The Role of the Board of Directors in Protecting the Environment for Future Generations

Report to the Ethics Centre Graduate Award Committee
Gail E. Henderson
May 22, 2012

Introduction

In a recent article in the *Harvard Business Review*, Duke Energy CEO James Rogers explained how his predecessor's failure to take seriously the business risks posed by environmental issues "nearly caused the company to break down."[1] TransCanada PipeLines' failure to take seriously concerns regarding the Nebraska Sandhills has delayed significantly US Presidential approval of the Keystone XL pipeline. Even when immediate risks to shareholder value are not apparent, however, there are compelling ethical reasons for directors and managers to take into account their companies' environmental impacts.

Advances in knowledge and technology have increased our capacity both to cause serious and irreversible environmental damage far into the future and to predict these consequences of our actions. This capacity means that we have a moral responsibility to incorporate the interests of future generations in the environment into government and business decisions. This point was made recently by corporate lawyer and law professor Ed Waitzer in an editorial in *The Globe and Mail*, in which he called on "legislatures, judges, pension fund trustees and, yes, corporate CEOs and boards of directors to consider and be held accountable for the impact current decisions have on future generations' interests".[2]

The importance of protecting the natural environment for future generations is set out in Section 1 of this essay. Since corporations represent one of the primary sources of environmental harm, environmental considerations will have to be integrated into corporations' decision-making processes. This suggestion bumps up against shareholder primacy, the currently dominant theory of corporate governance to which many directors and managers subscribe. The theory of shareholder primacy holds that the sole duty of directors and managers is to maximize shareholder wealth. Under this approach, it is not the role of directors to concern themselves with the negative environmental and social impacts of the corporation; rather, this is a job best left to government. The problem with the shareholder primacy theory is that direct government regulation is leaving significant gaps in the prevention of environmental harm. The reasons for these gaps are set out in Section 2.1. This means that even if corporations comply with existing government regulations, this level of prevention likely would prove insufficient to fulfill our moral obligation to protect the environment for future generations. As described in Section 2.2,

---

[1] James E Rogers, "How I Did It: The CEO of Duke Energy On Learning to Work with Green Activists", *Harvard Business Review* (May 2011).

[2] Ed Waitzer, "The next generation gap: equity and fairness", *The Globe and Mail* (Tuesday, February 21, 2012).

the shareholder primacy approach to corporate governance, in seeking to maximize profits to shareholders, exacerbates the gaps in the prevention of environmental harm.

My proposed solution to this problem is a duty on boards of directors to minimize the corporations' environmental impacts. This duty would require directors and managers to broaden their gaze to the environmental horizon, to gather information regarding the corporation's cumulative environmental impacts and to consider how they could reduce those impacts by making changes to the way the corporation does business. The specific ways in which such a duty could be expected to improve corporations' environmental performance, thereby fulfilling our moral obligation to protect the environment for future generations, are set out in Section 3. This section also addresses two key objections to this duty, accountability and enforcement.

I do not wish to be taken as suggesting that a duty imposed on boards of directors can *replace* other forms of environmental regulation. Nor am I suggesting that traditional forms of environmental regulation have not achieved significant improvements in environmental quality. A combination of regulatory approaches will be necessary to adequately protect the environment for future generations. Until the legal framework for corporate governance is aligned with the objective of environmental regulation, however, fulfilling our moral obligation to future generations will remain unachievable.

1. Justice for Future Generations

Until recently, most approaches to the problem of justice to future generations focused less on protecting the environment and more on passing on a similar level of total "capital", both natural and non-natural, as that enjoyed by current generations. This approach is sometimes referred to as "weak sustainability". The idea was that current generations could make withdrawals from the natural capital account, through the exploitation of natural resources and the degradation of the environment, so long as the equivalent value was invested for the future in, for example, public infrastructure, public institutions or sovereign wealth funds.[3] To some extent, this approach was based on the assumption of ever increasing prosperity.

The problem with the capital or weak sustainability approach is that it assumes that lost natural resources can always be replaced with technological substitutes. Certainly, there are hopeful signs that technology will allow us to replace non-renewable fossil fuels with renewable substitutes. The same cannot be said, however, of the many important environmental services provided by the earth's ecosystems. To take just one example, old growth forests conserve biodiversity (for which there is no technological substitute), store carbon dioxide, purify water and reduce the frequency of floods. Even if it were practically and financially feasible to find technological substitutes that would provide these services, it is highly unlikely that they would do so as efficiently as nature does. This is due to the "multifunctionality" of ecosystems: the old growth forest conserves biodiversity, stores carbon dioxide, purifies water and reduces floods all

[3] The Alberta Heritage Savings Trust Fund is an example of a sovereign wealth fund.

at once, just by being there, compared with technological substitutes providing only one service and likely causing other environmental impacts in the process. Planting new trees in place of the old growth forest will not supply the same environmental services.

The other problem with the capital approach is that we can no longer assume that the present and future benefits of today's economic development will outweigh the present and future environmental costs. It was easier to make this assumption in the past, when the scale and scope of natural resource extraction and economic activity was much more limited. It also was easier when the long-term effect of greenhouse gas emissions on global temperatures was unknown. Although there is some evidence of a positive correlation between economic development and environmental quality, this does not hold for greenhouse gas emissions, which continue to increase as a country becomes wealthier. Threats to biodiversity from economic development coupled with the predicted impacts of climate change mean that we can no longer assume that future generations will be made better off by present-day economic development that is undertaken with insufficient regard to its future environmental impacts.

Even if we could be certain of our ability to develop technological substitutes that would allow us to adapt to the worst effects of a deteriorating environment, we would still have a moral obligation to protect the environment for future generations. One important aspect of human equality is our ability to form and pursue our own ends and ideas of the good life. Current generations arguably have an obligation, therefore, to ensure that their actions do not narrow the range of values and goals that future generations are able to form and pursue. This includes the ability to benefit from and to enjoy the natural environment. It is possible that future generations will prefer plastic trees to real ones; nonetheless, current generations have an obligation to preserve their ability to make this choice for themselves. No one who has stood next to a Douglas fir in Cathedral Grove on Vancouver Island or observed the fall colours in Gatineau Park can argue with this as a general principle, despite the difficulties applying it in practice.

The question is how are current generations to ensure that these obligations are met? Part of the answer is a shift away from the current paradigm of continuous economic growth for its own sake. Slowing economic growth may be necessary to ensure justice to future generations, because some of the significant environmental impacts of economic activity remain unforeseeable despite improved scientific and social understanding. That said, some level of economic development, including the extraction of non-renewable natural resources, is required to maintain the level of social wealth necessary to a functioning democracy. Corporations play an important role in generating this social wealth, but they also represent one of the main sources of environmental harm. Fulfilling our moral obligations to future generations, therefore, requires that we reduce the level of environmental harm caused by corporations. As explained in the next section, the forms of environmental regulation on which we have relied to date may have reached the limits of their effectiveness, requiring us to look for other approaches to reduce corporations' environmental impacts.

2. Problems with the Existing Regulatory Framework

2.1 The Shortcomings of Traditional Approaches to Environmental Regulation

The standard response to the problem of controlling the negative social impacts of corporate activity is external regulation. By "external regulation", I mean regulation that is aimed not at the internal functioning of the corporation, but at the negative social impacts themselves. External regulations include regulations setting maximum limits on the quantities of pollutants a given facility may emit and regulations putting a price (or tax) on each unit emitted. The former is often referred to as "command-and-control" regulation; the latter is an example of market-based regulation. Although market-based regulations are implemented much less frequently, they are often put forward as the cure to what ails command-and-control, because they allow corporations greater flexibility in how they comply with the regulation (i.e., either by reducing emissions or by paying the price or tax). Both types of regulation, however, suffer from two important shortcomings that render them inadequate on their own to prevent environmental harm that will negatively impact future generations. These shortcomings are inherent to these forms of regulation; more funding to government environment ministries will not solve these problems, although recent budget cuts are likely to exacerbate them.

First, command-and-control and market-based regulations both focus on particular environmental problems in isolation from each other, rather than on continuous improvement of overall environmental performance. They tend to target specific pollutants being emitted into the air or discharged into water. This focus on industrial outputs results in regulation that *controls* rather than *prevents* environmental harm. Furthermore, these regulations are largely uncoordinated, allowing some companies to comply by transferring the location of their outputs from air to water or vice versa, depending on which is the less regulated media, rather than by making changes to their industrial processes to reduce total emissions.

Second, command-and-control and market-based mechanisms both require a tremendous amount of information in order to be effective, information that is likely to be more easily accessed by corporate officials. Although regulation can require companies to disclose environmental information, regulators still have to know enough about every type of industry to draft disclosure laws that capture the relevant harms or emissions. Furthermore, even if firms were forced to provide this information, it would be left up to regulators to determine how best to control each hazardous emission or environmental harm. Employees of the regulated corporation are likely to be in a better position than regulators to make this determination or to alter industrial processes so as to avoid the harm altogether.

It might be argued that directors already have a duty to the environment under provisions in environmental legislation making directors personally liable for some environmental offences. Although these provisions undoubtedly create some incentive for directors to monitor their corporation's environmental impacts, it does not appear to have had the effect of integrating environmental factors into board decision-making processes, a necessary step towards meeting our moral obligations to future generations. This may be because such provisions merely set a minimum standard of care, but do not require directors to encourage the corporation to go beyond regulatory requirements to reduce the corporation's overall environmental footprint.

2.2 The Problems with Shareholder Primacy

The dominant theory of corporate governance in the academic literature and the theory that appears to have had the greatest influence on corporate governance practice in North America is shareholder primacy. Shareholder primacy holds that the sole purpose of corporate law and corporate governance is to ensure that corporate directors and managers maximize shareholder wealth. Any other purpose or objective is viewed as illegitimate or outside the scope of corporate law.

Shareholder primacy is often defended as the best way to maximize the wealth not only of shareholders but of all the firm's stakeholders, including workers, suppliers and creditors, as well as society in general. This is based on two assumptions: First, in accordance with Adam Smith's theory of the invisible hand, an individual business owner seeking to maximize profits will in turn maximize society's overall level of wealth by hiring workers, borrowing money and purchasing supplies. Second, as holders of the right to the corporation's residual profits, shareholders have the best incentive of all of the firm's stakeholders to ensure that management is in fact maximizing profits. This is why proponents of shareholder primacy argue that directors ought to be legally required to manage the corporation in the best interests of shareholders alone.

These assumptions are much less likely to hold true when the interests of future generations in the natural environment are taken into account. First, there is a time horizon problem. The most serious effects of many environmental problems will not be experienced by those who caused the problems but by distant future generations. Climate change is the prime example. To the extent that maximizing shareholder wealth today will impose substantial environmental costs on future generations, the shareholder primacy approach to corporate governance is not maximizing social wealth, but simply transferring it from the future to the present.

Shareholder primacy also seeks to put goods to their "most valued use", meaning the use currently assigned the highest monetary value by the market. Markets, however, are notoriously incapable of valuing public goods such as environmental services, not to mention the potential future uses of natural resources. Attempts to monetize environmental services, such as carbon-trading schemes that give credits for carbon stored by forests, have had limited success. By failing to take into account the non-market value of natural resources, shareholder primacy works against protecting the environment for future generations.

The typical response to these criticisms of shareholder primacy is that these problems can be prevented through government regulation. As argued in the previous section, however, external regulation is insufficient to this task. It becomes necessary, therefore, to turn to regulation aimed at the internal functioning of the corporation to fill the gaps left by traditional forms of environmental regulation in order to ensure that the moral obligations of current generations to future ones do not go unfulfilled.

Shareholder primacy's appeal lies at least in part in its simplicity. It is straightforward, lets business be business, and leaves complex issues of intergenerational justice safely at the boardroom door. It also defines the boundaries of corporate governance in a way that seems manageable to those who would agree to act as directors. Pretending the world is simple will not make it so, however; nor will ignoring our moral obligations to future generations make them go away. An honest effort to confront the long-term environmental impacts of corporate activity forces us to consider the role of boards of directors in protecting the environment for future generations and the shape this role could take. I argue in the next section that this role should take the shape of a duty on boards of directors to minimize the corporation's environmental impacts.

3. A Duty to Minimize the Corporation's Environmental Impacts

Currently, under Canadian corporate law, directors have a duty of loyalty to act in the best interests of the corporation and a duty of care to act with the care, diligence and skill of a reasonably prudent person in comparable circumstances.[4] I propose adding a third duty to minimize the corporation's environmental impacts. Imposing this duty on boards should help to fill the gaps in the traditional forms of environmental regulation discussed above by improving corporations' environmental performance in the following three ways.

First, it should help to improve levels of compliance with existing regulation, thereby at least limiting the gaps in in the prevention of environmental harm left by external regulation. Another problem with the shareholder primacy approach to corporate governance is that it encourages directors and managers to view complying with the law as simply a cost of doing business, rather than as an ethical obligation based on the shared social goals that the law is trying to achieve. Although the current state of corporate law in both Canada and the US is that directors have a duty to ensure that the company is complying with the law, there are corporate law scholars who argue that managers ought to weigh the costs and benefits of violating a law in order to maximize profits. Satisfying the duty to minimize the corporation's environmental impacts would entail ensuring compliance with existing environmental regulations.

Second, a duty to minimize the corporation's environmental impacts should help directors to internalize a norm of environmental protection. Norms are "behavioural regularities supported at least in part by" ethical reasons.[5] William Bratton argues that one cause of the accounting scandals at Enron and elsewhere was the internalization by management of a norm of

[4] *Canada Business Corporations Act*, s. 122(1); Ontario *Business Corporations Act*, s. 134(1).
[5] McAdams & Rasmusen, 1576.

shareholder wealth maximization which resulted in an "obsession with short-term performance".[6] Although this norm was reinforced by the market, the idea that they were legally obliged to maximize shareholder wealth likely had at least some effect on directors' and managers' behaviour. Similarly, a statutory duty to minimize environmental impacts is likely to have some effect on the norms directors feel bound by when making decisions. A director who has internalized a norm of environmental protection will have a harder time setting aside environmental concerns to pursue profit maximization alone. This argument might appear naïve, but the fact is that the existing corporate governance structure relies on directors' sense of honour, responsibility and obligation to act in the corporation's best interests, given the weak enforcement of the current duties of loyalty and care.

Third, and perhaps most important, a duty to minimize the corporation's environmental impacts will help to integrate environmental factors into boards' decision-making processes. The integration of environmental factors into economic decision-making is one of the key principles behind the concept of sustainable development. Private sector participation in reconciling environmental protection with economic development is crucial, since most economic activity is conducted by private actors, rather than the state. Integrating environmental factors into the decision-making processes of boards of directors should help to ensure that steps are taken to prevent environmental harm before a project is undertaken. Since a board cannot take into account possible environmental impacts without the necessary information, a duty to minimize environmental impacts will help to ensure that information about possible environmental impacts of a proposed project or investment is gathered before any decisions are made. Once this information has been gathered and presented to the board, it becomes difficult to ignore. A requirement that directors' decisions are well-informed is already part of the business judgment rule applied by courts in reviewing board decisions.

The reason for adding the duty to the statutory duties of directors under corporate law rather than environmental legislation is to make the duty part of the legal framework governing the way that decisions are made within the corporation. Despite their increasing importance, environmental factors remain on the periphery of what boards do and the list of factors boards consider when making decisions. Making a duty to minimize the corporation's environmental impacts part of directors' statutory duties under corporate law signals to directors that environmental factors ought to be a central concern when making decisions.

The reader might ask whether such a duty is still necessary following the Supreme Court of Canada's decision in *BCE Inc v 1976 Debentureholders*. In *BCE*, the Court affirmed an earlier decision that the statutory duty of directors is owed to the corporation, and not to any particular stakeholder, or even to all of the stakeholders. In its reasons, the Court expressly stated that in determining the best interests of the corporation, directors may consider the environment. It would appear, therefore, that it is already permissible, although not mandatory, for directors to

[6] Bratton, 1284.

incorporate environmental considerations into their decision-making processes. This approach is similar to the recently revised statutory duty in the UK, which requires directors to run the company for the benefit of the shareholders, but, in so doing, to have regard to a list of other factors, including the company's impact on the environment.[7] While both *BCE* and the UK statute reflect a growing social expectation that corporations take greater responsibility for their environmental impacts, consideration of the environment is still tied to profit-maximization. This makes significant improvements to corporate environmental performance or changes to boardroom norms regarding environmental protection unlikely.

There are two key objections that one could raise against imposing a duty on boards to minimize the corporation's environmental impacts: First, that it will make management less accountable for their actions. Second, that it will be difficult to enforce.

Proponents of shareholder primacy argue that a fiduciary duty owed to shareholders alone is the best way to ensure that managers are in fact maximizing profits and are neither appropriating assets, nor slacking. The corresponding concern often raised against the stakeholder theory of corporate governance, which would require directors to act in the best interests of all of the firm's stakeholders, is that it would give management too much discretion in allocating corporate revenues. Imposing on directors a duty to minimize the corporation's environmental impacts appears to raise a similar concern. The opportunities for directors and managers to act in their own best interests on the pretense of minimizing environmental impacts seem limited, however. Greater disclosure on environmental issues – something many institutional investors are already demanding – also should help to alleviate this concern. Even without improved disclosure, other trends in corporate governance, such as the majority-vote standard for electing individual directors, will help to ensure that management remains accountable to the shareholders. And market forces will continue to motivate directors and managers to keep the corporation profitable.

The problem is that these same market forces may make it difficult for directors to comply with a duty to minimize the corporation's environmental impacts, which leads me to the second objection, that it is unenforceable. Direct legal enforcement of directors' duties by way of a derivative suit is a rare occurrence, given the expense of bringing a law suit and the high legal burden on the shareholder to prove a breach. The threat of a law suit is not the only incentive for directors to comply with their statutory duties, however. Institutional investors likely would play an important role in monitoring environmental performance and encouraging compliance with a duty to minimize the corporation's environmental impacts. A number of Canada's largest public-sector pension funds claim that they take environmental factors into account in making investment decisions. The long-term investment horizon of pension funds provides them with an incentive to monitor environmental performance, which may affect financial performance over the long term. Public-sector pension funds are also voting in support of shareholder proposals

[7] *Companies Act 2006* (U.K.), 2006, c. 46, s. 172.

aimed at making companies more accountable for their environmental impacts. While monitoring by institutional investors is not a complete answer to the problems of compliance and enforcement, it suggests that directors who ignore the environment –under either the amended legal duty proposed here or the existing corporate governance framework – could find themselves the subject of unwanted attention from large institutional investors.

Conclusion

Accountability and enforceability are not the only concerns raised by a duty on boards to minimize the corporation's environmental impacts. The effect, if any, on Canada's competitiveness, the possibility of increased personal liability and the effect this would have on individuals' decisions to serve on boards are all concerns that would need to be considered and addressed before making the change to Canadian corporate law argued for in this essay. Exactly what such a duty would entail in practice also remains to be worked out. The fact that this proposal raises these concerns, however, is not a good enough reason to stick with the status quo. The current federal government has demonstrated a palpable hostility to environmental issues, and specifically the environmental assessment process meant to improve the environmental outcomes of economic development. Most provincial governments have other priorities. The rest of the world may not share our governments' views, however, and this may hurt Canada's economic competitiveness in the long run. More fundamentally, the current political rhetoric about jobs and growth ignores the fact that a healthy economy requires a healthy environment. Now is the time for those concerned both with the efficient functioning of the corporation and with corporations' environmental impacts to engage in a serious discussion about how the existing corporate governance framework can be adjusted so as to work towards, rather than against, achieving the goal of an environmentally sustainable economy that can truly, in the words of the Brundtland Commission, "meet the needs of current generations without compromising the ability of future generations to meet their own needs."

Selected Bibliography

Ashford, Nicholas A & Charles C Caldart. *Environmental Law, Policy, and Economics: Reclaiming the Environmental Agenda* (Cambridge, Mass.: The MIT Press, 2008).

Bratton, William W. "Enron and the Dark Side of Shareholder Value" (2002) 76 Tul L Rev 1275.

Brown Weiss, Edith. *In Fairness to Future Generations: International Law, Common Patrimony, and Intergenerational Equity* (Tokyo: The United Nations University, 1989).

Collier, Paul. *The Plundered Planet* (New York: Oxford University Press, 2010).

Duhigg, Charles. "Cleaning the Air at the Expense of Waterways" *New York Times* (12 October 2009).

Ellis, Stephen E & Grant M Hayden. "The Cult of Efficiency in Corporate Law" (2010) 5 Va L & Bus Rev 239.

Fischel, Daniel & Alan Sykes. "Corporate Crime" (1996) 25 J of Legal Studies 319.

Greenfield, Kent. *The Failure of Corporate Law* (Chicago: University of Chicago Press, 2006).

Gunningham, Neil. *Smart Regulation: designing environmental policy* (New York: Oxford University Press, 1998).

Hanley, Nick, Jason F Shogren & Ben White. *Environmental Economics: In Theory and Practice*, 2nd ed (New York: Palgrave MacMillan, 2007).

Hansmann, Henry & Reinier Kraakman. "The End of History for Corporate Law" (2001) 89 Geo LJ 439.

Henderson, Gail E. "Rawls & Sustainable Development" (2011) 7 McGill International Journal of Sustainable Development Law & Policy 1.

Lazarus, Richard J. *The Making of Environmental Law* (Chicago: The University of Chicago Press, 2004).

McAdams, Richard & Eric B Rasmusen, "Norms and the Law" in A Mitchell Polinsky & Steven Shavell, eds, *Handbook of Law and Economics* (Amsterdam: Elsevier BV, 2007).

Orts, Eric. "Reflexive Environmental Law" (1995) 89 Nw UL Rev 1227.

Shelton, Dinah. "Describing the Elephant: International Justice and Environmental Law" in Jonas Ebbesson & Phoebe Okowa, eds, *Environmental Law and Justice in Context* (Cambridge, UK: Cambridge University Press, 2009).

Smil, Vaclav. *Global Catastrophes and Trends: The Next Fifty Years* (Cambridge, MA: The MIT Press, 2008).

Stern, Nicholas. *Stern Review on the Economics of Climate Change* (30 October 2006), online: National Archives of the United Kingdom <http://webarchive.nationalarchives.gov.uk>.

Stout, Lynn A. "On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite *Homo Economicus* to Join Your Board" (2003), 28 Del J Corp L 1.

The World Commission on Environment and Development. *Our Common Future* (New York: Oxford University Press, 1987) [Brundtland Commission].

Tremmel, Joerg Chet. *A Theory of Intergenerational Justice* (London: Earthscan, 2009).