ESG AND LAW

The EU Commission publishes the "Study on directors' duties and sustainable corporate governance" – Approaching the concretisation of a turnaround in corporate governance in Europe from "short termism" to "long termism"?

The "Study on directors' duties and sustainable corporate governance" ("Study") prepared by EY addresses centrally the phenomenon of "short termism", the short-term thinking in corporate governance (Study on directors' duties and sustainable corporate governance – Publications Office of the EU). The focus of corporate decision-makers on short-term shareholder value maximisation instead of long-term corporate interests reduces the long-term economic, environmental and social sustainability of European companies, according to the underlying thesis of the Study. The Study uses data material from recent decades to substantiate the phenomenon of short termism, and then presents essentially seven main causes ("Drivers") of short termism as well as three possible responses by the European Commission ("Commission") as remedies.

I. PRINCIPAL CONTENT OF THE STUDY

1. As essential evidence of short termism, the Study refers to data collected over the period 1992 to 2018 from listed companies in 15 Member States (including Germany) and the United Kingdom. The Study concludes from this that EU companies focus on short-term shareholder benefits rather than on the long-term interests of the company. One reason for this is the pay-outs to shareholders which has quadrupled from less than 1 percent in 1992 to almost 4 percent in 2018. Second, there is a reduction on the investment side; the ratio of CAPEX and R&D investments to revenues has been declining since the beginning of the 21st century.

2. The Study identifies seven main causes of short termism. According to the Study, legal frameworks and market practices in Europe are such that a long-term orientation of corporate governance plays no relevant role in the duties, remuneration or liability of directors / members of the board.

3. According to the Study, the "core problem" of the last three decades for listed companies in the EU is that company management focuses on the short-term benefit of shareholders and investors rather than on the long-term interests of the company.

4. In order to address short termism, the Study argues that the time horizon and perspective of corporate decisions need to be broadened, with a particular focus on the following objectives:

- Duty of directors to consider the long-term interests of the company (beyond 5 to 10 years) and other stakeholders, i.e. not only shareholders;
- Creation of incentives for longer-term investors;
- Duty of the board to integrate sustainability aspects into the business strategy and, among other things, to identify and monitor measurable sustainability targets;
- Adaptation of the remuneration policy to a long-term perspective;
- Guidelines for the composition of the boards of listed companies with sustainability expertise;
- Obligation to identify and mitigate sustainability risks and impacts, especially from the perspective of stakeholders;
- Provisions for the enforcement of liability against directors, also by stakeholders.

5. The Study presents three options to address the above objectives

- two "non-legislative / soft" options (Option A and B), namely

  Option A: EU campaign to foster sustainable corporate governance practices through awareness raising activities, communications, conferences and the like;

BEITEN BURKHARDT

Option B: Promotion of national legislative initiatives in the field of corporate governance/company law based on EU recommendations;

- a "legislative/hard" option (**Option C**) with binding regulations through direct legislative EU interventions.

6. The Study assumes that "EU intervention" is required. Only EU intervention can achieve a higher degree of corporate responsibility for long-term sustainable value creation and establish a minimum common basis for dealing with sustainability while avoiding market distortions.

II. FIRST ASSESSMENTS

1. The Study processes the terms of reference of the "Commission Action Plan on Financing Sustainable Growth" of March 2018 ("Action Plan"). The third part of the Action Plan addresses "promoting transparency and long term perspectives" and provides in Action 10 for the examination of "sustainable corporate governance and inappropriate short-term thinking (short-termism) in capital markets". The Study is also embedded in other studies initiated by the Action Plan, such as the "Study on due diligence requirements through the supply chain" which was published in January 2020. The Action Plan is itself a component of a large number of other Commission initiatives, such as the "European Green Deal", the "Investment Plan for a Sustainable Europe" or the "Renewed Sustainable Finance Strategy". Parallel to this, there are worldwide debates on topics such as "stakeholder capitalism", turning away from the decade-long model of shareholder primacy (shareholder value) or on "Purpose", i.e. the orientation of the object and purpose of companies in times of climate change and other global challenges.

2. The Study points to the limited availability of empirical studies on the long-term effects of the short-term behaviour of companies in Europe. It is also admitted that one indicator of short termism identified as significant – the increase in pay-outs to shareholders – occurred mainly in the 1990s, i.e. it is not a current, expanding phenomenon. However, these "warnings" about the data situation do not change the basic assumption of the Study that short termism exists in a quantifiable way and is responsible for undesirable developments in corporate management.

3. The Study assesses the economic, social, environmental, human rights and other impacts of Options A and B as rather "non-existent" or "small" while the impacts of Option C are considered "moderate" or "large". In addition, the Study is generally sceptical about Option A because it has no binding effect. The same applies to Option B, since the "recommendations" are also non-binding and the extent to which they are implemented depends on various variables. It is thus evident that Option C is the only relevant solution alternative from the perspective of the Study.

4. In the attached Annex under III. we have summarized the essential aspects of Option C – as the option relevant from the perspective of the Study – in relation to the respective Drivers. In this context, the following is striking:

   - In particular, the Study focuses, on the one hand, on clear legal obligations with regard to long-term corporate governance with special consideration of the interests of stakeholders and the implementation of correspondingly measurable sustainability targets in the business strategy (Drivers 1, 3 and 6) and, on the other hand, on appropriate legal enforcement vis-à-vis directors also and especially by stakeholders (Driver 7).

   - With the focus on long-term corporate governance, the Study aims to establish a link between a corresponding change in the remuneration structure (Driver 4).

   - Due to practical problems, the composition of the board is not at the top of the Study's agenda (Driver 5).

   - The Study is sceptical and opposed to interventions in quarterly reporting as a countermeasure against pressure from the capital markets; such "EU intervention" is considered counterproductive and is rejected (Driver 2).

5. The Study does not consider the negative economic impacts of Option C to be serious in the different alternatives. The Study concedes, however, that in the short term, companies would face burdens that would be compensated for in the long term. Whether this compensatory effect actually materialises (in time) for the companies affected is likely to be a crucial question, especially in times of crisis, on which much depends for the plausibility of the overall construction of "long termism". Furthermore, the Study deals only very briefly with the question of whether the introduction of sustainability requirements could have a negative effect on external, unaffected competitors outside the EU but denies this effect in the case of exports without further justification. Negative consequences for the competitiveness of EU companies from an import perspective are not even addressed in the Study. However, the effects of a legally binding long-term strategy in global competition and in particular on the competitiveness of European companies in export and import are obvious and must be answered.

6. It can probably be assumed that Didier Reynders, EU Commissioner for Justice, prefers the binding legal regulation – Option C. In a press release on the Study of 31 July 2020, he said: "*I am committed to achieving a more sustainable corporate governance. By sustainable, we mean encouraging businesses to frame decisions in terms of environmental, social and human impact for the long-term, rather than focuses on short-term gains. This study, focusing on directors 'duties, helps us see the root causes of 'short-termism' and identify possible EU-level solutions. We see support for mandatory rules, encompassing both director duties and a corporate due diligence duty. (...) The aim is to enable companies to overcome short-term pressures, act in the best long-term interest of the company while being accountable for the sustainability of their companies' business conduct.*"

7. Formally speaking, the Study refers to listed companies because of the data collected. According to its own statement, it has “only limited evidence” for small and medium-sized enterprises (“SMEs”). According to the Study, the low response rate of SMEs to the web survey, a very limited availability of relevant research sources and other organisational problems largely limit the assumed interaction between corporate governance regimes and sustainability in SMEs. However, a significant part of the European economy is, thus, only marginally covered by the Study in terms of content, even though SMEs are sometimes mentioned in the discussion of the variants and taken into account in the assessment process (e.g. in Driver 6). Nevertheless, the similarity in content to the supply chain study shows that further-reaching demands for (binding) standards are not dependent on a stock exchange listing. Nonetheless, based on the logic of the Study’s argumentation, it would have to be examined in more detail whether the view of an owner-managed company can or must be more differentiated or different from that of listed companies.

8. The Study is based on the one-tier system and does not differentiate between corporate management / executive management and supervisory board/advisory board. It remains to be seen whether and to what extent the planned obligations in the two-tier system, i.e. on the supervisory board / advisory board and the relationship to the operational management of the company, will be implemented.

9. The Study points out that a public consultation on sustainable corporate governance will be launched in autumn 2020.

   Keeping an eye on and accompanying this consultation appears to be of great importance for all involved and interested parties – be they companies, associations, consultants, etc. Option C would represent a kind of turnaround in corporate governance, not only with regard to the responsibility of company managers and, *inter alia*, their liability but especially for the companies themselves which may need to rethink their current corporate purpose and reorganise it or make substantial changes. This is not only a matter of adopting the shareholder value model which has long been rightly questioned but also of the question of what management should ultimately pay attention to. In any case, it should be more than the mere interests of the company which is currently the relevant standard, i.e. above all the preservation of stocks and sufficient financial reserves, i.e. profitability. The efforts to (re)orientate corporate management, which are given clearer outlines in the Study initiated by the EU Commission, are noteworthy in view of the manifold, complex and urgent problems. Nevertheless, it is a question of central “rules of the game”, in particular the envisaged change from short-term to long-term in corporate governance.

   In such a key change of course, one must not allow oneself to make any mistakes, neither in action nor in failure to act. The task is huge.

III. ANNEX

STUDY PRESENTATION OF THE DRIVERS IN CONJUNCTION WITH OPTION C – “LEGISLATIVE / HARD”

Driver 1 (duties too narrowly interpreted)

Driver: Legal duties of directors and the interests of the company are interpreted narrowly to favour only short-term maximisation of shareholder value.

Objective: EU-wide formulation of the duties of directors and the company interest, obliging directors to perform these duties: (i) to properly balance the following interests alongside the interests of shareholders: long-term interests of the company (beyond 5 to 10 years) as well as those of employees, customers, the local and global environment and society as a whole; (ii) to identify and mitigate sustainability risks and impacts, both in relation to the company’s operations and the value chain.

Instruments: Commission proposal for a new EU Directive.

Challenges: (i) Companies must adapt their corporate governance to the new concepts in the short term; (ii) clear and unambiguous formulation of legal duties of the managing board, for instance with regard to the balance/prioritisation of the various interests.

Driver 2 (pressure from investors)

Driver: Due to growing pressure from investors with a short-term orientation, the managing board is focusing on short-term financial returns at the expense of long-term value creation.

Objective: (i) Giving longer-term shareholders more control over companies or creating incentives for investors to take a longer-term approach, for instance by combining (a) voting rights (b) profit shares (c) reduction of or exemption from capital gains tax with the length of investment (“loyalty shares”); (ii) prohibition of profit forecasts and quarterly reporting.

Instruments: (i) Amendment of the Shareholders’ Rights Directive II, with binding rules obliging Member States to introduce mechanisms to provide incentives for longer periods of share ownership; (ii) amendment of the Transparency Directive, prohibiting profit forecasts and quarterly reporting for listed companies.

Challenges: According to the Study, the impact of the measures can be harmful by reducing transparency of listed companies and negatively affecting EU capital markets. The Study concludes that Option C is thus disproportionate compared to the initial problem.

Driver 3 (lack of a strategic perspective on sustainability)

Driver: Companies lack a strategic perspective on sustainability, current market practices do not allow to effectively identify and manage relevant sustainability risks and impacts

Objective: Legal duty of the managing board to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy, to identify and set measurable, specific, time-bound and scientifically based sustainability targets as part of the business strategy which are coordinated with more far-reaching objectives (such as the SDGs and the objectives of the Paris Convention on Climate Change) and to disclose relevant information.

Instruments: Commission proposal for a new EU Directive.

Challenges: Increase of compliance costs.

Driver 4 (Remuneration)

Driver: Remuneration structures offer incentives to focus on short-term shareholder value rather than long-term value creation for the company.

Objective: Alignment of executive remuneration policy with a long-term perspective by (i) limiting the possibility of selling shares; (ii) including non-financial ESG indicators linked to a company's sustainability objectives in the executive remuneration system.

Instruments: Amendment of the Shareholders' Rights Directive II.

Challenges: Increase of compliance costs.

Driver 5 (composition and expertise of the managing board)

Driver: The current composition of the managing board and existing competencies hinder a shift towards sustainability.

Objective: Statutory regulations governing the composition of the managing boards of listed companies, including an obligation for companies to take sustainability criteria into account when nominating executives.

Instruments: Commission proposal for a new EU Directive.

Challenges: (i) Recruitment of board members is more complicated, only limited knowledge and know-how in the field of sustainability is available; (ii) companies must be allowed to define the sustainability expertise relevant to them, in order to avoid, among other things, "box ticking".

Driver 6 (stakeholder interests not reflected)

Driver: Current corporate governance frameworks and practices do not sufficiently voice the long-term interests of stakeholders.

Objective: Legal requirement for the managing board to establish mechanisms for involving internal and external stakeholders in the identification, prevention and mitigation of sustainability risks and impacts as part of its business strategy.

Instruments: Commission proposal for new "binding EU rules".

Challenges: Negative impacts particularly in sectors with supply chains and a wide range of stakeholders, as, *inter alia*, identification and involvement of stakeholders render decision-making processes more complex and longer.

Driver 7 (liability)

Driver: Limited enforcement of directors' duties to act in the long-term interests of the company.

Objective: (i) Binding legal provisions for enforcement against directors for breaches of duties by stakeholders, described under Driver 1; (ii) empowering national authorities to initiate proceedings against directors if third parties or the environment are seriously harmed.

Instruments: Commission proposal for new "binding EU rules".

Challenges: Increase in lawsuits and thus administrative and compliance costs.

Dr André Depping
Lawyer | Mediator | M.L.E.
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Dr Matthias Etzel
Lawyer | Licensed Specialist
for Commercial and Corporate Law
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Dr Daniel Walden
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Imprint

This publication is issued by
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Ganghoferstrasse 33 | D-80339 Munich
Registered under HR B 155350 at the Regional Court
Munich/VAT Reg. No.: DE811218811

For more information see:
https://www.beiten-burkhardt.com/en/imprint

EDITOR IN CHARGE
Dr Matthias Etzel | Lawyer

© BEITEN BURKHARDT Rechtsanwaltsgesellschaft mbH.
All rights reserved 2020.

NOTES

This publication cannot replace consultation with a trained legal professional.

If you no longer wish to receive this newsletter, you can unsubscribe at any time by e-mail (please send an e-mail with the heading "Unsubscribe" to newsletter@bblaw.com) or any other declaration made to BEITEN BURKHARDT.

YOUR CONTACTS

MUNICH
Ganghoferstrasse 33 | 80339 Munich

Dr André Depping | Lawyer | Mediator
Phone: +49 89 35065-1331 | Andre.Depping@bblaw.com

Dr Matthias Etzel | Lawyer | Licensed Specialist for Commercial and Corporate Law
Phone: +49 89 35065-1410 | Matthias.Etzel@bblaw.com

Dr Daniel Walden | Lawyer
Phone: +49 89 35065-1379 | Daniel.Walden@bblaw.com