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2013-09-26

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Delivery Details

Date:	January 8, 2019 at 3:15 p.m.
Delivered By:	VERN KRISHNA
Client File:	GAAR

Corporate Tax Centre - Vern Krishna discusses the requirement of corporate directors to act in the best interests of the corporation that they manage and be responsible to the corporation's owners to maximize the rate of return within the bounds of the law.

Corporate Ethical Investing

Date: September 26, 2013

Corporate Ethical Investing

Vern Krishna

Corporate directors are required to act in the best interests of the corporation that they manage. In doing so, they can exercise their business judgement. The principal stakeholders in a corporation are its shareholders, who put up the money to run the business, assume the risks, and the rewards of stock ownership. Thus, directors have a duty to use their judgement to maximize shareholder wealth.

To be sure, in addition to their shareholders, corporations also have broader societal obligations to the community and their employees. Thus, in managing the corporation's portfolio, directors may take into account the interests of various constituencies. However, they cannot lose sight of their primary duty to the shareholders.

Advocates of so-called "ethical investing" argue that corporate managers should shun all "unethical" investments. This places managers of Canadian portfolios in a difficult legal position. Canada represents about two percent of the world's capital markets. Hence, in terms of asset diversification and managing risk, it is not financially prudent to restrict portfolio investments to only Canadian securities. But by further restricting portfolio investments to only those that are considered "ethical", corporate managers run the risk of being imprudent by exposing shareholders to unwarranted financial risk.

Of course, any ethical investment policy would first require some reasonable consensus on what we mean by "ethical". Generally, if one can eat it, smoke it, drink it, gamble or fight with it, the product has a reasonable chance of being labelled "unethical" by some constituency. Tobacco, of course, is the conventional whipping boy. Tobacco usage is bad for one's health. Close behind is sugar and fat, deadly for diabetes—the silent killer.

Tobacco and "fat food" companies sell legal products and contribute substantial amounts in tax revenues to governments. Canadian federal and provincial tax revenues (excluding sales tax and GST) from tobacco sales, for example, amounted to $7.5 trillion in 2010-2011. The revenues support other societal purposes, such as, health care, education, and welfare. Of course, banks and financial institutions extend credit to tobacco companies. If we are to brand governments and financial institutions that support tobacco and gambling as unethical, the potential pool of investments shrinks even further and increases financial risk.

Some go even further and suggest, for example, that preppy clothing merchant Abercrombie & Fitch Co. is a vice stock because basically what they sell is sex. Similarly, Limited Brands Inc., the Ohio-based retail holding company that owns lingerie retailer Victoria's Secret might be on the vice list. Hilton Hotels might not be eligible on a portfolio of ethical investments because it offers a combination of income that it derives from special in-room entertainment and Paris Hilton.

Even if one could arrive at a clear consensus on ethical corporations, products and services, there is the added problem of trying to determine who actually produces the product or service. Corporations are opaque and it is not at all easy to determine what they do and where they do it. For example, despite the ban by Canada, the United States, the United Kingdom, France and Germany on apartheid South Africa in the 1970s and 1980s, corporations in each of these countries broke the ban indirectly by dealing through intermediary organizations and trusts in banking and secrecy havens. The lure of gold and diamonds in South Africa was just too great and profitable to keep hidden away. Indeed, the United States, France and Germany supplied arms and weapons to the South African apartheid regime, which the government of the day used against its impoverished citizens working in the gold and diamond mines.

Large conglomerates produce a variety of products, which, depending upon their use, can serve humanity or cause terrible harm. For example, General Electric, the world’s largest company, manufactures gas turbines, medical imaging systems, jet engines, home appliances, locomotives, water-filtration products, engineered materials, industrial products, and light bulbs. It also owns NBC/Universal Broadcasting and GEC Services, which offers consumer and commercial financial products, insurance and equipment-management services. Jet engines and gas turbines have civilian as well as military uses. They can be used to protect a country’s independence or to oppress nations.

Directors as fiduciaries are responsible to the corporation’s ultimate owners to manage corporate assets and maximize the rate of return within the bounds of the law. A lower rate of return on investments is inefficient and takes from the owner shareholders of the business. Directors who avoid portfolio investments in corporations that engage in legal activities and thereby deprive shareholders of their just return on investments may become exposed to shareholder litigation against the enterprise if they are not acting in the best interests of the corporation.

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