Company Law, Prudent Management and Corporate Sustainability

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1. INTRODUCTION

In this issue, the editors of European Company Law have kindly agreed to publish the proceedings of the panel 'Company Law, Prudent Management and Corporate Sustainability' organized by the Business and Financial Law Special Interest Group (SIG) of the European Law Institute (ELI). The panel was held in Vienna on 6 September 2019, in the context of the ELI annual conference, to discuss the possible role of accounting and legal capital rules in the European company law debate on sustainability and environmental and social governance.

The Special Interest Groups are core components of the European Law Institute that aim at providing subject-based expertise and progressive ideas for future developments in the law.[1] The SIGs of the ELI scrutinize the latest developments in their respective fields of interest and provide their members with an active forum for discussing these developments also in view of preparing draft ELI projects.

The Business and Financial Law SIG was established in 2015 and held its inaugural workshop on 23 June 2017. Every year, it organizes meetings and workshops to discuss the current developments in European business and financial law. At these meetings, the members of the SIG have discussed topics such as the codification and implementation of EU company law instruments, the role of information in company law, transparency and accountability in groups of companies, the use of digital tools in company law, the role of shareholders and stakeholders in European corporate governance, and the problems related to the creation of a harmonized framework to enable the cross-border mobility of legal entities.[2]

The panel held in Vienna on 6 September 2019 explored the role of accounting and capital rules in the sustainability debate, in view of preparing a SIG project on 'Corporate Sustainability, Financial Accounting and Share Capital', which is currently the subject of talks for the ELI endorsement at the ELI Council. In its current form, the draft project aims at investigating the relationship between corporate sustainability, share capital rules and financial accounting, to assess how – without jeopardising the competitiveness of European companies – disclosure obligations, accounting principles, creditor protection tools, and share capital rules may be improved and aligned with the achievement of environmental and social governance goals. In essence, the project aims at reassessing the consistency of the existing European legal framework on share capital and accounting with the achievement of sustainability goals, highlighting emerging contradictions and recommending suitable improvements. To achieve this purpose, Yuri Biondi, one of the chairpersons of the Special Interest Group, has been assembling an interdisciplinary research team of scholars and experts in accounting, sustainable corporate governance and company and financial law.

The panel, whose proceedings are published in this issue, focused its attention on the accounting aspects of this ongoing research work, and provided the participants – mainly legal scholars such as myself – a broader perspective on how, from the accounting viewpoint, the recent shifts in the debate on accounting principles and share capital can help reassess the legal framework on share capital and accounting rules.

2. THE ROLE OF COMPANY EQUITY IN PROMOTING SUSTAINABLE POLICIES

In the first article, Yuri Biondi, from the French CNRS (the National Centre for Scientific Research of France), and Colin Haslam, from Queen Mary University of London, adopt a fresh perspective to investigate an old problem of European company law, namely that of financial capital maintenance. They argue that the rules on the distribution of dividends, and in particular Article 56 of Directive (EU)

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1 For additional information on the SIGs of the ELI, *see*, https://www.europeanlawinstitute.eu/hubs-sigs/sigs/.

2 For more details on the activities of the Business and Financial Law SIG, *see*, https://www.europeanlawinstitute.eu/hubs-sigs/sigs/business-and-financial-law-sig/.

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2017/1132,[3] do not provide sufficient safeguards against the underfunding of companies, especially in those companies that they characterize as 'financialized', meaning the entities that, by necessity or choice, adhere strictly to the paradigm of shareholder value maximization.

According to Biondi and Haslam, share capital requirements should definitely be designed to provide assurance and protection to creditors, but also to strengthen companies to ensure the continuity of these entities as going concerns. Yet, for several reasons, these goals are not currently achieved in financialized companies: firstly, these companies are unable to maintain effective shareholder equity reserves because they may operate with high leverage, and also because the accounting metrics employed to define distributable funds have become 'increasingly fluid and blurred', allowing, for example, to take into account unrealized earnings to increase the amount of distributable funds. Moreover, the authors suggest that capital requirements should not simply be understood in the interest of creditor protection, since these requirements also play a broader role in ensuring the solvency of companies. The authors argue that the risk of insolvency in financialized companies is increasing, and they highlight how this higher risk might have implications not only for shareholders and creditors, but, more generally, for all stakeholders that have relationships with companies.

Finally, Biondi and Haslam investigate if the roots of these problems can be found in the existing EU accounting and company law. They suggest that these problems derive from the use of International Financial Reporting Standards (IAS/IFRS). In fact, they argue that the conceptual framework adopted by the IASB to provide regulation on financial reporting endorses the primacy of shareholder investors' information needs over the needs of other stakeholders. This conceptual framework may run counter to the efficient functioning of the internal market.

The authors believe that, to achieve efficient functioning of the internal market, the connection between company law and accounting metrics governing prudential maintenance of shareholder equity – as they currently stand – should be reconsidered. On the one hand, at the entity level, accounting regulations have become disconnected from a prudential maintenance of shareholder equity, and, on the other hand, at the market level, it may be difficult to reconcile the existing share capital regulatory framework with the need to manage the company as a sustainable going concern. To address these issues, Biondi and Haslam, in view of sustaining the company as a going concern, recommend reforming the existing regulatory framework to ensure a prudential maintenance of shareholder equity reserves.

3. THE INTRODUCTION OF THE SUSTAINABILITY RESERVE

In the second article, Clémence Garcia, from Gakushuin University in Tokyo, addresses the problem of how accounting rules, and in particular accounting rules on company equity, may help promote sustainability on a practical level. The author suggests that the reporting of social and environmental issues should not be separate from financial reporting. Effective reporting on social and environmental issues should be achieved by improving the existing framework on financial reporting: currently, the rules on capital and reserves do not reflect concerns about long-term corporate sustainability, but are instead focused on companies' ability to generate profits in the short term.

Relying on the Japanese conceptual framework for financial accounting, Garcia suggests improving the current presentations of net assets by: (1) ensuring that retained earnings only include the realized net income, (2) providing more detailed reporting on treasury stock, (3) excluding from the scope of shareholder equity unrealized gains and losses on the current value adjustments of assets and liabilities, (4) introducing the sustainability reserve as a new item, and (5) reporting the equity element of convertible bonds and other hybrid instruments as a separate item of the net assets.

The author further recommends improving financial reporting, clarifying that payout ratios should be based on the parent company's distributable income for the year, and not on the entire net income of the group. This will improve transparency on the dividend policies adopted by companies.

However, the most interesting proposal put forth by Garcia consists of the introduction of a sustainability reserve to account for environmental and social risks. The author acknowledges that this type of risk may already be taken into account in financial reporting, for example, as contingent liabilities, in the form of provisions, or by impairing the reported amount of some assets. Garcia argues that this new reserve could be formed, like the legal reserve, by setting aside a percentage of the revenues or profits. However, unlike the legal reserve, the percentage to be set aside would change depending on the specific risk profile of the industries in which the company operates. When the environmental and social risk materializes, the reserve may be used to offset losses and, eventually, take protective actions.

According to the author, this approach would be innovative because it would be based on the identification of specific risks and would not affect the net income of companies, but the destination of it. However, the author also acknowledges that this approach would practically rely on an industry-wide, rather than company-specific, assessment of risks.

4. ADOPTION OF NORMATIVE THRESHOLDS TO VERIFY COMPLIANCE WITH SUSTAINABLE POLICIES

In the third article, Mario Abela, from the World Business Council for Sustainable Development, examines how company law is currently shifting from the paradigm of shareholder value maximization toward a new paradigm that gives relevance to the interests of

3 Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law [2017] OJ L169/46.

stakeholders. Yet he refuses to contrast the interests of stakeholders with those of shareholders. In his opinion, evidence of this paradigm shift may be found in the enactment of Directive 2014/95/EU on non-financial reporting.[4]

Firstly, Abela examines how the new disclosure obligations emerged in the context of financial disclosure obligations. Then, he highlights the trends in these new disclosure obligations, examining both mandatory and voluntary disclosure, and discussing the role of regulators in this field. By providing some anecdotal examples, the author further argues that this evolution is evidence of the increasing pressure that companies face to take sustainability into account in their operations.

Abela concludes his article by arguing that the existing disclosure obligations on non-financial information are insufficient to give substance to sustainable policies in company law, as these obligations do not provide normative thresholds. Instead, normative thresholds – such as the rules on capital maintenance – exist in financial accounting, and severe consequences can result from a violation of these rules, while a violation of the rules on non-financial disclosure normally does not result in material consequences. In the end, Abela believes that policymakers and regulators should provide precise parameters to promote sustainable policies, grounding these parameters in science-based sustainability targets.

5. RECENT INITIATIVES OF THE EUROPEAN COMMISSION IN THIS FIELD

Obviously, all these articles, along with the draft project on 'Corporate Sustainability, Financial Accounting and Share Capital' and the panel held in Vienna, should be understood from the broader perspective of the initiatives undertaken by European and national authorities to improve the legal framework on accounting in light of the sustainability debate. The European Commission has recently taken action in this field. For example, in January 2020, upon request of the Commission, the European Financial Reporting Advisory Group (EFRAG) prepared an opinion on the potential alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments.[5] The EFRAG advised that the Commission should recommend to the IASB to review some specific aspects in the treatment of equity instruments within IFRS 9, and, in March 2020, taking into account the recommendations of the EFRAG, the Commission invited the IASB to take action on this subject.[6]

Even more interestingly, the Consultation on the Renewed Sustainable Finance Strategy opened by the Commission in April 2020, after acknowledging the report of the EFRAG and the Commission's subsequent actions, asked for feedback on whether stakeholders saw 'any further areas in existing financial accounting rules (based on the IFRS framework) which may hamper the adequate and timely recognition and consistent measurement of climate and environmental risks'.[7] This renewed interest for the role of accounting in the sustainability debate further confirms that the discussions within the Business and Financial Law SIG of the ELI came at a timely moment in the evolution of the European debate on sustainability in company law.

4 Directive 2014/95/EU of the European Parliament and of the Council of 22 Oct. 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups [2014] OJ L330/1.

5 European Financial Reporting Advisory Group, *EC Request for Technical Advice on Alternative Accounting Treatments for Long-Term Equity Investments* (30 Jan. 2020), https://www.efrag.org/Assets/Download?assetUrl=/sites/webpublishing/Project%20Documents/1806281004094308/Technical%20advice%20letter%20Equity%2030%20January%202020.pdf.

6 DG Financial Stability, Financial Services and Capital Markets Union, *Letter to IASB* (19 Mar. 2020), https://ec.europa.eu/transparency/regcomitology/index.cfm?do=search.documentdetail&Dos_ID=18970&ds_id=66506&version=1&page=1.

7 European Commission, *Consultation on the Renewed Sustainable Finance Strategy* 12 (2020), https://ec.europa.eu/info/consultations/finance-2020-sustainable-finance-strategy_en.