Business for Social Responsibility

The Stakeholder Fiduciary: CSR, Governance and the Future of Boards

By Allen L. White
Senior Advisor, BSR

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Table of Contents

Note:

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1. Executive Summary[1]

In the dynamic world of corporate social responsibility (CSR), remarkably little attention has been focused on the role of corporate boards. This is at once unfortunate, unsurprising and unacceptable: unfortunate because the board is the supreme governing entity of the corporation and should be a major actor in shaping the firm's CSR strategy; unsurprising because the board, by virtue of law and tradition, perceives its role in CSR to be either negligible or contradictory to its mandate; and unacceptable because the board, as ultimate steward of the well-being and performance of the organization, cannot afford to be a passive bystander in shaping the organization's CSR strategy.

This paper explores how corporate boards do, could and should relate to the CSR agenda. In equal shares, it observes the present and envisions the future, seeking to both position the board as an agent of CSR under current rules and show how to reconstitute it under different rules that may emerge in the coming decades. Our core premise is this: the board's current posture is incommensurate with the changing nature of the social contract between business and society, and with the attendant opportunities and risks that lie ahead. This incongruity must be corrected if the board is to function in a way that enables the firm to create and allocate long-term wealth in a form consistent with 21st century needs and expectations. In short, it is time to transform the board from a shareholder fiduciary to a stakeholder fiduciary.

II. What Boards Do[2]

Corporate boards, by history, law and practice, are overseers of the corporation. As early as the 18th century, U.S. entrepreneurs and political leaders such as Alexander Hamilton and Benjamin Franklin saw the need for corporate boards to act as supervisors of corporate management. This oversight function remains remarkably intact centuries later, most notably in General Corporate Law of Delaware,[3] the benchmark for modern U.S. corporation governance that has left evident fingerprints on corporate governance practices in many parts of the world.

As the corporation has evolved from modest-scale private partnerships controlled by family interests and few investors to transnational entities publicly traded by thousands of investors, this "oversight" function has become more complex and multi-faceted. In the modern corporation, the board is integral to shaping the values and culture of the

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[1] My appreciation to Anna Fleder for research support, and to Matt Hirschland, Emma Stewart and Lyuba Zarsky for comments on an earlier draft of the paper.

[2] The point of reference of this piece is the corporate board in the Anglo-American tradition. However, this tradition exerts a strong influence on the governance structures in other nations, including the major emerging economies. Profiles of boards in a few such economies appear in section IV.

[3] Jay Losch with Elizabeth MacIver, *Pawns or Potentates: The Reality of America's Corporate Boards.* Boston: Harvard Business School Press, 1989, 7.

organization. It approves and oversees business strategy. It reviews and monitors financial performance and capital allocation. It ensures compliance with the law. It sets its own compensation and that of top executives. The board also structures its own governance process, notably, procedures for conducting business and constituting committees—e.g., audit, finance, compensation, governance, nominations, ethics and, in a few cases, CSR.

Underlying all the board's actions are three pillars: duty of loyalty, duty of care and good business judgment. All these pillars arise from state corporate law in the U.S., inspired in particular by Delaware's approach.[4] *Duty of loyalty* means that corporate directors must act in the best interests of the organization consistent with their roles as guardians of its future. *Duty of care* means that loyalty must be accompanied by due diligence, or the responsibility to seek and obtain all information necessary for making decisions for which it is responsible. *Good business judgment*, or the business judgment rule, derives from a long history of judicial rulings that assign to corporations the ability to make business decisions that support the long-term interests of the corporation even in cases where short-term interest—most notably, profit-maximization—may be sacrificed.[5] This last pillar has particularly powerful implications for how boards relate to CSR, an issue to which we return below.

In fulfilling its various duties, the board—knowingly or unknowingly—helps shape the CSR agenda of the organization.[6] As the highest governance body, directors are instrumental in setting the values and standards within the organization through their decisions regarding strategy, incentives and internal control systems. Board actions set the tone of how the organization fulfills its social contract and how it manages both the privileges and the obligations conferred by society in return for permission to engage in commercial activity. Through its remuneration, nominations, audit and finance committees, the board signals to management, employees and external stakeholders how it views the tough trade-offs between short-term shareholder value and long-term wealth creation. The board can make choices to enhance various aspects of corporate responsibility, such as defining CEO salaries versus the employee average; improving diversity in board recruitment to reflect the spectrum of stakeholder interests; demonstrating commitment to social audits along with financial audits; and guiding capital investment and portfolio investment with an eye toward contributing to sustainable development. . Even absent a CSR committee of the board or a strong awareness of CSR issues among individual directors, the board inevitably, by choice or by chance, exerts a powerful influence on the organization's CSR performance.

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[4] Paul P. Brountas, *Boardroom Excellence: A Commonsense Perspective on Corporate Governance.* San Francisco: Jossey-Bass, 2004.
[5] Einer R. Elhauge, "Corporate Managers' Operational Discretion to Sacrifice Corporate Profits in the Public Interest," in Bruce L. Hay, Robert N. Stavins and Richard H.K. Vietor (eds.), *Environmental Protection and the Social Responsibility of Firms: Perspectives from Law, Economics and Business.* Washington, DC: Resources for the Future, 2005, 13-76.
[6] Craig Mackenzie and Simon Hodgson, *Rewarding Virtue,* report of Insight Investment, Business and the Community, FTSE Group, London, November 2005.

III. On Whose Behalf?

On whose behalf do boards perform their many functions, including those that impinge upon CSR?

Some three decades ago, the answer to this question was formalized by academics (not the courts) in the theory of Principal–Agent: The board's primary duties are to oversee company operations on behalf of shareholders.[7] In its purest form, the board is the agent that serves, and shareholders are the principals. The principals expect boards to ensure that their interests are prioritized.

Day to day, the board mediates conflicting interests that play out within the corporation as it goes about its business of producing goods and services. The contractual relationships between boards and managers, managers and employees, and managers and suppliers form the framework within which the board executes its responsibilities. As it oversees and monitors this nexus of contracts, it is obligated, according to principal-agent theory, to ensure that shareholders' interests remain preeminent. While the business judgment rule, referenced earlier, allows flexibility in *how* the board (and managers) executes its role as agent, it does nothing to dilute the primacy of shareholder interests.

Though principal-agent theory is the most common framework within which directors' duties are defined, it is by no means the only one. Distilling directors' duties to a bi-lateral (shareholder-board) relationship may be elegant from a legal and analytical perspective, but from a CSR perspective, this elegance gives way to obsolescence. To define the duties of the supreme governance body of a corporation in such a uni-dimensional form contradicts the most fundamental tenet of CSR: Corporations are responsible to multiple stakeholders, all of whom are integral to the success of the business. All contribute to wealth creation, and all merit the attention of boards (and management) to ensure long-term success of the company. Doing otherwise, directly or indirectly, introduces risks and ignores opportunities that undermine the single most important asset of any firm—trust in its leadership, products and services.

The most direct challenge to the principal-agent framework is the team production model (TPM).[8] The core of TPM is that the corporation comprises a multitude of parties that jointly and inseparably contribute to its capacity to produce wealth. Shareholders are one such contributor (Figure 1), but there are many others: employees who contribute their human capital; suppliers who contribute their technology know-how; consumers who place their trust in the products and services of the organization; communities that contribute their infrastructure and environmental assets (water, air and

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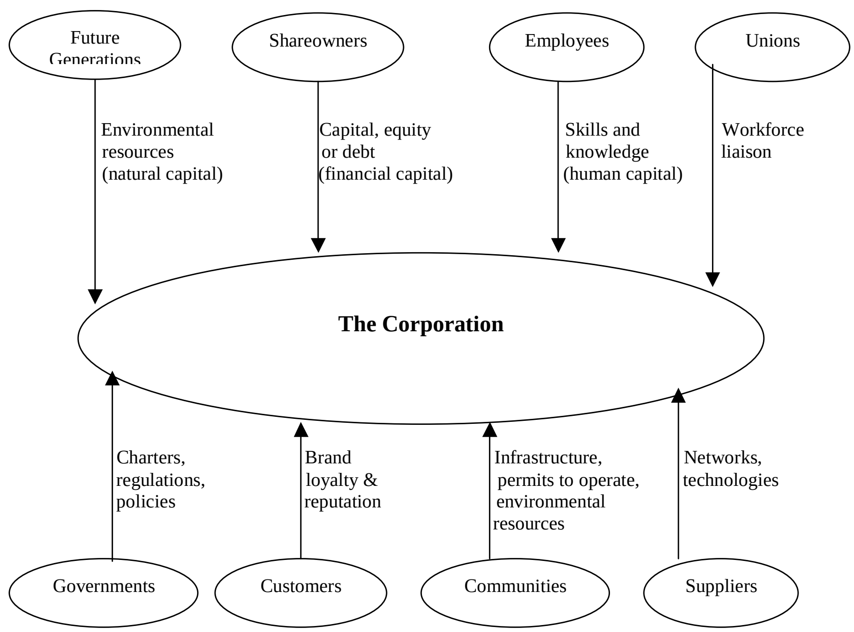
[7] Michael Jensen and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," Journal of Financial Economics, October, 1976, V. 3, No. 4, pp. 305-360.

[8] Margaret M. Blair and Lynn A. Stout, "A Team Production Theory of Corporate Law," 85 University of Virginia Law Review 247, 250 (1999).

land); and government that provides a stable legal framework that enables the corporation to function within reasonably certain rules and procedures.

Figure 1 Resource Providers to the Corporation



In the TPM framework, it is the combination of these contributors that provide "specialized inputs" into the corporation. Remove any one, and the organization cannot function, at least not for long and certainly not prosperously.

The implications of the TPM framework for corporate boards and CSR is both profound and, to a large degree, self-evident. If all of the aforementioned stakeholders contribute their assets to the corporation, it follows that each should be given voice in the corporation's governance structure at a level commensurate its contributions. To one degree or another, all put their assets at risk, analogous to the shareholders that risk their financial capital. Employees cast their lot with a company and expect their human capital to be rewarded and retained. Suppliers apply their know-how to new technologies sought by their customers and build their inventories to respond to the customers' needs on short notice. Communities provide environmental assets and physical and legal infrastructure with the expectation they be rewarded with a pool of jobs and tax revenues.

The details vary, as does the risk/return equation. But the underlying logic is straightforward: shareholders are neither the only asset providers nor the only risk takers; and boards, in their selection, composition and decision-making should be accountable to these multiple parties. This is the essence of what might be called *stakeholder governance*, a concept that directly challenges the received wisdom that boards exist to promote and protect the interests of one party only, those of investors.

In the 1980s, the concept of *stakeholder management* described the need for corporate recognition of non-financial stakeholders in fashioning strategy and management of the organizations.[9] In general, recognition signified a process of identifying those groups whose interests in the organization reached a level that merit management's attention, and proceeding to communicate with such groups to address and assuage their concerns. The formation of community advisory panels by chemical manufacturers is one of the early cases of stakeholder management. Like many, such panels were tied to facility-level issues, e.g. materials storage and emergency response plans.

In the 1990s, focus shifted to the next level of stakeholder consideration, that of *engagement.* Best management practices, such as the standard AA1000,[10] defined approaches to not only identify stakeholders, but also to build and sustain relationships with all parties substantively affected by, or those who affect, the activities of the corporation. Advisory councils and consultations on specific CSR issues such as human rights and climate change became increasingly prominent. Partnerships to address critical sustainability and global health issues such as HIV/AIDS, gender equality and education provided vehicles for translating such partnerships into social value for stakeholders.

Now, two decades after the birth of the stakeholder concept, stakeholder governance is unfolding as the next chapter, following recognition and engagement, in the empowerment of groups to "[make] decisions that fairly balance the claims of all key stakeholders."[11] Stakeholder governance represents an elevation of affected parties beyond a first stage of ad hoc, relatively passive actors, to a second stage of more systematic, two-way dialogue, to a third stage of integration into formal governance structures. What form stakeholder governance takes and at what pace remain fluid, as we shall see later.

IV. A Quick Tour

To set the stage for these models of the possible futures, let's pause for a quick tour of selected board governance developments in a small sample of countries to provide a context for the models that follow. The focus here is on developments that directly or indirectly impinge upon the prospects of stakeholder governance in the coming years.

[9] R. Edward Freeman, *Strategic Management: A Stakeholder Approach.* Boston: Pitman, 1984.
[10] www.accountability.uk.org
[11] www.bsr.org

United States

Governance failures beginning in 2001 that lead to enactment of the Sarbanes-Oxley legislation (SOX) shed light on the composition of boards and their relationship to company financial performance. In particular, the requirement to increase the fraction of independent directors was viewed not only as an instrument to enhance integrity, but to calm capital markets made nervous by now discredited accounting and accountability systems that wreaked havoc on trust in the markets. While it is not clear whether firm performance is directly related to the number of independent directors, stock market price does increase consistently when outsiders are added.[12] Similarly, outsiders are viewed as more likely to prioritize the interests of shareholders and to undertake the primary monitoring functions when on boards. Furthermore, markets react positively when outside directors have more additional directorships. Thus, from the standpoint of integrity and market confidence, SOX may well prove to be a success. But from the standpoint of stakeholder governance—elevating the voice of non-financial interests in board decision-making—little has changed.

In addition to the number of independent directors, diversity among directors has been an issue for many years, even before the Enron-era scandals of the last five years. The roots of board diversity awareness pre-date the CSR movement and are more directly linked to the civil rights era.[13] Nonetheless, after decades of non-mandatory pressures, minority representation on boards of major U.S. corporations is scant. A recent study of Fortune 100 company boards shows that women and minorities together hold less than one-third of board positions of more than 60% of the companies surveyed.[14] As of September 2004, women accounted for 200 of 1196 board directors, whereas men accounted for 996, or 83%. Minorities held 178 of the directorships (15%), a figure diluted by the presence of the same minority directors on multiple boards.

Germany

Large German corporations have a two-tiered board: the Management Board, which manages the company day-to-day and has the responsibility to "increase the sustainable value of the enterprise;" and the Supervisory Board, which "appoints, supervises and advises" the Management Board.[15] In companies of 2000 or more employees, employees elect half of the members of the supervisory boards, though shareholders retain control over appointment of the chair. In companies with more than 500 employees, the Supervisory Board also contains employees of the company. At the factory level, worker councils are elected by employees and play a strong role in matters such as hours, timing of work and safety. The German Stock Corporation Act prohibits participation on both

[12] Benjamin E. Hermalin and Michael S. Weisback, "Board of Directors As an Endogenously Determined Institution: A Survey of the Economic Literature," Center for Responsible Business, Working Paper Series, University of California, Berkeley, 2003.
[13] A notable development in this field: Norway now mandates that in its largest companies, 40% of board members must be women.
[14] http://www.washingtonpost.com/wp-dyn/content/article/2005/05/11/AR2005051102027_pf.html
[15] http://www.corporate-governance-code.de/eng/kodex/4.html; Jonathan Springer, "Corporate Law, Corporate Constituency Statutes: Hollow Hopes and False Fears," New York University School of Law, Annual Survey of American Law, 85 (1999).

boards in order to clearly separate management from general supervision. This co-determination arrangement in Germany is perhaps the longest standing institutionalized expression of a multi-stakeholder board in any country.

Japan

Corporate governance in Japan is moving toward the U.S. model.[16] Since 2000, amendments to the Japanese Commercial Code have become more frequent than in the past, now occurring several times per year rather than once every few years. The amendments primarily aimed to give managers of Japanese corporations more flexibility in their organizational duties and to increase the effectiveness of monitoring procedures. As such, in 2002, the Commercial Code was amended to offer Japanese companies the option of utilizing the existing *kansayaku*, or corporate auditor system, or switching to the U.S. board committee system. Still, the acceptable board committee system is not identical to that of the U.S. The primary distinction lies in the definition of what constitutes an independent director. In Japan, the committee must have a majority of outside directors, where such directors may include a major shareholder or a person otherwise involved with a parent company. Japanese legislation requires adherence to a much less strict definition of "independent director" than U.S. legislation requires. From a CSR perspective, one can expect, at best, slow movement toward opening Japanese corporate boards to formal or informal stakeholder influence owing to a deep-seated business culture that resists exposure of the inner workings of the organization to outsiders.[17]

United Kingdom

In 1998, the United Kingdom's Combined Code issued guidelines for board reform, implementing the creation of board committees and the disclosure of executive pay. It was revised in 2003 to move in a direction similar to trends in the U.S. by requiring more accountability and more independent members on the board. The Code now includes new provisions such as requiring one-half, rather than one-third, be independent directors; emphasizing fairness and representation on the board; and separating the positions of CEO and chairman of the board.[18] Further, as laid out in the Company Law Reform White Paper of 2005,[19] "a director must (so far as reasonably practicable) have regard to…the interests of employees, suppliers, customers, the community and the environment." And further: "The basic goal for directors should be the success of the company for the benefit of its members as a whole; but that, to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and

[16] Curtis Milhaupt, Professor of Law, Columbia Law School: "Choice as Regulatory Reform: The Case of Japanese Corporate Governance," speech delivered on May 12, 2004. http://www.rieti.go.jp/en/events/bbl/04051201.html
[17] The Economist Intelligent Unit, *The Way of the Merchant: Corporate Social Responsibility in Japan,* 2005.
[18] http://www.accountingweb.co.uk/cgi-bin/item.cgi?id=119232&d=448&h=0&f=0
[19] www.dti.gov.uk/cld/WhitePaper.htm

suppliers, and in the community more widely." This language was the result of years of special commissions that explored if and to what extent directors' duties should be expanded to include non-financial issues material to shareholders—the so-called *enlightened shareholder* framework of corporate governance. Though its future remains uncertain, the White Paper represented a modest step in the direction of stakeholder governance.[20]

South Africa

In South Africa, board reforms that have been implemented in recent years mimic structures in the UK and the U.S. In 1994, South Africa's King Committee issued a report with recommendations for board reforms similar to those in the UK's Cadbury Code.[21] The report informed the King Report of 2002, which lays out guidelines for corporate boards that are similar to those for U.S. boards. However, noteworthy differences exist. The King Report frames the entire corporate governance question in a broader social context, blending the realities of post-apartheid South Africa with emerging international standards of good governance, suggesting that governance of the company should attend to both financial and non-financial objectives. For example, the board should identify and monitor key non-financial aspects of the corporation; and, the demographics of the company should be considered in board composition.[22] Further, non-financial reporting using the Global Reporting Initiative framework is recommended by the King Report, reflecting again its view of the corporation in a broader social context and the duty of directors to ensure such considerations are incorporated into board responsibilities.

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[20] Recommendations in the White Paper were at a standstill as of early 2006, owing to Chancellor of the Exchequer Gordon Brown's termination of the Company Law Reform Process. For a status report, see Ben Schiller, "This OFR and No Further," Ethical Corporation, April 2006, 12-13.

[21] Center for International Private Enterprise, http://www.cipe.org/publications/fs/ert/e31/e31-3.htm

[22] http://www.cliffedekker.co.za/files/CD_King2.pdf;
http://www.ecseonline.com/PDF/King%20Committee%20on%20Corporate%20Governance%20-%20Executive%20Summary%20of%20the%20King%20Report%202002.pdf

China

In China, the Corporate Law, recently amended in 2005, dictates both a board of directors as well as a supervisory board. The supervisory board often has "labor union, party and major shareholder representation," and loosely monitors the operations of the board and top executives.[23] The recent amendments of the Corporate Law served to bolster the efficiency and accountability of the corporate board. Revisions include allowing a board chairman, executive director or manager to be designated by shareholders as the legal representative of the company and requiring independent directors on corporate boards of listed companies.[24]

In sum, this sketch of some recent developments in five countries reveals a mix of inertia and change: inertia in the sense of the continued primacy of shareholder interests as the focus of board duties, and change—albeit modest and uneven—toward broadening board composition and duties to incorporate diverse stakeholder interests. The former, should it be sustained in the coming decade, is a business-as-usual scenario that at best leaves boards indifferent to CSR and, at worst, positions them as impediments to corporations achieving continuously higher standards of CSR practices. The change scenario that has occurred helps align board interests with the evolving redefinition of business-society relationships that confronts boards in both industrial and emerging nations.

V. Prototypes for the Future

If a commission were formed today with the mandate to revisit the structure and function of boards, what directions might it pursue?

To begin, it is fair to say that the duties, loyalties and composition of boards mirror the shareholder-centric organization that has evolved over many years of judicial decisions and extra-legal practice. If the emergence of stakeholder governance, as we have argued, is the wave of the future, then we are logically led to ask how boards might be reconstituted to reflect such governance. To be sure, boards are not the only expression of stakeholder governance. Corporations such as Nike and Ford have long convened diverse stakeholders to advise them on shaping and implementing their CSR agendas. Through its longstanding Community Advisory Panel efforts, the chemical industry has involved host communities in assessing and monitoring storage and transport risks. And, on the regulatory side, offices of state consumer advocates and, more broadly, administrative law proceedings in siting and expanding electric power plants have served as mechanisms for stakeholder input. But when we speak of reconstituting boards, we are moving from the outside to the inside of the organization, embedding stakeholders into

[23] http://www.marshall.usc.edu/media/pressroom/pdf_long/GLOB_LIN_CHINAXL.pdf
[24] http://www.newsgd.com/business/laws/200511020018.htm

company operations on a deep and ongoing basis at the highest levels of corporate governance.

The notion of elevating stakeholder interests is by no means untried. In the U.S., a wave of *corporate constituency statutes* were enacted in the 1980s to empower states to fend off hostile takeovers and protect the interests of non-shareholders—particularly employees and communities—in the face of management decisions perceived as contrary to the interests of such constituents.[25] By the mid-1990s, 30 such laws were enacted by various states, though notably, Delaware, which historically sets the tone for U.S. corporate law, was not among the participating states. However, the impact of these laws on the ground has been limited, due to vagueness in language of the statutes, questions as exactly which groups would be granted legal standing in a court of law, and enactment of other anti-takeover measures by states that diluted the use of constituency statutes for that purpose. Though their impact on elevating non-shareholder interests has been minimal, the fact that so many were enacted in a relatively short time speaks to the preceding and latent discomfort with the definition of directors' duties.

In a similar vein, as early as 1989, a major Harvard study[26] of directors' duties recommended a series of "systemic changes" to boards, including enlargement of the scope of constituents to which boards should be held accountable. "Corporations exist to provide more than a return to their owners—they also provide goods and services, and employment, which in turn produces taxpayers and contributes to the nation's economic well-being. Their conduct affects a wide range of national interests… It makes no sense to instruct their governors to rule only for investors…" Indeed, to do so forces directors to govern with personal *inconsistency*, that is, in a form that conflicts with the individual's recognition of the profound social consequences of corporate activities because the governance body operates under a one-dimensional, shareholder-focused mandate.

For some observers, the question of directors' duties blends legal and moral considerations.[27] It is a perspective consistent with the evolution from stakeholder management to stakeholder engagement and stakeholder governance, at the same time that it directs attention to fundamental ethical questions about the nature of ownership and control of the corporation itself. Shareholders do not "own" corporations in any usual sense of the word. They cannot exclude others from holding shares (as is the case with privately held property), they cannot make decisions about day-to-day management of the corporate assets, and they cannot sell or buy specific portions of the assets.[28] Further, they are no more owners of a corporation than bondholders who own corporate bonds, suppliers who own the corporation's inventory or workers who "own" their labor.

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[25] Springer, op cit

[26] Lorsh 1989, 187-191.

[27] Kent Greenfield, *The Failure and Future of Corporate Law.* Chicago: Chicago University Press, forthcoming 2006.

[28] For some observers, short-term shareholding, because of its fleeting and passive nature, has drifted so far from traditional definitions of ownership that it now has little meaning and is ripe for change. Harvard Business School Professor Joseph Bower observes: "I think in another 10 years our laws will be very different. It's not at all obvious that very short-term investors should be regarded as owners. They are basically speculators to whom we are giving the rights of ownership." (Stephan Stern, "The short-term shareholders changing the face of capitalism," *Financial Express*, April 8, 2006.) If this is the case, short-term shareholders in the future may well be accorded fewer claims to corporate profits than employees, communities or other stakeholders.

Following this logic (which underpins Figure 1), each of these constituents, and the many others that contribute to wealth creation, are no less (or more) entitled to reap the rewards of corporate wealth creation and, by implication, be represented within the corporation's governance structure.

If one wholly or partially accepts this line of reasoning, then it is appropriate to question why boards are constituted to represent just one group among the many stakeholder groups with legitimate claims on the corporation, namely, the shareholders. Basic democratic principles suggest that the current situation is a misalignment between those affected by corporations and those who govern. Whether one adopts a legal or ethical lens through which to view corporate governance, the picture that emerges is the same. Corporations are licensed to exist by government and, like all acts of government, have a public purpose at their core.[29] Serving such purpose requires a governance structure that is responsive to this public purpose, not one in which public purpose is left to the discretion of the directors asked to serve the interests of one among many stakeholder groups.

The proliferation of governance principles and reforms in the last 10 years has made only a modest contribution to correcting this misalignment. In the U.S., SOX legislation focused on strengthening control systems and transparency to better protect investor interests, leaving unchallenged the primacy of such interests in governing the corporation. Governance principles of the Organization for Economic Co-Operation and Development (OECD)[30] and the International Corporate Governance Network (ICGN)[31] follow a similar path, focusing on issues such as shareholder voting rights, transparency, audit systems, remuneration of executives' rights, and selection and qualification of directors. In the case of ICGN, reference is made to "corporate citizenship" in relation to "managing successful and productive relationships with the corporation's stakeholders." SOX, OECD and ICGN are suggestive of trends in governance reform not only in the U.S., but in many countries that look to the Anglo-American model for inspiration—strengthening systems and processes to protect shareholder interests without advocating a shift to serious stakeholder governance.

Let's return, then, to the opening question of this section: If boards were invented today to meet 21st century needs and expectations of business-society relations, what would they look like? To answer this question, consider prototypes of future boards (Prototypes 2-4 are juxtaposed against the present structure [Prototype 1]). These prototypes are simplified portraits of future possibilities, designed to draw reasonably clear distinctions between one another and between the board structure that is typical of the contemporary corporation. Many details as to election and removal of board members, rules and procedures of the board's internal operations, and similar terms and conditions are largely left to future specification. These are idealized depictions, each with 10 members,

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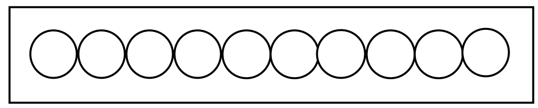
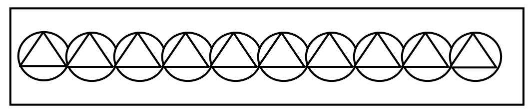
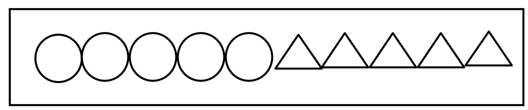
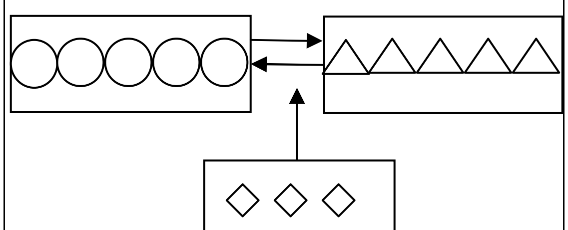
[29] Dennis M. Ray, "Corporate Boards and Corporate Democracy," Journal of Corporate Citizenship, 20 (Winter 2005), 93-105.
[30] http://www.oecd.org/dataoecd/32/18/31557724.pdf
[31] http://www.icgn.org/organisation/documents/cgp/revised_principles_jul2005.pdf. The first sentence of the principles unambiguously affirms the rights of shareholders: "The overriding objective of the corporation should be to optimize over time the returns to shareholders."

beginning with the contemporary and moving along a spectrum from a modest to a more dramatic reconstitution.

Figure 2 Models of Corporate Boards

Prototype 1: Present	
Prototype 2: Capacitated Board	
Prototype 3: Reconstituted Board	
Prototype 4: Bi-Cameral Board	

○ Shareholder interests
△ Non-shareholder interests
◇ Mediators

Prototype 1 depicts the **present board**. In this case, 10 members operate under current rules of governance in which shareholder returns are positioned as the overarching purpose of the corporation and thus the driver of board decision-making. It is a self-perpetuating board, whereby a nominating committee selects candidates to succeed departing members and shareholders vote on the proposed slate. The extent of direct nominations of new board members varies by country, but in no case are explicit competencies or representation of other stakeholder interests embedded in the selection process. To the extent that CSR issues are on the board's agenda, they originate via an occasional shareholder resolution, e.g. in relation to climate change or GRI reporting, and/or are filtered through top management during times of crisis, e.g. press allegations of worker rights violations or an acute environmental incident at a factory or mine site.

Prototype 2, the **capacitated board**, depicts a modest but noteworthy step in the direction of stakeholder governance. Here the contemporary rules of governance remain unchanged in terms of the legal mandate of boards to prioritize shareholder interests. However, unlike Prototype 1, the capacitated board has been formally trained and credentialed in relation to CSR issues. In this future, business associations, associations of corporate directors and academic institutions that already offer board training have expanded their offerings to include the standard menu of CSR topics: human rights, labor standards, marketing, environmental stewardship, community relations, non-financial reporting, stakeholder relations and the like.[32] This scenario essentially puts in place a formal mechanism aligned with the aforementioned "enlightened shareholder value" concept now popular in the UK whereby boards integrate stakeholders' issues as means to maximizing long-term shareholder value. Shareholder primacy is unchanged as the core of fiduciary duty, but its interpretation is now more broad in the spirit of the enlightened shareholder concept. Board training has emerged as a standard practice based on the generally accepted belief that corporate directors—no less than physicians, accountants, pilots and educators—should be held to standards of professional competency in their roles in governing corporations. Training institutions offer various levels of credentials. Directors on boards of large, global corporations are required to obtain the highest level; those who serve smaller enterprises achieve a lower bar. In all cases, the equivalent of continuing education to keep abreast of new CSR issues is a requirement.

Prototype 3, the **reconstituted board**, is a more aggressive step toward stakeholder governance. Here, three key changes have occurred. First, multilateral and national governance principles have evolved to the point where parity between shareholder and non-shareholder interests is generally accepted. The rules of governance, both mandatory and voluntary, share language that asserts that the corporate purpose is to advance the public interest, and that such interest is best served by actions that support the corporation's capacity to produce long-term wealth. Second, reflecting this revised mandate, the board is split between those with backgrounds and competencies in shareholder matters versus those with backgrounds and competencies in non-investor matters, e.g. environment, human rights and labor. The duty of both clusters is the same—to promote the corporation's sustainability and capacity to produce long-term wealth—and the composition of the reconstituted board mirrors this new mandate. Third, the method for board selection has been democratized. Mechanisms for direct election by various stakeholder groups are now in place, replacing the earlier indirect and incumbent-dominated system in which existing board members put slates of nominees forward and shareholders were asked to either approve or, in the U.S., abstain. The combination of a redefined corporate purpose, a reconstituted board and new procedures for board selection represent a dramatic advancement in stakeholder governance.

[32] An example of board credentialing without a CSR emphasis is The Directors' College of DeGroote School of Management, McMaster University and the Conference Board of Canada, www.thedirectorscollege.com. Graduates received the Chartered Director designation.

Prototype 4, the **bi-cameral board**, rests on the same assumptions as the reconstituted board, except in this case power is divided into shareholder and other stakeholder chambers. In addition, a standing mediatory body adjudicates disagreements between the chambers under certain circumstances where major decisions are under review and consensus has not been achieved, e.g. an acquisition or merger of a certain scale, major plant relocation or a major downsizing of the workforce. The bi-cameral board configuration is, of course, similar to the checks and balances system embodied in the U.S. and other modern constitutional democracies. The adjudicatory body is analogous to the judicial branch in this case, resolving major strategy disagreements.

For those who hold the view that boards should be held to the same standards of democratic process as political democracies, the bi-cameral structure has much appeal. In its best form, it establishes a creative tension between stakeholders who, though mandated to look after the best interests of the corporation as a whole, inevitably resort to protecting the special stakeholder interests they are chosen to represent. This is not necessarily an unhealthy behavior, but it is one that requires a mediation mechanism such that business decision-making is not unduly impaired by competing stakeholder interests. At the same time, skeptics understandably will doubt the functionality of this complex structure in relation to running the corporation. Will it inevitably lead to high transaction costs, delays in time-sensitive choices with implications for the firm's competitiveness and, most fundamentally, erosion of the duty of loyalty to the firm as a whole, as opposed to the special interests of diverse stakeholders? The advocates and skeptics both make valid points. Some empirical evidence is available in the split management and supervisory board structures in Germany, though the comparability is not perfect. Nonetheless, Prototype 4 represents novelty in both shareholder governance as well as a high standard of democratization of an institution—the corporation—that many believe faces a severe democratic deficit.

VI. Is it Time for Stakeholder Governance?

Boards are not the only body through which corporate accountability to stakeholders is realized. Such accountability occurs through a host of other mechanisms, such as collective bargaining between management and labor, employee ownership arrangements and specific statutes that regulate, for example, workplace health and safety, consumer protection and environmental impacts. All mechanisms impose terms and conditions on the corporation's license to operate, seeking to ensure that its activities fall within the boundaries of prevailing social norms and expectations.

Yet all these instruments of corporate control have been in place for many decades, operating more to contain harm than to fundamentally expand the rights of stakeholders in corporate governance. In this historical context, the CSR movement of the past two decades may be interpreted as an attempt to realign corporate governance with emerging norms of corporate responsibility. But this realignment remains unfinished business.

Containment is not a substitute for systemic change. The loss of public trust on the part of business and indeed, the entire debate about business-society relations, may be viewed through the lens of stakeholder governance. The rising tide of demand for accountability, transparency and access are precursors to further escalation of demands to democratize the corporation in the coming years.

Reconstituting boards to become more representative, responsive and responsible to all of the corporation's stakeholders is part of the broader debate about the obligations and duties, privileges and protections of corporations in the 21st century. Rethinking corporate governance is part of a larger unfolding story of how to address the governance deficit in a dynamic, globalizing world where traditional boundaries and behaviors are rendered increasingly obsolete. It is against this backdrop that boards must emerge from the shadows to the forefront of stakeholder governance to assert their unique role as trustees—indeed, creators—of the socially responsible corporation of the future.

About Allen White

Allen White in his Senior Advisory capacity with Business for Social Responsibility (BSR) has been charged with challenging both BSR and businesses engaged in the work of corporate social responsibility to think in new and different ways. In practice this has meant drafting a series of thought provoking public white papers and business briefs designed to serve as the catalyst for dialogue among the many stakeholders that affect, and are affected by the nature of business and society relations.