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'Considering Social Sustainability in Company law Reform: Corporate Goals and Organisational Innovations'

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Abstract

The purpose of this paper is to show that the primary corporate goal (profit maximisation) is posited on the company's capacity to extract value from labour. Accordingly, it is not that the company needs different mechanisms to encourage it to be more cognisant of social sustainability but that its very success is posited upon an affront to social sustainability. Furthermore, in order to extract value from labour and to avoid the costs involved in achieving this it will innovate organisationally. Innovation often means that companies will shed their corporate network in favour of an outsourcing model of production. Problematically, this takes the socially harmful activities of the company away from the ambit of company law and the effects of company law reform. I hope to demonstrate the process and motivation for organisational innovation through the double lens of Coase's transaction cost theory and labour value theory.

Shareholder maximization is mandated in the UK under the Companies Act 2006, section 172[1]. The other stakeholders on the list[2] differ in their likelihood to be attended to when directors are acting for the benefit of company members. The environment, given a social interest in this and the impact of CSR *may* be well attended to. Not so labour. The truth of this contention may in part be illustrated by musing upon a more radical reformulation of section 172 which replaces the phrase 'member's interest' with 'labours' interest' an enlightened *labour* value model. Such a reform would be nothing short of alarming because it fundamentally deconstructs the current institutional form and goals of the company. As a matter of social norms companies exist for the benefit of shareholders, not employees. Companies exist to utilise labour to make money for

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[1] Section 172 of the UK's Companies Act 2006 states that 'A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company *for the benefit of its members as a whole*, and in doing so *have regard* (amongst other matters) to – (a)' – (f). This can be seen as a form of instrumental stakeholding or enlightened shareholder value, in that it *may* enhance shareholders' interests to consider a wider group of constituents when making decision-making, equally it may not.

[2] Set out in section 172 (a)-(f)

shareholders. The enlightened shareholder value approach of section 172 distorts this truth a little, the stakeholder approach distorts it a lot[3] but the labour formulation clarifies the essential function of companies by offering such an – from the mainstream point of view – unpalatable alternative.

My aim in this paper is to show that companies continually innovate their organisational forms in order to extract maximum value from labour; a point I demonstrate by examining the organisational forms taken by multi-national companies (MNCs) through the lens of Coase's transaction cost theory and through a labour based interpretation of Coase's theory. Organisational adaptability means that law reform which attempts to inhibit the company's primary goal can be sidestepped. Thus I examine labour governance initiatives which may be able to attach to companies regardless of organisational restructuring.

How companies extract value: MNCs, Coase and transaction costs theory

Use of foreign subsidiaries by UK based parent companies has been evident since the end of the nineteenth century.[4] However, use of complicated corporate networks of parent and subsidiary companies massively intensified over the last forty years of globalisation. The global economy of MNCs is organized around some 80,000 parent companies and 800,000 subsidiaries.[5] Within this, the largest companies 'have their own internal operations and employees spread over 40 or more nations, and may boast of thousands of supply chains and strategic 'partners' worldwide'.[6]

There is an increased tendency for companies in the developed world to relocate the productive part of their business to developing countries. This expresses a global shift in production patterns where developing country subsidiaries will engage in the lower skilled part of

[3] Because 'the interest of members' is already ensured through such quarters as the equities market where the valuation of shares (and thus the measure of management competency) is based on the expected returns to shareholders.

[4] *Bartholomay Brewing Company (of Rochester), Limited v Wyatt*, Respondent. Noel *Dynamite Trust Company, Limited, Appellants; v Wyatt*, Respondent.[1893] 2 Q.B. 499 The *London Bank of Mexico and South America, Limited v Apthorpe*.[1891] 1 Q.B. 383

[5] Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework
<www.ohchr.org/documents/issues/business/A.HRC.17.31.pdf >

[6] Farok J. Contractor, Vikas Kumar, Sumit K. Kundu and Torben Pedersen 'Reconceptualising the Firm in a World of Outsourcing and Offshoring: The Organizational and Geographical Relocation of High-Value Company Functions' (2010) *Journal of Management* 1417,1428

production (such as assembly work) and the developed country's company will manage production utilising skilled local labour. Apple famously assembles its products in China, taking advantage of cheap labour,[7] a profitable strategy despite the bad publicity it has received.[8] All MNCs by definition have a global corporate network, however some retain all or most of their operations within the network while others will rely more on outsourcing. Illustrating the latter model, Associated British Foods' subsidiary Primark bought directly from one of the clothes factories involved in the disaster in Dhakar where 1,129 people were killed.[9] Many of the extractive industries utilized the former model, safe in the knowledge that parent company assets were protected from its subsidiaries' losses by the corporate veil.[10]

The decision to engage in economic activity either within organizational structures or within the market was first explained by Coase in his 1937 article.[11] Here he showed that as market conditions were not perfect,[12] obtaining goods and services from the market entailed transaction costs. As these costs increased it became more efficient to bring these arrangements in house thus forming a business organization or 'firm' where resources could be efficiently allocated by the 'entrepreneur'. The size of the firm was really a measure of how much it outperformed the market.

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[7] Apple's products are mainly produced and assembled by Foxconn (owned by Taiwanese company Hon Hai Precision Industry Co., Ltd) and its China-based subsidiaries. www.carnegiecouncil.org/publications/ethics_online/0068.html (accessed 1 Dec. 2013)

[8] /www.pcmag.com/article2/0,2817,2422763,00.asp (accessed 1 Dec. 2013)

[9] Emma Rowley, 'Bangladesh factory collapse: Primark to pay compensation' (Telegraph 29 April) <http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/10026307/Bangladesh-factory-collapse-Primark-to-pay-compensation.html >(accessed December 1 2013)

[10] *Adams v Cape Industries* [1990] Ch.433. Since *Adams* many plaintiffs who suffered injury from employment in subsidiary companies of extractive industries have sought compensation from parent companies in tort. This approach easier today because the doctrine of *forum non conveniens* can no longer be used in the UK (as a Contracting State to the Brussels Convention) to decline jurisdiction over a case on the grounds that the court of a non-Contracting State would be a more appropriate forum and since the decision in *Chandler v Cape Plc* [2012] EWCA 525 which found that the parent company owed a duty of care to the employee of a subsidiary.

[11] Ronald Coase 'The Nature of the Firm' (1937) 4 Economica 386–405

[12] Oliver Williamson later showed that as the market consisted of flawed and complicated individuals with bounded rationality and prone to act opportunistically it necessarily encompassed inefficiencies. Oliver Williamson *The Economic Institutions of Capitalism'*(The Free Press 1985)

An alternative way of conceptualizing the processes described in Coase's transaction cost theory is to say that firms or companies emerge because they more effectively extract value from labour than does the market. Within the firm, labour's time is organized so as to maximize its productivity – the division of labour being a typical method for maximizing labour productivity. There are costs for capital in the organisation of production in this way, but those costs are off-set by higher returns. As William Lazonick observes, 'it was the closer supervision of the workers afforded by the factory setting that, despite its higher capital costs, ultimately made it more profitable than domestic industry.'[13] The organisational features of the company, which in particular encompass the idea of authority and hierarchies, are successful precisely because they enable the exercise of power by capital over labour.

Modern thinking on transaction costs: Labour exploitation and outsourcing

Coase's transaction cost theory has been utilized by recent management scholarship to set out the conditions under which 'firms' (usually MNCs) will opt for outsourcing in preference to a network of subsidiaries and vice versa. Some studies conclude that transacting costs in developing countries are too high for significant outsourcing to be viable. A tendency to social instability or 'environmental dynamism' will increase market inefficiencies and the costs of transacting. For example, significant social flux may render contracts unenforceable or local suppliers may be able to act opportunistically and charge higher than market prices because their local knowledge is superior. To counter this companies outsourcing will need to increase monitoring which will create additional costs.[14] Other studies indicate that as developing countries supply such cheap labour, the benefits to MNCs are still significant provided that labour is utilized in the low skilled part of production. Transaction costs will arise if the outsourced labour is engaged at the high technology end of production because, it is argued, high technology is vulnerable to theft of intellectual property in a way that low skilled production is not.[15]

[13] William Lazonick *Business Organisation and the Myth of the Market Economy* (Cambridge University Press 1994, first edition 1991) 187

[14] Cher- Hung Tseng and Liang-Tu Chen 'From Capabilities as Moderators of transaction cost factors and subsidiary domestic outsourcing' (2013) 51(1) *Management Decision* 5, 10

[15] ibid

The barriers to extracting value from labour in the studies noted above appear to be rapidly dissipating because of innovations in organisational structuring and management technique which are enabling outsourcing of higher end production in developing countries. For example, research indicates that the 'core' areas that an MNC needs to protect have become increasingly condensed. Pharmaceutical companies will keep the 'science' of experiments within the core company (the parent) but outsource the preparation of test batches. This part comprises around 40% of R&D budgets but does not compromise the protection of key knowledge.[16] Furthermore, high level knowledge outside of the core is fragmented by design so that elements of the productive process that can be outsourced 'very close to the "core competencies" of the firm.'[17] Corporate knowledge is also more codified so that it can be transferred throughout the organisation. Transfer of knowledge enables outsourcing but it also (potentially) enables theft of corporate knowledge. Codified knowledge, broken into discrete portions enables more outsourcing and 'may not greatly increase the threat of opportunism.'[18]

Global outsourcing continually grows as companies are driven to innovate ways of extracting value from labour.[19] Slicing production in the ways described above allows the 'core' knowledge to be trimmed down and for outsourcing to increase its reach in the search for appropriate labour. New corporate strategies have increased the tasks that may be undertaken by outsourced labour without compromising the company's intellectual property. This changes the shape of companies so that 'the firm's boundaries have become more permeable while its geographical scope has increased.'[20] The development of different management strategies are liberating business from the need to have complicated corporate networks and to outsource more effectively. This makes social reform through company law reform tricky because increasingly

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[16] Farok J. Contractor, Vikas Kumar, Sumit K. Kundu and Torben Pedersen 'Reconceptualising the Firm in a World of Outsourcing and Offshoring: The Organizational and Geographical Relocation of High-Value Company Functions' (2010) *Journal of Management* 1417,1423

[17] ibid 1419

[18] ibid 1423

[19] One study looked at 1722 offshore projects undertaken from 2002 to 2005 by MNCs and concluded that the EU15 was the least attractive area for such projects while China and India were the most favoured locations. Demirbag, M. and Glaister, K. W. 'Factors determining offshore location choice for R&D projects: a comparative study of developed and emerging regions'. 2010 *Journal of Management Studies* 1467

[20] Farok J. Contractor, Vikas Kumar, Sumit K. Kundu and Torben Pedersen 'Reconceptualising the Firm in a World of Outsourcing and Offshoring: The Organizational and Geographical Relocation of High-Value Company Functions' (2010) *Journal of Management* 1417,1428

transactions do not take place within same corporate network and are instead a series of contracts.

Operationalising sustainability through labour-orientated governance

Labour-orientated governance requires labour's empowerment through the unions, through their presence on a supervisory and management board and through control over their working practices and conditions throughout the value chain. Traditionally, the power to shape labour-orientated governance resided with labour unions and their role certainly remains significant. However, as the experience of the UK and US car industry indicates, strong unions may fall-stall wage cuts and redundancies and resist changes to working practices, but market pressures and anti-union state policy mean that unions cannot resist them indefinitely.[21] Direct labour engagement with decisions about the productive process would enable labour to engage creatively with reskilling and restructuring, rather than just defend outdated practices. Labour representation in the corporate decision making process, though such mechanisms as the supervisory board, would enable this.

Labour representation and protection throughout the chain of production may also be facilitated by private labour governance initiatives (civil-society initiated codes of conduct in respect of the treatment of labour). Some codes have the potential to protect labour in the value chain regardless of whether it is outsourced labour or labour within a corporate network. However, to meet that potential such codes must contain specific requirements rather than general principles, they must meaningfully involve stakeholders and have an external monitoring system. These base requirements are absent from most labour governance initiatives such as the Ethical Trading Initiative (used by Primark in Dhakar), ISO 26000 to promote CSR in companies,[22] the UN Global Compact[23] and Ruggie's Guiding Principles.[24] However, other initiatives do conform to the base standard of specificity, engagement and monitoring. One such example is the Social Accountability 8000 (SA 8000), originally developed by Social Accountability International in

[21] L E Talbot *Progressive Corporate Governance for the 21st Century* (Routledge 2012) 58-66

[22] International Organization for Standardization, "ISO 2600- Social Responsibility" <http://www.iso.org/iso/home/standards/iso26000.htm> accessed June 26th 2013

[23] http://www.unglobalcompact.org

[24] John Ruggie, 'Guiding Principle on Business and Humna Rights: Implementing the United Nation's "Protect, Respect and Remedy" Framework'< http://www.business-humanrights.org/media/documents/ruggie/ruggie-guiding-principles-21-mar-2011.pdf >

1998, to reduce sweatshop practice. SA8000 is highly regarded by many commentators and considered to be 'one of the most stringent certification standards in the area of labour governance.'[25] The current 2008 version SA8000 states as its purpose to 'protect and empower all personnel within a company's scope of control and influence'.[26] This includes producers, suppliers, subcontractors and home workers. To be certified, SA8000 requires detailed auditing to ensure that its very specific standards and requirements are met and are verifiable.

SA8000 also requires stakeholder engagement, through consultation and engagement with information relating to compliance, including monitoring. The company must 'demonstrate its willingness to participate in dialogues with all interested stakeholders, including, but not limited to: workers, trade unions, suppliers, subcontractors, sub-suppliers, buyers, nongovernmental organisations, and local and national government officials, aimed at attaining sustainable compliance with this standard.'[27] All companies will be subject to announced or unannounced audits to certify compliance and they must keep appropriate records to show compliance.[28] Social Accountability International reports that SA8000 is currently certifying 3231 facilities in 68 countries, over 65 different industries, employing a total of 1,829,776 workers. [29] However, even this 'good' example has been subject to substantial criticism. The Clean Clothes Campaign reported that SA 8000 was failing to deliver because it was not easily enforcable and

[25] Jimmy Donaghey, Juliane Reinecke, Christina Niforou, Benn Lawson, 'From Employment Relations to Consumption Relations: Balancing Labor Governance in Global Supply Chains' *Human Resource Management* Forthcoming, 2014. More recently though, even this 'good' example has been subject to criticism in respect of its lack of enforcebility and because of its failure to monitor the agencies qualified to certify a business as SA8000 compliant. The Clean Clothes Campaign,'Fatal Fashion Analysis of recent fcatory fires in Pakistan and Bangladesh: a call to protect and respect garment workers' lives' <http://www.cleanclothes.org/resources/publications/fatal-fashion.pdf >24-27

[26] Social Accountability *International Social Accountability 8000* (SA8000) <http://www.sa-intl.org/_data/n_0001/resources/live/2008StdEnglishFinal.pdf> 4

[27] ibid 10

[28] ibid

[29] SA8000 Certified Facilities List, June 30, 2013 <http://www.saasaccreditation.org/certfaclists/2013_Q2/Q2%202013%20SA8000%20Certs%20List,%20Public%20List.pdf>

because of its failure to monitor the agencies qualified to certify a business as SA8000 compliant.[30]

Research has also indicted that these labour governance initiatives are more effective when coupled with other supporting elements. Donaghey et al find that although labour and consumer power operate on different areas of governance, if they work simultaneously they can enhance the effectiveness of labour governance.[31] There are potential connections between many diverse activists around the company which may enhance labour governance by creating a pincer effect that may force companies to modify their shareholder primacy orientation. Equally though there are limits to this approach because it depends on different groups sharing the same goal. Consumer choices made in the developed world may be difficult to reconcile with the needs of labour in developing world. With life experiences so different it seems highly unlikely that labour in developing countries and consumers in developed countries will agree on the priorities, even in areas like child labour. Other scholarship shows that parties who are far removed from the process of production such as shareholders or consumers are not well placed to decide on the best interests of labour, even where their input is well intentioned.[32]

Conclusion

In this paper I contend that company success is posited upon finding innovative ways to extract the maximum value from labour. Company organisational forms innovate to achieve that end. That is the nature of a company. Law reform to raise the status of labour fundamentally subverts

[30] The Clean Clothes Campaign,'Fatal Fashion Analysis of recent fcatory fires in Pakistan and Bangladesh: a call to protect and respect garment workers' lives' <http://www.cleanclothes.org/resources/publications/fatal-fashion.pdf >24-27

[31] Jimmy Donaghey, Juliane Reinecke,, Christina Niforou,, Benn Lawson, 'From Employment Relations to Consumption Relations: Balancing Labor Governance in Global Supply Chains' *Human Resource Management* (Forthcoming, 2014)

[32] Aaron Dhir, 'Shareholder Engagement in the Embedded Business Corporation: Investment Activism, Human Rights and TWAIL Discourse' *Osgoode CLPE Research Paper* 2009 No. 12/2009 <http://dx.doi.org/10.2139/ssrn.1416198> accessed 15 June 2012 shareholder initiatives to improve the life of the company's foreign workers failed because they misunderstood what these workers actually required

the nature of the company, but if sustainability is to be achieved that subversion is unavoidable. The key goal of shareholders is to maximise their investment, in large part by retaining the liquidity necessary to pursue areas of high value extraction when they arise and to abandon low value areas as revealed through the short term information delivered from the equity market. Company law reform can address this to a degree but, as I argue here, it is important to be cognizant of the innovative capacity of companies to side- step such reform.

The real challenge is to straightjacket investor demands so that sustainability can breathe. This will involve measures to halt the pursuit of shareholder primacy through the equities market, a removal of shareholder powers in company law and a rejection of the shareholder governance initiatives currently dominating the corporate governance agenda. And then the long list of reforms; distribution at the point of production through higher wages, hard law measures to control the proliferation of financial property forms[33] and the public enforcement of a directors' duty to labour and sustainability.[34] In all of this the empowerment of labour is paramount. The key goals of labour are to progress as individuals, to enjoy stable employment and to work in safe environments – goals compatible with sustainability. As we have seen in the current financial crisis, a corporate capitalism built around shareholder primacy does not even embrace its own sustainability. It will certainly not embrace the sustainability of people.

[33] L E Talbot Why shareholders shouldn't vote: a Marxist-progressive critique of shareholder empowerment' *Modern Law Review* (2013) 76(5) 791-816

[34] Rene Jones and Michelle Welsh 'Toward a Public Enforcement Model for Directors' Duty of Oversight' (2012) 45(2) *Vanderbilt Journal of Transnational Law* 343, L E Talbot *Progressive Corporate Governance for the 21st Century* (Routledge 2012) 225-226