed is somewhat ambiguous. However, arguably it suggests that ESG matters can be considered even where such matters do not assist in the maximisation of profit, and implicitly where they may reduce the ultimate value of a company's assets.[12]

The current Government has indicated an intention to repeal s 131(5), stating that "the law already allows directors to take into account ESG factors and this new subsection is therefore redundant".[13] However, the subsection is not redundant if s 131(5) allows ESG matters to be taken into account even where promoting such factors would not maximise corporate and shareholder wealth.

The proposition that ESG matters can *override* a consideration of corporate and shareholder wealth maximisation is inconsistent with the approach to the best interests duty in Commonwealth case law. Considering ESG matters even where such matters do not assist in the maximisation of profit does not align well with a duty based on protecting the interests of the residual claimants to a

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10 Supplementary Order Paper 2023 (399) Companies (Directors' Duties) Amendment Bill 2021 (75-2).

11 Companies (Directors Duties) Amendment Bill 2021 (75-1).

12 See Lynn Buckley "Directors' duty of loyalty and ESG considerations: Aotearoa New Zealand's controversial 'Companies (Directors' Duties) Amendment Act 2023'" (2024) 39 Aust Jnl of Corp Law 323 at 325, suggesting that the purpose of the amendment was to dispel uncertainty in cases where financial considerations appear to conflict with ESG-related ones. See also Companies (Directors Duties) Amendment Bill 2021 (75-2) (select committee report) at 2.

13 Cabinet paper "Modernising the Companies Act 1993 and making other improvements for business" (31 July 2024) at [18].

company's assets (shareholders, and in some cases, creditors), or a duty based on maximising the value of the corporate fund.

The traditional approach in Commonwealth case law was that favouring the interests of parties other than shareholders was only permitted where that provided benefit to the ongoing business of the company and shareholders. So, for example, gratuitous payments to employees or former employees were not considered appropriate (and in some cases even considered to go beyond the company's capacity) where the company had no ongoing business.[14]

The position has traditionally been similar in the United States. There also, the case law suggests that the interests of stakeholders other than shareholders should only be considered where that would benefit shareholders.[15] Blair and Stout did suggest that the United States case law has permitted directors to *sacrifice* shareholders' returns for other constituencies.[16] However, the case law does not support that proposition.[17]

B ESG Factors as a Contributor to Corporate and Shareholder Wealth

Having regard to ESG factors can of course, in some circumstances, be completely consistent with the maximisation of corporate and shareholder wealth.

The paper normally credited as the origin of ESG, *Who Cares Wins*, suggested that the use of ESG factors was consistent with shareholder wealth maximisation. The paper noted how "good management of ESG issues contributes to shareholder value creation", stated that companies who perform better on ESG measures "can increase shareholder value by better managing risks related to

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14 *Hutton v West Cork Railway Co* (1883) 23 ChD 654 (CA); and *Parke v Daily News Ltd* [1962] Ch 927 (Ch). Now, however, under s 132 of the Companies Act, it is permissible to make payments to employees on the sale or cessation of the company's business.

15 *Revlon Inc v MacAndrews & Forbes Holdings Inc* 506 A 2d 173 (Del 1986) at 182; *eBay Domestic Holdings Inc v Newmark* 16 A 3d 1 (Del Ch 2010) at 33; Stephen M Bainbridge "Interpreting Nonshareholder Constituency Statutes" (1992) 19 Pepp L Rev 971 at 982–983; Leo E Strine Jr "The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law" (2015) 50 Wake Forest L Rev 761 at 768; and Dorothy S Lund and Elizabeth Pollman "The Corporate Governance Machine" (2021) 121 Colum L Rev 2563 at 2579–2580. More generally, see James J Hanks Jr "Playing with Fire: Nonshareholder Constituency Statutes in the 1990s" (1991) 21 Stetson L Rev 97 at 99–102. Any consideration of benefit for non-shareholder groups "must be rationally related to the interests of stockholders": at 102.

16 Margaret M Blair and Lynn A Stout "A Team Production Theory of Corporate Law" (1999) 85 Va L Rev 247 at 303–305.

17 David Yosifon *Corporate Friction* (Cambridge University Press, Cambridge, 2018) at ch 4; and Stephen M Bainbridge *The Profit Motive: Defending Shareholder Value Maximization* (Cambridge University Press, Cambridge, 2023) at ch 4. See also Alan J Meese "The Team Production Theory of Corporate Law: A Critical Assessment" (2002) 43 Wm & Mary L Rev 1629 at 1689, stating "each of the decisions that Blair and Stout invoke is consistent with the shareholder primacy norm, and some unambiguously support it".

emerging ESG issues, by anticipating regulatory changes or consumer trends, and by accessing new markets or reducing costs" and commented that "ESG issues can have a strong impact on reputation and brands, an increasingly important part of company value".[18]

The New Zealand Institute of Directors, in its 2021 best practice document for corporate governance, expressly noted a connection between consideration of community interests and "long-term maximisation of shareholder value".[19] It also suggested that institutional investors were paying greater attention "to ESG matters and the impact they have on current and future investment returns".[20]

For example, taking an environmentally appropriate approach to business may also be in the shareholders' interests if it avoids the risk of legal action or if it protects the company from being subject to more rigorous regulation.[21]

Matters that fall under the heading of ESG can impact a company's risk and, therefore, potential financial return.[22] They can also impact its corporate reputation and brand.[23] A company that is perceived to be socially irresponsible can lose customer support[24] (though it is also true that a firm

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18 United Nations Global Compact *Who Cares Wins: Connecting Financial Markets to a Changing World* (December 2004) at 9. See also Elizabeth Pollman "The Making and Meaning of ESG" (2024) 14 Harvard Business L Rev 403 at 413–417; and Lund and Pollman, above n 15, at 2613.

19 Institute of Directors New Zealand *The Four Pillars of Governance: Best Practice for New Zealand Directors* (2021) at 17.

20 At 35.

21 Susan Watson *The Making of the Modern Company* (Hart Publishing, Oxford, 2022) at 259–260. See also Michael J Vargas "In Defense of E Merrick Dodd: Corporate Social Responsibility in Modern Corporate Law and Investment Strategy" (2018) 73 Bus Law 337 at 370: "… self-imposed moderation in the name of ESG may help counter systemic risks created by deregulation"; and Larry E Ribstein "Accountability and Responsibility in Corporate Governance" (2006) 81 Notre Dame L Rev 1431 at 1444: "Given present and potential government regulation and civil remedies, corporate harms can trigger substantial costs that can reduce share prices".

22 NZX *NZX Corporate Governance Code* (January 2025) at 32: "material risks … may include health and safety and other ESG factors"; Financial Markets Authority *Corporate governance in New Zealand: Principles and guidelines* (2018) at 22, recommending that entities consider ESG matters as part of their risk assessment; and Stavros Gadinis and Amelia Miazad "Corporate Law and Social Risk" (2020) 73 Vand L Rev 1401 at 1426, claiming ESG's mission "is to identify risks that, though emanating from a social or moral core, can lead the company into deep financial trouble, hurting its earnings and stock price performance". See also at 1411 and 1467.

23 Institute of Directors New Zealand, above n 19, at 12.

24 At 29.

can suffer huge loss of customer support by favouring liberal social causes which its more conservative customer base does not agree with[25]).

However, to the extent that ESG matters enhance long-term company and shareholder value, there is no need for specific reference to such matters in s 131. As Alex Edman notes, ESG is "no better or worse than other factors that drive long-term value".[26]

C The Use of ESG Factors When Inconsistent with Enhancement of Corporate Value

While the taking into account of ESG factors originally may have been sold on the basis of the theory that such factors enhance long-term corporate and shareholder value, some have since pushed for ESG factors to be considered as a driver for social change, regardless of whether corporate and shareholder value is enhanced by doing so.[27] For many, ESG simply became associated with a form of corporate social responsibility.[28]

Section 131(5) itself is capable of interpretation as a provision intended to drive social change. The way s 131(5) is worded appears to depart from the original focus of ESG as a mechanism for enhanced corporate and shareholder wealth and to permit the pursuit of social objectives for their own sake. The wording appears to permit directors to take account of ESG matters even where that would prejudice shareholder interests (as the section arguably allows consideration of ESG matters even when they are not consistent with the maximisation of profit). If interpreted in that way, the inclusion of s 131(5) would, in my view, be unprincipled, economically undesirable and undemocratic.

III CONSISTENCY WITH THE FIDUCIARY DUTY OF LOYALTY

The first concern with s 131(5) is whether it is unprincipled because it is inconsistent with the nature of the best interests duty as a fiduciary duty. The argument is that s 131(5) has the result that

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25 See for example the huge loss of shareholder value suffered in 2023 by the parent company owning the Bud Light beer brand: B&T "Go Woke, Go Broke! Bud Light's Parent Co Loses $6 Billion in Six Days Following Trans Backlash" (14 April 2023) <www.bandt.com.au>.

26 Alex Edmans "The end of ESG" (2023) 52 FM 3 at 5.

27 Pollman, above n 18, at 428–433.

28 See for example Ann M Lipton "Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure" (2020) 37 Yale J on Reg 499 at 532: "Far from pursuing investor wealth, much of the sustainability movement is designed to make corporate profits difficult to achieve unless management attends to the needs of noninvestor stakeholders".

the fiduciary duty of loyalty to protect the interests of the company's residual claimants (or alternatively to preserve the corporate fund) no longer achieves that objective.[29]

As economist Milton Friedman famously said in 1970 in relation to the actions of a corporate executive: "Insofar as his actions in accord with his 'social responsibility' reduce returns to stock holders, he is spending their money".[30] Actions made by a director in support of his or her own sense of social responsibility amount to an involuntary wealth transfer from shareholders to non-shareholders.[31]

In the United States context, Lynda Oswald has even argued that statutory provisions that allow directors to transfer wealth from shareholders to other stakeholders amount to an unconstitutional taking of private property.[32] In the context of trust law, it would be a breach of fiduciary duty for trustees to make investment decisions based on their own social, moral or political views where other investments would be more financially advantageous, at least where the purpose of a trust is the provision of financial benefits.[33]

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29 Rosemary Teele Langford "Best Interests: Multifaceted but Not Unbounded" (2016) 75 CLJ 505 at 526:

> … effecting actual protection and promotion of stakeholder interests (independently of a reference point such as the interests of the company or entity maximisation and sustainability) via the best interests rule arguably renders the current model of directors' duties unworkable and undermines the fiduciary paradigm.

30 Milton Friedman "A Friedman doctrine—The Social Responsibility of Business Is to Increase Its Profits" *The New York Times* (New York City, 13 September 1970). See also Gregory R Andre "Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform" (1987) 12 Del J Corp L 865 at 883: "Private corporations … are not organized expressly for charitable purposes and should not be operated for charitable purposes at the expense of shareholders".

31 Christopher Smart "Takeover Dangers and Non-Shareholders: Who Should be Our Brothers' Keeper?" [1988] Colum Bus L Rev 301 at 319.

32 Lynda J Oswald "Shareholders v Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause" (1998) 24 J Corp L 1. Oswald gives as an example the acceptance by the directors of Conrail Inc of a merger that valued Conrail at $102 per share rather than an all-cash offer at $115 per share, where the chairman of Conrail justified that decision as being in the "best interests of Conrail and its constituencies, including shareholders, employees, suppliers, customers, and communities served": at 23.

33 *Cowan v Scargill* [1985] Ch 270 (Ch) at 287–289 (trustees of mineworkers' pension scheme held obliged to exercise power of investment so that trust funds yielded the best return notwithstanding the personal moral objection of some trustees to investments in oil and overseas investments); *Martin v City of Edinburgh District Council* [1988] SCLR 90 (Court of Session) at 96 (members of council acting as trustees held to breach duty by not applying their minds to the question of whether divestment of South African investments would be in the best interests of beneficiaries when applying an anti-apartheid policy without taking professional advice); *Harries v The Church Commissioners for England* [1992] 1 WLR 1241 (Ch) at 1246–1252 (Court refused to make declaration that would have required trustees to exclude certain investments on moral grounds where that would risk significant financial detriment to trust funds); Geraint W Thomas "The duty of trustees to act

A breach of the fiduciary duty of loyalty to a company has very important remedial consequences.[34] A breach of fiduciary duty gives rise to special remedies that do not arise in the context of non-fiduciary duties. In particular, such a breach can lead to rescission of contracts[35] or liability of third parties for knowing receipt or dishonest assistance.[36] Permitting directors, in assessing their fiduciary duty of loyalty, to take account of ESG matters, even where that would prejudice the interests of the residual claimants of a company, would impact the availability of such special remedies.

For example, how would standard remedies for breach of fiduciary duty, such as rescission of contracts, apply when a director deliberately acts disloyally, contrary to the interests of the residual claimants of the company, but seeks to justify the decision based on some ESG consideration? In that situation, would the normal remedies for breach of a fiduciary duty of loyalty simply not apply?

Alternatively, if a director fails to take into account some ESG consideration in entering into a contract for the company, is there a risk that a minority shareholder takes legal action, arguing that entering into the transaction should be considered to be in breach of s 131? The shareholder might then argue that an injunction should be granted to prevent the transaction, or that the transaction should be set aside.[37] By way of example, minority shareholders have already shown a willingness to bring legal action seeking to interfere with board policy on matters related to the reduction of emissions.[38] The risk of legal action that seeks to interfere with board policy on matters with an environmental or social dimension (including entering into contracts) must increase with the introduction into s 131(5)

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in the 'best interests' of their beneficiaries" (2008) 2 J Eq 177; and Lord Nicholls "Trustees and their Broader Community: Where Duty, Morality and Ethics Converge" (1996) 70 ALJ 205 at 211.

34 See also John Land "Defining the Scope of the Fiduciary Duty to Act in the Best Interests of the Company after *Sequana*: Remember the Remedial Implications" (2024) 27 NZBLQ 227.

35 *Kinsela v Russell Kinsela Pty Ltd (in liq),* above n 7; *Westpac Banking Corp v Bell Group Ltd (in liq) (No 3)* [2012] WASCA 157, (2012) 89 ACSR 1; *Mernda Developments Pty Ltd (in liq) v Alamanda Property Investments No 2 Pty Ltd* [2011] VSCA 392, (2011) 86 ACSR 277 at [47]–[48] and [56]; *Netglory Pty Ltd v Caratti* [2013] WASC 364 at [364], [389]–[391] and [759]; *Australian Growth Resources Corp Pty Ltd (recs and mgrs appt'd) v Van Reesema* (1988) 13 ACLR 261 (SASC) at 271; *Lindgren v L & P Estates Ltd* [1968] Ch 572 (CA); and *Bishop Warden Property Holdings Ltd v Autumn Tree Ltd* [2018] NZCA 285, [2018] 3 NZLR 809 at [18], n 3.

36 *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)* (1997) 26 ACSR 544 (VSC); *Madoff Securities International Ltd (in liq) v Raven* [2013] EWHC 3147 at [347]–[373]; and *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465 at 472 and 478–479 (NSWCA).

37 For an example of a (successful) application for interim injunction to prevent action alleged to be in breach of s 131, see *Shell (Petroleum Mining) Co Ltd v Todd Petroleum Mining Co Ltd* CA70/05, 3 August 2005 at [93]. For examples of cases where the remedy of rescission (avoidance) of contracts has been sought for contracts said to entered into in breach of the duty to act in the best interests of the company, see n 35 above.

38 *ClientEarth v Shell plc* [2023] EWHC 1897 (Ch).

of an express reference to ESG matters. That risk could adversely affect commercial certainty in relation to contracts entered into by boards.

Accordingly, s 131(5) detracts from the concept of the duty to act in the best interests of the company, being a true fiduciary duty of loyalty owed to the company for the benefit of the residual claimants, and may jeopardise commercial certainty.

IV THE CORPORATE FORM AS AN ENGINE FOR ECONOMIC GROWTH

The second concern with s 131(5) is how the suggested focus on matters other than profit fits in with the economic purposes behind permitting or encouraging the corporate form of business organisation.

What are we trying to achieve through the corporate form of business organisation? The answer to that question must surely be the promotion of a method of business organisation that is conducive to the efficient operation of markets and economic growth.

The economic benefits of the corporate form were a substantial consideration for the Law Commission, and the New Zealand Parliament, in the law reform process that led to the passing of the Companies Act.

The Law Commission referred in its principal report 9 to "the economic and social benefits of company form".[39] The Act itself as passed reinforces this. It notes in its long title that a purpose of the Act is:

> to reaffirm the value of the company as a means of achieving economic and social benefits through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks …

Nobel Prize winner and President of Columbia University, Nicholas Butler, described the limited liability company as "the greatest single discovery of modern times", saying further "Even steam and electricity … would be reduced to comparative impotence without it".[40]

How do we ensure that the economic benefits produced by competitive markets are best achieved where the market participants are largely firms using the corporate form?

Economic benefits are obtained through the production and sale of products in markets. As a matter of basic economics, free markets produce the quantity of goods and services that maximise the

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39 Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989) at [22].

40 Nicholas Murray Butler, President of Columbia University "Politics and Business" (Address at the 143rd Annual Banquet of the Chamber of Commerce of the State of New York, New York City, 16 November 1911), as cited in George A Mocsary "Freedom of Corporate Purpose" [2016] BYU L Rev 1319 at 1341 and n 108.

sum of consumer and producer surplus.[41] Higher prices and profits provide the incentive for the transfer of resources from less profitable to more profitable activities.[42]

There are two qualifications to this.

First, the relevant market for the sale of a particular good or service needs to be reasonably competitive for this to be true. If a firm or group of firms are able to exercise market power, this will distort the efficient allocation of resources. Profit maximisation will not lead to optimal outcomes if a country's markets are not reasonably competitive.[43] Competition law and policy are based on the principle that the incentives created in competitive markets will ensure that resources are devoted in such a way that the welfare of society is maximised.[44] As the High Court noted in *Wellington International Airport Ltd v Commerce Commission*, it is the prices that tend to be generated in workably competitive markets that provide incentives for efficient investment and innovation.[45]

The second qualification occurs where the activities of a given industry, or particular firms in an industry, have adverse side effects that affect persons who are not participants in the market. Such side effects are known as market "externalities".[46] Some, but not all, of the matters considered under the heading of ESG might be described as externalities. The impact of a firm's activities on the environment is an obvious example. The problem of market externalities is commonly dealt with by regulation.

Subject to the potential problems of market power and externalities, however, free markets have the potential to produce substantial benefits to society.

Markets work because they are an efficient means to ensure that investment is put into areas of production that are desired by consumers. This occurs through supply and demand. If demand for a particular product is higher, then prices for that product will rise, and suppliers of the products will make profits. That, in turn, will cause investors to divert resources into the supply of that product so as to share in those profits.

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41 N Gregory Mankiw *Principles of Economics* (9th ed, Cengage Learning, Boston, 2021) at 143–145.

42 Wilber G Katz "Responsibility and the Modern Corporation" (1960) 3 JLE 75 at 80.

43 Mark J Roe "The Shareholder Wealth Maximization Norm and Industrial Organization" (2001) 149 U Pa L Rev 2063 at 2066–2068 and 2080.

44 Herbert Hovenkamp *Federal Antitrust Policy: The Law of Competition and its Practice* (West Publishing Co, St Paul, 1994) at 2–3.

45 *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289 at [20].

46 Michael C Jensen "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (2002) 12 Business Ethics Quarterly 235 at 239.

On the other hand, if supply is greater than demand, then the profits of suppliers will fall or perhaps even result in losses. That, in turn, will cause suppliers to divert their capital to other areas which consumers value more.

It is the incentive to employ resources in areas where profits are made that makes markets work. The making of profits and losses provides incentives to supply innovative and better goods and services demanded by customers and to reduce costs. Profit and loss signals lead to resources being employed in the production of different, more highly valued products and services. They may, for example, have led investors to withdraw investment in chains of video hire stores like Blockbuster, and instead invest in streaming services such as Netflix or Disney+.

The drive towards profit maximisation ensures efficient allocation of resources. De Bow and Lee comment:[47]

> An evolutionary process prevails in which those firms that organize in ways that best facilitate the cooperation of owners, managers, and workers for the purpose of creating consumer value have the best long-run prospects for survival. Corporate law's current focus on profit maximization plays an important role in this evolutionary process by promoting and disciplining organizational innovations in ways that, over time, increase economic productivity. … In fact, any legal regime that promotes business decisions directed at anything other than profit maximization has a negative effect on economic efficiency and, by extension, on consumer and social welfare.

The drive towards profit maximisation also encourages innovation. Christina Skinner comments: "profit incentivizes experimentation, which leads to break-through technologies, medicines, or consumer services, ultimately enhancing human welfare".[48]

It is then the decisions of investors as to where resources are employed, driven by the profit motive, that are key to the operation of markets.

In the case of the corporate form, the investors are the shareholders. It is the shareholders who are the persons who need to be encouraged by the incentive of obtaining profits to employ resources in those sectors of the economy where consumers will most value the products or services produced. Shareholders, as the residual claimants of a firm, have the appropriate incentives consistent with efficient decision-making, such as to invest in new products and plant when the gains from doing so exceed the costs.[49]

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47 Michael E DeBow and Dwight R Lee "Shareholders, Nonshareholders and Corporate Law: Communitarianism and Resource Allocation" (1993) 18 Del J Corp L 393 at 418.

48 Christina Parajon Skinner "Cancelling Capitalism?" (2021) 97 Notre Dame L Rev 417 at 429.

49 Frank H Easterbrook and Daniel R Fischel "Voting in Corporate Law" (1983) 26 JLE 395 at 403. See also Robert Charles Clark *Corporate Law* (Little, Brown and Company, Boston, 1986) at 389.

As Eugene Rostow, then Dean of Yale Law School, said in supporting the position that directors owe a duty for the benefit of shareholders:[50]

> The law books have always said that the board of directors owes a single-minded duty of unswerving loyalty to the stockholders, and only to the stockholders. The economist has demonstrated with all the apparent precision of plane geometry and the calculus that the quest for maximum revenue in a competitive market leads to a system of prices, and an allocation of resources and rewards, superior to any alternative, in its contributions to the economic welfare of the community as a whole.

Stephen Bainbridge credits the shareholder wealth maximisation norm as being responsible for the high standard of living in the United States.[51]

From a perspective of economic efficiency, then, I would suggest that directors advancing an objective of shareholder wealth maximisation is optimal. It is the approach that is most likely to lead to the efficient production of goods and services that consumers most desire.

As discussed above, taking into account ESG matters can be quite consistent with shareholder wealth maximisation.

An approach, however, that allows ESG consideration to *outweigh* shareholder wealth maximisation would detract from the effectiveness of the corporate form in its use in the market economy and undermine the wealth-creating attributes of the corporate form of business organisation.[52]

DeBow and Lee comment that a communitarian (ESG) approach to corporate law would "substitute political pressures for market incentives as the guide for investment decisions", a course of action which was "guaranteed to adversely affect the long-run performance of the economy".[53] The

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50 Eugene V Rostow "To Whom and for What Ends is Corporate Management Responsible?" in Edward S Mason (ed) *The Corporation in Modern Society* (Harvard University Press, Cambridge (Mass), 1959) 46 at 63. See also 67; and Ribstein, above n 21, at 1464:

> While commentators might denigrate decisions that 'merely' produce profits, the fact that the company is selling products for more than they cost the company to produce is an important signal that it is creating social wealth.

51 Stephen M Bainbridge "In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green" (1993) 50 Wash & Lee L Rev 1423 at 1446.

52 Jensen, above n 46, at 243; and Committee on Corporate Laws "Other Constituencies Statutes: Potential for Confusion" (1989) 45 Bus Law 2253 at 2268.

53 DeBow and Lee, above n 47, at 419.

long-run costs of such an approach would be imposed not just on shareholders but the general public:[54]

> … through a less efficient allocation of resources and a less innovative and productive economy, as compared with the allocation of resources that now results from firms' profit seeking under the current legal regime.

More recently, Edward Rock has commented that the worry is that "using private law to solve social problems will destroy the value generating potential of private law while failing to solve the social problems, leaving all of us worse off".[55]

How specifically would this occur?

A Incentives to Invest

First, a move away from shareholder wealth maximisation would naturally dampen incentives to invest.[56]

If shareholders do not receive a return commensurate with the risk they are taking, they will likely divest their shareholding in favour of other investments, and the cost of the firm obtaining equity capital will rise. A number of commentators have made the point that a move away from a shareholder-focused approach to corporate purpose will naturally diminish incentives to invest and increase the cost of capital.[57] Decreased incentives to invest will in turn inhibit and lessen economic growth.[58]

54 At 419. See also at 421: "… shifting control over management away from the stockholders and towards nonshareholders would result in a dramatic departure from the optimal use of the society's resources".

55 Edward B Rock "For Whom Is the Corporation Managed in 2020?: The Debate over Corporate Purpose" (2021) 76 Bus Law 363 at 395.

56 John Lintner "The Financing of Corporations" in Edward S Mason (ed) *The Corporation in Modern Society* (Harvard University Press, Cambridge (Mass), 1959) 166 at 188–190, finding that profitability and the pressure of increasing sales were the dominant determinants of investment outlays; Julian Velasco "The Fundamental Rights of the Shareholder" (2006) 40 UC Davis L Rev 407 at 454; and Charles M Elson and Nicholas J Goossen "E Merrick Dodd and the Rise and Fall of Corporate Stakeholder Theory" (2017) 72 Bus Law 735. Contrast Michael Vargas "In Defense of E Merrick Dodd: Corporate Social Responsibility in Modern Corporate Law and Investment Strategy" (2018) 73 Bus Law 337.

57 Hanks, above n 15, at 117; and Frank H Easterbrook and Daniel R Fischel "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harv L Rev 1161 at 1192.

58 William T Allen, Jack B Jacobs and Leo E Strine Jr "The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide" (2002) 69 U Chi L Rev 1067 at 1090.

From the point of view of the New Zealand economy, the risk with a move away from shareholder wealth maximisation is that investors take their capital "to more investor-friendly jurisdictions".[59]

Some commentators suggest that many shareholders do not supply fresh capital to companies so we should be less concerned about looking after the interests of shareholders as a way of ensuring investment of capital. However, this ignores the substantial impact that secondary markets for the sale of shares have on investors' initial willingness to invest. The primary market for investment is only made possible by the existence of a secondary market that allows liquidity for sale of shares at favourable prices.[60]

B Misallocation of Resources

Secondly, a move away from a focus on shareholder wealth maximisation would interfere with the market signals that ensure an efficient allocation of resources, and the incentive for innovation.[61]

Directors exercising their powers based on what they decide is the public good, rather than in the interests of shareholders, could undermine the efficiency of the market system. As Rostow puts it: "The new corporate morality may result in prices and wages which sabotage the market mechanism and systematically distort the allocation of resources".[62]

A decision by directors not to maximise profit will lead to capital being attracted to areas which they would not have been "if the market mechanism had been more accurate in measuring the comparative intensity of consumers' desires for different products".[63] This would result in inefficient allocations of capital resources and stagnate the economy.[64] The production of profits through products being sold for more than they cost is a signal that a company is creating social wealth.[65] If managers are not driven by shareholder wealth maximisation, then managers are diverted from the conduct likely to create such wealth.

Christina Skinner also notes the importance of shareholder profit in providing the "motivational spark" for innovation leading to "break-through technologies, medicines, or consumer services".[66]

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59 Roger Partridge "Directors' Duties Bill is well-meaning but harmful" *The New Zealand Herald* (online ed, Auckland, 4 May 2022). DeBow and Lee make a similar point: DeBow and Lee, above n 47, at 409–415.

60 Douglas Litowitz "Are Corporations Evil?" (2004) 58 U Miami L Rev 811 at 826.

61 DeBow and Lee, above n 47, at 415–422.

62 Rostow, above n 50, at 64.

63 Rostow, above n 50, at 65.

64 Smart, above n 31, at 330.

65 Ribstein, above n 21, at 1464.

66 Skinner, above n 48, at 429.

Theodore Levitt many decades ago referred to sentiment as a debilitating influence, saying that it "fosters leniency, inefficiency, sluggishness, extravagance, and hardens the innovationary arteries".[67]

C Reduced Accountability

Thirdly, allowing directors the ability to take into account ESG matters, even where that decreases corporate and shareholder wealth, will mean reduced accountability on directors. In turn, that means less pressure on directors to maximise revenues and reduce costs. As Bebchuk and Tallarita state:[68]

> Specifically, enhanced insulation and reduced accountability would increase managerial slack, worsen corporate performance, and reduce economic efficiency and value-creation. Indeed, there is a substantial body of empirical evidence that increased insulation and reduced accountability are associated with worse managerial decisions and worse corporate performance.

D Impact on Risk-Taking

Fourth, allowing directors leeway to sacrifice corporate wealth for ESG factors will dampen the drive for economic growth through risk-taking. The advantage of the corporate form as a driver for economic growth through risk-taking was highlighted by the Law Commission in its report leading to the passing of the Companies Act. The Commission commented:[69]

> It is important to appreciate that the benefits of limited liability lie not only in the limitation of risk to individual investors (which is an incentive for aggregation of capital) but also in enabling risk-taking. The taking of business risks is central to the success and social utility of the company.

By contrast, Blair and Stout appear to suggest directors should be entitled to choose the "quiet life", granting concessions to other stakeholders even where that is contrary to shareholder interests.[70]

They even appear to suggest that directors are to be applauded for avoiding business risk where that benefits the directors themselves. Blair and Stout give as one example reducing the risk of a company by acquiring an unrelated business. They suggest this might not benefit shareholders but would benefit directors and other stakeholders "who have a stronger interest than the shareholders do in ensuring that the firm remains solvent".[71]

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67 Theodore Levitt "The Dangers of Social Responsibility" (1958) 36(5) Harv Bus Rev 41 at 48.

68 Lucian A Bebchuk and Roberto Tallarita "The Illusory Promise of Stakeholder Governance" (2020) 106 Cornell L Rev 91 at 167.

69 Law Commission, above n 39, at [22(d)]. See also [11], [23] and [323] for the Law Commission's views as to the economic and social value of the corporate form in permitting the aggregation of capital and the taking of business risks.

70 Blair and Stout, above n 16, at 306.

71 At 307.

Conservative firm management that seeks to protect directors' own positions is not the kind of commercial risk-taking that many have recognised as desirable for economic growth.

E Reduced Competitiveness

Fifth, in some cases, firms that do try and maximise matters other than shareholder wealth may be weakened competitively, and potentially even fail. Jensen comments that stakeholder theory will leave the firm "handicapped in the competition for survival".[72]

The extent to which a wider approach to corporate purpose could impact competition and the efficient operation of markets is indicated in the recent debate between Bebchuk and Tallarita, and Colin Mayer. Bebchuk and Tallarita had asked whether directors might be expected to take account of the effect of a firm's activities on the workers of *competitors* of the firm.[73] Surprisingly, Mayer answers "yes, of course".[74] But the effectiveness of competition as a driver for economic success depends on competitors *not* pulling their competitive punches!

One of the best-known quotes from a leading competition law case is that found in *Ball Memorial Hospital Inc*:[75]

> Competition is a ruthless process. A firm that reduces cost and expands sales injures rivals – sometimes fatally. The firm that slashes costs the most captures the greatest sales and inflicts the greatest injury. The deeper the injury to rivals, the greater the potential benefit. These injuries to rivals are byproducts of vigorous competition, and the antitrust laws are not balm for rivals' wounds. The antitrust laws are for the benefit of competition, not competitors. … The antitrust laws protect efficient production for the benefit of consumers.

This passage has been frequently cited with approval by commentators and courts in many jurisdictions, including New Zealand.[76] Competition law is encouraged for its economic benefits. It would be bizarre if what is encouraged under the Commerce Act 1986 could then be undermined by principles of corporate governance. Further, as Bowen LJ said back in 1889:[77]

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72 Jensen, above n 46, at 237.

73 Bebchuk and Tallarita, above n 68, at 118.

74 Colin Mayer "Shareholderism versus Stakeholderism—A Misconceived Contradiction: A Comment on 'The Illusory Promise of Stakeholder Governance', by Lucian Bebchuk and Roberto Tallarita" (2021) 106 Cornell L Rev 1859 at 1863.

75 *Ball Memorial Hospital Inc v Mutual Hospital Insurance Inc* 784 F 2d 1325 (7th Cir 1986) at [44].

76 See for example Matt Sumpter *New Zealand Competition Law and Policy* (CCH New Zealand, Auckland, 2010) at 256.

77 *Mogul Steamship Co Ltd v McGregor and Co* (1889) 23 QBD 598 (CA) at 615; aff'd [1892] AC 25 (HL).

> To say that a man is to trade freely, but that he is to stop short at any act which is calculated to harm other tradesmen, and which is designed to attract business to his own shop, would be a strange and impossible counsel of perfection.

In summary, requiring directors to make decisions based on ESG factors, even where that sacrifices corporate and shareholder wealth maximisation, will detract from the effectiveness of the corporate form as an engine of economic growth, thereby undermining a key purpose behind the passing of the Companies Act.

V THE MAKING OF SOCIAL AND POLITICAL DECISIONS

The third concern with s 131(5) is whether the suggested focus on ESG matters above shareholder wealth gives rise to democratic concerns.

What are directors doing when they make decisions based on ESG factors in a situation where doing so detracts from corporate and shareholder wealth maximisation? In such a case, directors are not acting to manage the business of the company as required by s 128 of the Companies Act. They are instead acting as drivers of social change when the proper policymakers on matters of social reform are our democratically elected Parliament.

It is true to say that s 131(5) is a provision enacted by Parliament. However, Parliament has not clearly defined what specific socially desirable actions it considers companies should follow, nor have any such specific actions been the subject of study or democratic debate.

There is no problem of course in Parliament passing specific legislation that imposes on businesses regulations for the protection of, for example, the environment. That is what Parliament is there for. Passing such legislation ensures that externalities (such as adverse environmental impacts) are minimised by regulation that applies to *all businesses*, and not just those companies whose directors choose to follow ESG objectives.

The objection instead is to providing directors with the vague permission to take into account "environmental, social, and governance matters" without any precision as to what that entails.

A The Vagueness of ESG

There is no clear or fixed definition of ESG.[78] The Ministry of Business, Innovation and Employment, in advising the parliamentary select committee on the Companies (Directors' Duties) Amendment Bill 2021, said that it was not clear that there was a "recognised" set of established ESG factors.[79] The NZX ESG Guidance Note comments that "A definitive list of ESG issues does not

78 Quinn Curtis, Jill Fisch and Adriana Z Robertson "Do ESG Mutual Funds Deliver on Their Promises?" (2021) 120 Mich L Rev 393 at 402; and Pollman, above n 18, at 439.

79 Ministry of Business, Innovation and Employment *Companies (Directors' Duties) Amendment Bill: Initial briefing to the Economic Development, Science and Innovation Committee* (13 January 2023) at [31].

exist" and that such factors appear to be constantly changing.[80] Elizabeth Pollman describes the term ESG as a "highly flexible moniker".[81]

The number of issues that potentially fall within ESG is large. Amanda Rose comments that the ESG acronym is used as a shorthand for a "dizzyingly broad array" of environmental, social and governance topics affecting businesses.[82] Gadinis and Miazad comment "ESG's scope expands by the day with new concerns vying for corporate attention, like the use of sugar in packaged foods or children and screen time".[83]

The United States Department of Labour has previously suggested that the term ESG was "not a clear or helpful lexicon for a regulatory standard".[84]

There are models for ranking companies on their consideration of ESG matters. However, these have been prepared by private organisations rather than by Parliament. Further, standards for reporting on ESG matters diverge. There are more than 600 ESG ratings organisations with the number continuing to grow.[85] The NZX ESG Guidance Note comments that "there is no consensus on reporting standards globally".[86]

The New Zealand Institute of Directors similarly notes that there are a significant number of frameworks and forms of reporting on what it refers to as "external extended reporting" that extends to reporting on environmental, social and cultural impacts. The Institute of Directors comments that this has created "a complex reporting environment" and sets out in its governance best practice guidelines a lengthy shopping list of potential frameworks, forms and standards.[87]

Amanda Rose comments that ESG performance ratings "are inconsistent and difficult to decipher".[88] Elizabeth Pollman comments that ratings may be unreliable, and not subject to

80 NZX *Guidance Note: NZX ESG Guidance* (24 May 2024) at 4.

81 Pollman, above n 18, at 407.

82 Amanda M Rose "A Response to Calls for SEC-Mandated ESG Disclosure" (2021) 98 Wash U L Rev 1821 at 1822. For the wide range of issues covered by ESG, see Curtis, Fisch and Robertson, above n 78, at 403.

83 Gadinis and Miazad, above n 22, at 1415 (footnote omitted).

84 Rose, above n 82, at 1827.

85 Pollman, above n 18, at 437; and Curtis, Fisch and Robertson, above n 78, at 400 and 403.

86 NZX, above n 80, at 8.

87 Institute of Directors New Zealand, above n 19, at 223–224.

88 Rose, above n 82, at 1825.

standardised approaches.[89] ESG ratings vary substantially among providers, as organisations vary both in the data they collect and the methodology they use to incorporate the data.[90]

A recent study by Berg and others shows ratings from six different ratings providers diverge substantially. The authors comment: "ESG ratings disagree to an extent that leaves observers with considerable uncertainty as to how good the company's ESG performance is".[91]

The Berg study identified three different sources of divergence: scope divergence (ratings being based on different sets of attributes), weight divergence (where rating agencies take different views on the relative importance of attributes) and measurement divergence (where rating agencies measure the same attribute using different indicators).

In relation to scope divergence, the authors of the study comment that "structures of different ESG ratings are incompatible" and different rating agencies cover different attributes.[92] In relation to measurement divergence, the authors comment that in some cases "the level of disagreement is so severe that rating agencies reach not merely different but opposite conclusions".[93] In relation to weight divergence, the authors comment that "different raters have substantially different views about the most important categories".[94]

Ratings of ESG factors involve a significant subjective element. It is therefore perhaps not surprising that the Berg study suggests that ratings are influenced significantly by the identity of the personnel responsible for ratings assessments.[95] There is also evidence that ratings are influenced by conflicts of interest held by ratings agencies.[96]

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89 Pollman, above n 18, at 439.

90 Curtis, Fisch and Robertson, above n 78, at 403.

91 Florian Berg, Julian F Kölbel and Roberto Rigobon "Aggregate Confusion: The Divergence of ESG Ratings" (2022) 26 Review of Finance 1315 at 1323.

92 At 1323.

93 At 1330.

94 At 1331.

95 At 1338–1341.

96 Dragon Yongjun Tang, Jiali Yan and Chelsea Yaqiong Yao "The Determinants of ESG Ratings: Rater Ownership Matters" (6 June 2022) Social Science Research Network <www.papers.ssrn.com>, finding that firms sharing the same major shareholders with the rater receive higher ESG ratings, but have poorer future ESG outcomes.

The subjective elements, and inconsistencies, involved in ESG ratings make it difficult to draw any robust conclusions from ESG ratings. For example, Curtis and others comment that Tesla received a *top* ESG rating from MSCI and a *bottom* ESG rating from FTSE Russell![97]

Yet, under s 131(5) directors will be permitted to take into account ESG matters despite the vague nature of the term and widely different approaches to assessment of what amounts to good or bad ESG behaviour. This gives rise to a number of objections when directors are permitted to take into account ESG matters even where that is inconsistent with company and shareholder wealth maximisation.

B Social Reform by Stealth

The first objection to directors being expected to take into account ESG matters is that there is a risk that a particular political agenda is advanced by stealth, when a transparent democratic consideration of the issues may not have supported that agenda. There is an associated concern that a social agenda advanced by some boards through reliance on s 131(5) may be inconsistent with, and undermine, regulatory regimes that have been carefully and transparently enacted by a fully democratic parliamentary process.

Phil Gramm and Mike Solon in the Wall Street Journal comment:[98]

> Stakeholder capitalism imperils more than prosperity, it imperils democracy itself. Self-proclaimed stakeholders demand that workers and investors serve their interests even though no law has been enacted imposing the ESG agenda.

Robert Miller makes a similar point suggesting that "stakeholderism provides a way of advancing a political agenda *that has lost in the democratic process*".[99] Miller gives as an example regulation to reduce emissions to counteract climate change, but which regulation has not been enacted due to a lack of public support.[100]

If you do not have democratic support to elect a government that will pass the specific regulatory measures you want, it is inappropriate to expect company directors to spend shareholders' money to do something that Parliament has not required. As Friedman comments:[101]

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97 Curtis, Fisch and Robertson, above n 78, at 400. See also Pollman, above n 18, at 438.

98 Phil Gramm and Mike Solon "The 'Stakeholder Capitalism' War on the Enlightenment" *The Wall Street Journal* (online ed, New York City, 24 May 2022).

99 Robert T Miller "How Would Directors Make Business Decisions Under a Stakeholder Model?" (2022) 77 Bus Law 773 at 798 (emphasis in original).

100 At 798–799.

101 Friedman, above n 30.

> What it amounts to is an assertion that those who favor the taxes and expenditures in question have failed to persuade a majority of their fellow citizens to be of like mind and that they are seeking to attain by undemocratic procedures what they cannot attain by democratic procedures.

Some commentators suggest that growing demands for stakeholder governance stem in part from government inaction on urgent social problems.[102] However, the solution to that is for the electoral public to vote for governments that will address the issue, not to abandon the democratic process.

C Directors are not Suited to Making Social Policy Decisions

The second objection is that company directors are not suited to evaluating and remedying issues that impact society as a whole.

Permitting or requiring directors to take into account other interests ahead of shareholder interests would mean that directors (and judges considering the appropriateness of directors' decisions) are essentially making social or political decisions, balancing the interests of different groups in society.[103]

ESG has developed to sometimes include politically charged and controversial topics. Different approaches to ESG by the last two United States administrations suggest ESG may be "ideologically or politically tinged".[104]

Why should directors elected by shareholders make such decisions? As Theodore Levitt said some time ago, "Government's job is not business, and business's job is not government".[105]

Directors have (or should have) expertise in making business decisions and are commonly selected for their commercial acumen. They are not trained to make social or political judgements.[106] In fact, the different nature of skills (as between business skills and distributive skills) "appear to be almost

102 William Savitt and Aneil Kovaali "On the Promise of Stakeholder Governance: A Response to Bebchuk and Tallarita" (2021) 106 Cornell L Rev 1881 at 1893–1894; Leo E Strine Jr "Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy" (2021) 76 Bus Law 397 at 422–423; and Gadinis and Miazad, above n 22, at 1436. See also Tom CW Lin "Incorporating Social Activism" (2018) 98 BU L Rev 1535 at 1559: "… contemporary political gridlock and obstructionist partisanship have made these new corporate channels of social change more appealing relative to the traditional public channels of government".

103 Committee on Corporate Laws "Other Constituencies Statutes: Potential for Confusion" (1990) 45 Bus Law 2253 at 2270.

104 Pollman, above n 18, at 444.

105 Levitt, above n 67, at 47.

106 Smart, above n 31, at 318.

incompatible" and the criteria for success "utterly dissimilar".[107] Gadinis and Miazad note that "most directors' qualifications are unlikely to have much to do with ESG" and that directors have historically been picked on the basis of skills that will assist them in monitoring financial returns.[108]

We should not expect company directors to make social or political decisions in which they decide whether, and by how much, to prefer the interests of particular social causes to those of shareholders. Company directors do not have any particular expertise in assessing social or political issues. Nor are they informed about those issues by political processes like through government officials' advice or select committee submissions. Managers of companies are "unlikely to know what is best for society".[109]

Social reforms should not be led by various boards of directors who are uninformed by detailed policy debates and consultations and may have different and potentially conflicting views as to how to address and implement social policy issues. Further, those views may be inconsistent with the views that have led a democratically elected Parliament to pass a carefully designed regulatory scheme, having regard to the impact of potential regulatory solutions on different public groups.

D Social Policy Should be Made by Persons Accountable to the Public

The third objection to giving directors the power to make decisions on ESG matters that conflict with corporate and shareholder wealth maximisation is that directors are elected by, and accountable to, shareholders. They have not been elected by the wider public, as might be expected if directors' decision-making is going to balance the interests of different groups in the community.[110]

Distributional decisions about how resources are allocated are traditionally made by elected leaders who are accountable to those affected by those decisions, while company directors are not

107 Henry G Manne "The 'Higher Criticism' of the Modern Corporation" (1962) 62 Colum L Rev 399 at 414 and 414, n 45.

108 Gadinis and Miazad, above n 22, at 1463. Gadinis and Miazad do suggest, however, that it is within the core competency of boards to assess business risks, and that risks arising out of the social implications of company actions fall within that: at 1467.

109 Ribstein, above n 21, at 1436. See also 1462–1464.

110 Skinner, above n 48, at 432. See also Ribstein, above n 21, at 1463:

> At a given level of social wealth, should the managers help the poor, or help consumers at labor's expense, or vice versa? This could involve perplexing questions of distributive justice.

publicly accountable.[111] Van Der Weide cautions against giving persons not elected by the public as a whole the right to make political decisions.[112]

There is no good reason for public functions or matters of social policy to be decided on by the directors who happen at the time to be in charge of particular companies, chosen for those positions by private groups of shareholders.[113]

Some commentators argue that directors should be able to engage in socially beneficial conduct regardless of whether that is to the benefit of shareholders because otherwise, important social issues will be overlooked.[114] But that means a small group of directors, unelected by the public, would be imposing their personal (and potentially conflicting) views of social objectives on others.

Corporations are not the institutions, and corporate officers not the individuals, through which society makes or should make its educational, foreign or political policy.[115] Attempts to drive different firm behaviour based on societal, political and moral judgement about what behaviour is appropriate should be guided by standards that have democratic legitimacy.[116]

E Social Reforms Require a Balancing of Objectives and Interests and a Proper Law Reform Process

It is undoubtedly the case that there are important social objectives that are deserving of being addressed, including serious environmental issues.

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111 Smart, above n 31, at 316–317 and 319. See also Neil Minow "Shareholders, Stakeholders, and Boards of Directors" (1991) 21 Stetson L Rev 197 at 219: "The danger is in allowing corporate managers to make policy trade-offs. That should be left to those who have another kind of accountability – through the political process."

112 Mark E Van Der Weide "Against Fiduciary Duties to Corporate Stakeholders" (1996) 21 Del J Corp L 27 at 55.

113 Milton Friedman *Capitalism and Freedom* (University of Chicago Press, Chicago, 1962) at 161. Friedman described the suggestion that corporate officials be decision-makers on questions of social responsibility as a "fundamentally subversive doctrine".

114 See for example Lund and Pollman, above n 15, at 2632: "Simply put, tying a company's obligation to engage in socially beneficial conduct to value maximization means that important issues may slip through the cracks".

115 Rostow, above n 50, at 68; and William T Allen "Our Schizophrenic Conception of the Business Corporation" (1992) 14 Cardozo L Rev 261 at 269, citing views expressed by Kenneth Arrow, Friedrich Hayek and Milton Friedman. See also Ben W Lewis "Power Blocs and the Operation of Economic Forces: Economics by Admonition" (1959) 49 Am Econ Rev 384 at 395.

116 Hans B Christensen, Luzi Hail and Christian Leuz "Mandatory CSR and sustainability reporting: economic analysis and literature review" (2021) 26 Review of Accounting Studies 1176 at 1232.

However, if there are externalities that need addressing, it is better to do so with regulated solutions by a democratically elected legislature who can address those solutions precisely and legitimately, and with the benefit of proper advice from government departments.

Regulated solutions often require a balancing of different economic and social objectives and consequences from potential reforms. Take, for example, regulation for the purpose of addressing climate change. It is generally accepted that climate change threatens human well-being and planetary health.[117] However, the extent and speed of the reduction in emissions, and the manner in which that reduction is achieved, may have other serious consequences. Johan Norberg, for example, suggests that certain approaches to the aggressive reduction of emissions may have highly adverse consequences such as extreme poverty, "unprecedented social collapse", financial costs of "tens of thousands of billions of dollars" and "large scale starvation".[118]

When there are such important potential social and economic considerations to weigh, this should be done on a consistent and informed basis by our elected policymakers, not on an ad hoc, inconsistent and uninformed basis by different boards of directors.

In the example of climate change, the New Zealand Parliament has endeavoured to enter into a balancing exercise of the various social and economic consequences by creating incentives for reducing emissions.[119] In further support of this, Parliament has also passed legislation that makes climate-related disclosures mandatory for certain organisations.[120]

Should it be for company law (or, for that matter, tort law[121]) to seek to adjust or undermine the balancing exercise by our elected Parliament?

Lord Leggatt SCJ in *Philipp v Barclays Bank UK plc* recently set out the institutional competence of legislators and regulators to address social problems and noted that courts do not have the same capacities.[122] Even less so do directors.

117 *Smith v Fonterra Co-operative Group Ltd* [2024] NZSC 5, [2024] 1 NZLR 134 at [14].

118 Johan Norberg *The Capitalist Manifesto: Why the Global Free Market Will Save the World* (Atlantic Books, London, 2023) at 185–186. As to the potentially significant impact of policies to address carbon emissions on the public and particularly the poor, see also Zohar Goshen, Assaf Hamdani and Alex Raskolnikov "Poor ESG: Regressive Effects of Climate Stewardship" (ECGI Law Working Paper 764/2024, April 2024).

119 Climate Change Response Act 2002.

120 Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021, which amended certain provisions of the Financial Markets Conduct Act 2013 and Financial Reporting Act 2013.

121 See *Smith v Fonterra Co-Operative Group Ltd*, above n 117.

122 *Philipp v Barclays Bank UK plc* [2023] UKSC 25, [2024] AC 346 at [23]. See also Jack Hodder "One Advocate's Opinions – The 'Least Dangerous Branch'? Predictability and Unease" [2024] NZ L Rev 423 at 438 and 441.

The solution to social problems should be led and designed by publicly elected policymakers acting through the parliamentary process with the input of research by government departments and consultation through accepted law reform processes. As Jack Hodder comments, governmental and legislative processes "are designed to raise, gather information and opinions on, and decide" on contentious public policy issues.[123] Board processes are certainly not designed for that purpose.

Further, the actions of the legislature are publicly transparent and "subject to public debate and scrutiny and constrained by public opinion and censure".[124] That cannot be said of the actions of boards of directors (and individual directors) taken behind closed doors in a multitude of companies.

As Lynda Oswald comments, the result of allowing directors to take into account stakeholder interests:[125]

> … is that delicate political questions about societal wealth allocation and redistribution are shifted from an open political process involving the legislature to a private, hidden process involving managers, who by nature lack both the 'political legitimacy' and the competency to make such determinations.

F EXTERNALITIES ARE BETTER ADDRESSED BY REGULATION

Many commentators argue that a drive towards profit can cause social problems.[126] That is no doubt true in some cases, but that suggests the need for better regulation to address the externalities caused by the operation of businesses (including but not limited to companies).

As Rock notes:[127]

> … we should never forget that many of our problems require regulatory solutions and that we should not fool ourselves into thinking that tinkering with corporate objective can begin to substitute for regulation to control climate change, assure decent wages and working hours, and decent health care, as well as social insurance against the various downsides from competitive global markets.

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123 Hodder, above n 122, at 426. Contrast Gadinis and Miazad, above n 22, at 1432, suggesting that companies have access to superior information sources from internal and external stakeholders.

124 Oswald, above n 32, at 26.

125 At 26 (footnotes omitted).

126 See for example Gerald F Davis "Corporate Purpose Needs Democracy" (2021) 58 Journal of Management Studies 902 at 904–906, referring (among other examples) to the obesity epidemic as being the "predictable outcome" of processed food industries seeking to maximise profits.

127 Rock, above n 55, at 394–395. See also LS Sealy "Directors' 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 Mon LR 164 at 176:

> The interests of consumers, the environment, welfare and the causes of equal opportunity, good race relations and so on can only be furthered by positive legislation extraneous to company law.

As Strine, Bebchuk and Tallarita note, regulation is a more focussed solution for social problems.[128]

When the New Zealand Companies Act was first proposed, the Law Commission resisted the suggestion that the duty to act in the best interests of the company should take account of matters that might be considered to fall under the ESG banner. The Law Commission made it clear that it considered that matters such as the protection of the environment was best dealt with in other legislation:[129]

> … we have also taken the view that a Companies Act is not the appropriate vehicle for imposition of general social reforms such as a requirement of worker participation in management or the imposition of environmental goals upon companies. These matters should be pursued through specific legislation imposed upon all employers and business enterprises.

As Lynda Oswald suggests, legislative provisions allowing directors to take into account the interests of persons other than shareholders in a very real sense "permit the legislature to abdicate its political role".[130] Rather than the legislature deciding directly what is in the best interests of the public, s 131(5) permits the directors of the company to do so. If they choose to attempt to do so they will inevitably do so on an ad hoc and inconsistent basis.

We cannot have any confidence that attempts by directors to advance social issues will be useful or consistent. The New Zealand Institute of Directors comments:[131]

> Nor is it efficient or in the best interests of the company for directors or management to allocate shareholder and company wealth according to policies, social agendas or world views that they happen to subscribe to at the time, for purposes which do not support the company's long-term sustainability or profitability.

Giving directors the ability to take into account stakeholder interests where that does not enhance corporate or shareholder value is potentially a license to allow directors to advance their own "pet causes"[132] regardless of whether those causes will advance the interests of the company or its

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128 Leo E Strine Jr "Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit" (2012) 47 Wake Forest L Rev 135 at 155; and Bebchuk and Tallarita, above n 68, at 96. See also Luca Enriques and others "The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies" in Reinier Kraakman and others (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd ed, Oxford University Press, Oxford, 2017) 79 at 93.

129 Law Commission, above n 39, at [19]. See also [284]–[286].

130 Oswald, above n 32, at 26. See also 27.

131 Institute of Directors New Zealand, above n 19, at 17.

132 Lin, above n 102, at 1585. See also at 1587: "… the issues that a corporation decides to support or oppose frequently reflect the values of its senior executives, not its shareholders".

shareholders, or whether there is general public support for such causes. Michael Jensen commented that stakeholder theory allows "directors to invest in their favorite projects that destroy firm-value whatever they are (the environment, art, cities, medical research) without having to justify the value destruction".[133]

A possible example is the decision by the executives of Silicon Valley Bank (which subsequently collapsed) to donate US 73 million to the activist organisation Black Lives Matter.[134]

Some commentators have suggested that companies are often able to resist or "neutralise" regulatory reforms.[135] However, the answer to that is better regulation, not changing general corporate governance standards. Corporate officers that have resisted regulatory reforms are hardly likely to implement the social changes desired from those reforms just because they are permitted to do so through a change to the scope of the duty to act in the best interests of the company.

Former Delaware Supreme Court Chief Justice Leo Strine also suggests regulation is a more effective way to protect interests such as the environment, workers and consumers.[136] He notes that just allowing directors the ability to consider other interests without giving those interests voting or enforcement rights "is more an exercise in feeling good than in doing good" and "largely shifts power to the directors to couch their own actions in whatever guise they find convenient, without making them more accountable to any interest".[137]

A provision like s 131(5) may give directors a better ability to mask self-interested transactions.[138] But it is not the best mechanism for the implementation of social or environmental policy.

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133 Jensen, above n 46, at 242.

134 Bradford Betz "SVB donated $73M to Black Lives Matter movement, social justice causes" (15 March 2023) New York Post <www.nypost.com>.

135 Christopher M Bruner "Corporate Governance Reform and the Sustainability Imperative" (2022) 131 Yale LJ 1217 at 1225.

136 Strine, above n 15, at 768 and 793. See also David Millon "Enlightened Shareholder Value, Social Responsibility and the Redefinition of Corporate Purpose Without Law" in PM Vasudev and Susan Watson (eds) *Corporate Governance after the Financial Crisis* (Edward Elgar Publishing, Cheltenham, 2012) 68 at 95.

137 Strine, above n 15, at 768.

138 Peter Watts *Directors' Powers and Duties* (3rd ed, LexisNexis, Wellington, 2022) at 183; Bainbridge, above n 51, at 1438 (plant closing example) and 1441–1442; Bainbridge, above n 15, at 1012–1013; Bebchuk and Tallarita, above n 68, at 165: "… support for stakeholderism may well be strategic: an attempt to advance a managerialist agenda dressed in stakeholder clothing to make it more appealing to the general public"; and William J Carney "Does Defining Constituencies Matter?" (1990) 59 U Cin L Rev 385 at 420–424.

VI CONCLUSION

If ESG is being referred to in s 131(5) because considering ESG factors enhances company and shareholder value, then there is no need to refer to it separately in s 131. Taking into account ESG considerations would already be permitted as part of the general rule that enhancing company and shareholder value is in the interests of the company.

Section 131(5), however, appears to suggest that ESG factors can be considered, even where that is not profitable for a company; that is, ESG factors can override the pursuit of shareholder wealth. That would suggest that the purpose of s 131(5) is to address externalities or promote social reform.

Section 131(5) creates added complexity for how to assess whether directors' actions amount to a breach of the fiduciary duty to act in the best interests of the company. That is problematic when the duty is a fiduciary duty of loyalty which gives rise to equitable remedies such as rescission (avoidance) of contracts. The additional complexity caused by making wide-ranging ESG factors relevant to the fiduciary duty therefore detracts from commercial certainty.

Secondly, distracting directors from a focus on company and shareholder wealth enhancement lessens the benefit of the corporate form as an engine for economic growth.

Finally, an approach that favours "environmental, social, and governance matters" over shareholder interests is also inherently undemocratic. The democratically elected Parliament has not clearly defined what socially desirable actions it considers companies should follow, nor have any such specific actions been the subject of study, proper legislative scrutiny or democratic debate. Directors unelected by the public are thereby encouraged to implement imprecisely expressed social objectives when they have no expertise in such matters and are not publicly accountable for their choices. If there is a need to address externalities or encourage social reform, then that should be done by specific regulatory measures enacted by Parliament.

Accordingly, the Government was right to suggest that s 131(5) should be repealed, but not necessarily for the reason it has given. Section 131(5) should be repealed, not because it is "redundant",[139] but because it detracts from commercial certainty, adversely impacts the use of the corporate form as an engine for economic growth and is undemocratic.

139 See Cabinet paper, above n 13.