The link between ESG, CSR and corporate governance: why it matters to business

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Introduction

There have been a number of recent examples in the media of high-profile businesses focusing on topics such as sustainability, Environmental, Social, and Governance (ESG) concerns and corporate social responsibility (CSR). Unilever and DSM, for example, have been rewarded for their business models which are based on sustainability with a strong component of social responsibility. BlackRock, one of the world's largest asset managers, has announced that "to prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society" (Fink, L. (2018). Annual Letter to CEOs: "A Sense of Purpose"). Climate activist group "Follow This" is demanding that Shell reinvest all its profits from polluting fossil fuels in renewable energy. These examples and many more have been emerging in the last few years, emphasizing the increasing awareness of sustainability developments in business.

In today's business, then, concepts such as sustainability, ESG and CSR are becoming more prevalent and widespread, as evidenced by various initiatives and trends. Over the past two decades, more and more major investors have committed to incorporating ESG issues into their investment decisions by signing the UN Principles for Responsible Investment. In addition, the 17 Sustainable Development Goals (SDGs), endorsed by civil society, businesses and governments, provide a framework towards building a better and more sustainable world. Furthermore, governments, civil society organizations and increasing numbers of consumers and employees are urging companies to bear responsibility for the society in which they operate.

Although most of these and other initiatives in the area of sustainability apply to publicly traded companies, they also have an important effect on non-listed companies. After all, in today's globalized world non-listed and listed companies are both part of the same supply chain. If a large, publicly traded supplier company has committed to sustainability goals, it will expect and demand the same from other entities in its supply chain and its business network. Any companies in the supply chain that do not meet its sustainability demands might lose their contracts or, even worse, find themselves being boycotted. In addition, companies that are not sustainability-compliant will struggle to obtain favourable financing terms, due to the high level of risk associated with their business practices. Finally, sustainability-compliant companies are more likely to be eligible for new financing avenues than companies that do not engage in sustainable practices.
The aim of this contribution is to explore the link between ESG, CSR and corporate governance in a business context. The next section focuses on the increasing importance of ESG from the perspective of institutional investors. In the section after that, the concept of CSR is discussed, and a link is made to the two main corporate governance models. Section 4 contains a brief description of the Dutch regulatory framework for CSR, and provides some recommendations for companies on how to implement CSR concerns in their corporate governance framework. Section 5 presents some concluding remarks.

Institutional investors integrating ESG strategies into their investment decisions

Given their size and informational advantage, and the significant amount of equity in their investment portfolios, institutional investors are considered as dominant market players, which enables them to influence corporate behaviour, increase allocation efficiency, promote management accountability and aggregate capital for businesses to grow. Equipped with these characteristics, institutional investors have, during the past two decades, also been a huge driver for including material ESG factors in investment analysis and investment decisions, in both private and public markets. ESG, the abbreviation used for environmental, social and governance concerns (as noted above), refers to a set of corporate performance evaluation criteria used by investors to evaluate the resilience

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and strength of a company's governance mechanisms and its ability to effectively manage its social and environmental impact. Institutional investors have, for example, made significant investments towards environmental, societal and economic challenges such as safe and healthy working environments, corporate governance improvements, renewable energy and the transition to a low-carbon economy, etc.

There are various reasons why institutional investors might decide to adopt an ESG approach. First, a substantial body of literature and multiple studies have confirmed that the main drivers for ESG investing among institutional investors are risk management/risk mitigation and financial return potential. Investors are increasingly aware of ESG risks that entail unexpected costs, which could be detrimental to long-term financial returns. That is why institutional investors, when compiling their portfolios, increasingly look at companies that are actively engaged in sustainable practices with the aim to reduce social, governance and environmental risks as much as possible. Another motive for institutional investors' ESG investing is the increasing call for sustainability from governments, policymakers and society at large (examples include the Sustainable Finance Disclosure Regulation, the UN Sustainable Development Goals, the UN Principles for Responsible Investment, etc.). Reputational concerns and fiduciary/contractual obligations are another factor in adopting ESG investments. Regardless of the investors' motivations, it is important for companies, from multinationals to medium-sized local organizations, to consider the increasing awareness across the investment community of the social and environmental impact of companies' business activities.

The link between corporate governance and corporate social responsibility

Faced with the broader role of business in society (as described above), the business community can no longer ignore its increased societal accountability, and should therefore seek to generate positive externalities (e.g. alternative energy sources) while reducing its negative externalities (e.g. levels of resource depletion). This is what lies at the heart of CSR. Since 2011, the European Commission has defined CSR as "the responsibility of enterprises for their impacts on society", going on to list a set of those responsibilities:

> *"to fully meet their corporate social responsibility, enterprises should have in place a process to integrate social environmental, ethical, human rights and consumer concerns into their business operations and core strategy*

in close collaboration with their stakeholders, with the aim of:

- *maximizing the creation of shared value for their owners/shareholders and for their other stakeholders and society at large;*
- *identifying, preventing, and mitigating their possible adverse impacts. (Communication of the European Commission on its CSR Strategy 2011-2014, October 25, 2011).”*

According to this definition, companies that accept CSR go beyond strict compliance with the law, and need to have relevant “processes” in place to ensure that key issues are addressed. This implies that companies should create a sound governance, risk-management and internal control environment in order to integrate CSR into every part of their organization and in its daily activities. It is beyond the scope of this article to discuss all the various processes that this requires. For this reason, the focus here is on the relationship between CSR and corporate governance. To explore the link between CSR and corporate governance, it is worthwhile touching briefly on the concept and definition of corporate governance.

Corporate governance can broadly be defined as a set of rules and structures (formal and informal) that shape managerial decision-making and accountability. This then leads to the question: how should top executives be monitored? What interests should the company serve? To answer these questions, two alternative models have been developed over the past three decades: the shareholder model (which is dominant in English-speaking countries) and the stakeholder model (which is the dominant model in Continental Europe). The shareholder model charges the directors of a company with a specific fiduciary duty towards the company’s shareholders, by reflecting the importance of primacy of the shareholders’ interests and enhancing shareholder value. By contrast, the stakeholder model represents the idea that companies exist to serve a number of different interests, not just those of their shareholders, but also those of customers, creditors, employees, local communities and suppliers.

With these definitions in mind, a natural synthesis can be identified between the stakeholder model and CSR, as both concepts are based on the principle of balancing divergent interests and aiming to align as closely as possible the interests of individuals, companies and society. Sir Adrian Cadbury, who contributed significantly to the development of corporate governance, already underlined this relationship between corporate governance and CSR by indicating that corporate governance mechanisms are part of a larger economic context in which environmental and societal interests play a major role:

> *"Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society.*
> *(Cadbury, Foreword in World Bank, Corporate Governance, a Framework for Implementation, Washington 2000)."*

To this end, therefore, corporate governance mechanisms should have incentives in place to reconcile the interests of the company with the interests of society. By contrast, the shareholder model, which encourages corporate boards to consider only interests of the shareholders, essentially ignores other interests such as environmental or social factors unless they run parallel to the shareholders' interests.

> *"In light of the increasing regulatory attention and the mounting pressure from institutional investors, consumers, and society at large, it is advisable for companies to implement CSR concerns in their corporate governance framework."*

However, a new direction is also gaining traction in the shareholder model, as demonstrated by the Business Roundtable Statement, which expresses the business approaches of over 180 of the largest companies (mainly in the English-speaking world, and mainly oriented towards the shareholder model). It states a company's sole and main objective or purpose is not to maximize shareholder value (which has been the basic assumption since 1997) but rather "to create value for all our stakeholders". However, this raises the question of whether, and to what extent, this statement is empty rhetoric or whether it represents an actual tipping point where these CEOs really mean what they say.

The Dutch corporate law framework and corporate social responsibility

Dutch companies are governed by their articles of association and by statute. The relevant statutory law is enshrined in Book 2 of the Dutch Civil Code ("DCC"). In addition, publicly traded Dutch companies are also required to apply the Dutch Corporate Governance Code ("DCGC"), which contains a comply-or-explain regime. As one of its first key principles, the DCGC stipulates that companies should pursue "long-term value creation", where stakeholder interests need to be taken into careful consideration. This derives from the principle of plurality: the fact that within a company a multitude of interests are pursued that are weighed against each other in order to add to the long-term value creation for the company and its affiliated enterprise. This principle of plurality can be found in Article 8 of Book 2 of the DCC, which relates to reasonableness and fairness in the Dutch corporate context, and Articles 140/250 of Book 2 of the DCC, which dictate that a company's board of directors and supervisory board must allow their actions to be guided by the interests of the company and its affiliated enterprise, in which all the company's various stakeholders play an important role.

The fact that the Dutch regulatory frameworks place such a strong emphasis on all the various stakeholders makes it possible for corporate boards to include corporate social responsibility and sustainability in their risk management systems and corporate strategies without being bound by the demands of shareholders. This regulatory approach towards the stakeholder model, which applies both to publicly traded companies (NV: "public limited liability company") and private companies (such as the BV: "private limited liability company"), is also echoed by various judgments in the Netherlands. For example, in the Cancun, Akzo Nobel and ABN AMRO cases, Dutch courts ruled that the interests of shareholders do not take precedence over the interests of other stakeholders. In addition, in Fortis, the Enterprise Chamber (a special division of the Court of Appeal of Amsterdam) explicitly highlighted the interests of the community in a company's governance.

In light of the increasing regulatory attention and the mounting pressure from institutional investors, consumers, and society at large, it is advisable for companies to implement CSR concerns in their corporate governance framework. This could be given shape by considering the following points: provide incentives for the board of directors to look beyond short-term shareholder value; implement effective monitoring through objective/independent directors; share relevant streams of data and information in order to make effective monitoring possible; ensure appropriate trade-offs by redefining the role of the board, and manage conflicts of interest to ensure that personal interests do not undermine corporate interests.

Conclusion

Given society's increased expectations of the business sector, and the financial, reputational and legal implications for companies, it is no longer sufficient for companies to focus solely on maximizing shareholder value and profits. Therefore, both listed and non-listed companies are increasingly expected to have appropriate governance structures and processes in place to internalize CSR considerations in their business practices. Some firms have already realized this development, by acknowledging that sustainable shareholder value does not necessarily contradict or exclude the pursuit of stakeholders' interests, and have adapted their corporate governance framework accordingly.

If you have any questions about sustainability, ESG or CSR within the Dutch corporate environment, please contact *Rebwar Taha*.

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