EUROPEAN LAW INSTITUTE

BUSINESS & FINANCIAL LAW SIG

“Corporate Sustainability, Financial Accounting and Share Capital”

ELI Project Presentation

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Corporate Sustainability, Financial Accounting and Share Capital: The Project

Project run by the ELI SIG on Business and Financial Law, drawing upon the green paper issued after the first workshop in 2017, since Feb 2021 endorsed as ELI Project (2021 – 2022)

Presentation Focus on:

- ✓ project's aim,
- ✓ output,
- ✓ the Project Team composition
- ✓ preliminary findings
- ✓ preliminary assessment of possible EU policy options
- ✓ ELI Principles of Corporate Sustainability (under development)

Project Aim

Current debate on how companies do and should respond to environmental and social considerations.

Our ELI project points to the relationship between **corporate sustainability, company law and financial accounting**.

Only financially robust companies are capable of responding to environmental, social and governance (ESG) considerations, while assuring investor and creditor protections.

Company law requirements concerning share capital management are then fundamental to assure corporate sustainability through time and circumstances.

Financial accounting/reporting provides a convenient legal-economic instrument to control share capital management for managerial, governance and regulatory purposes.

Expected Project Outcome

A **set of recommendations** –summarised in a Statement of Principles – aimed to being impactful on the overall EU policy debate

Our recommendations aim at:

- ✓ Contributing to the regulatory and legislative work at EU and Member States levels **concerning company law, especially prudential capital management and distributions to shareholders;**
- ✓ Clarifying the duties by directors and auditors, enhancing legal security for fulfilling their obligations toward the company and society;
- ✓ Disentangling key policy options for accounting law. As such, our company law principles imply accounting adjustments (similar to tax law).

First Project Outcome

European Company Law review (Proceedings of ELI 2019 Annual Meeting Panel)

Symposium on Company Law, Prudent Management and Corporate Sustainability

European Company Law journal by Kluwer

Volume 17, Issue 5 (October 2020)

https://kluwerlawonline.com/journalIssue/European+Company+Law/17.5/19542

Project Research Team and Advisors

Interdisciplinary and International, common interest in EU law and regulation

Reporters:

Yuri Biondi, Corrado Malberti, Colin Haslam

Advisory Committee - Balance between academic and non-academic members

- ✓ Council of Bars and Law Societies of Europe (CCBE)
- ✓ Financial Reporting Council (FRC)
- ✓ European Commission Informal Expert Group On Company Law And Corporate Governance
- ✓ France's Accounting Authority
- ✓ Italy's Supreme Court
- ✓ Club of Rome

Project Background Findings: Empirical Evidence

Several **reports** have been nurturing our analysis:

- ✓ Report on empirical evidence of corporate practice
- ✓ Report on the EU legal framework concerning sustainability
- ✓ Country reports on Germany, Italy, France and Croatia on financial accounting and share capital management
- ✓ Country reports on Japan and United Kingdom (comparative benchmarks)

Evidence of corporate practice:

- ➢ In line with the Inception Impact Assessment on Sustainable Corporate Governance by the EU Commission (published on 30 July 2020) and accompanying studies
- ➢ Many companies, in particular those listed on regulated exchanges, face pressure to focus on generating financial return in a short timeframe
- ➢ They distribute a large part of their income generated to shareholding investors
- ➢ Excess distributions may be at detriment of the long-term development of the company, as well as of sustainability

Project Background Findings: Regulatory Overview

Our research team prepared a comprehensive review of law and regulation on corporate sustainability.

The idea of sustainable development builds upon the regulatory paradigmatic backbones of:

- ✓ A company as a ‘going-concern’
- ✓ High level of protection of employees and creditors rights
- ✓ Sustainable investments, covering environmental concerns

- ➢ Current capital maintenance regime does not refer to long-term sustainability and is threatened by regulatory competition between Member States;
- ➢ Dependence on international accounting standards, which are weakened by current value measurements (fair value accounting).

Project Background Assessment: EU Policy Inconsistencies

Identified policy inconsistencies between the purpose of corporate sustainability and:

- ✓ Received approach to corporate governance, focusing on shareholder rights and shareholder value orientation while neglecting other stakeholders, the environment and society at large;
- ✓ Received approach to freedom of establishment, neglecting undue pressures on corporate sustainability due to regulatory competition and opportunistic use of transnational entities and transactions, including corporate groups;
- ✓ Received approach to legal/equity capital (including the grand acquis of EUCJ case law), neglecting its dependency on accounting standards, as well as new types of distributions such as share buybacks and reserve distribution.

Project Background Assessment: Possible EU Policy Options

These matters of policy inconsistency claim for:

- Harmonisation at the EU level to avoid regulatory competition and a race to the bottom concerning corporate sustainability and social responsibility;
- Establishment of a level playing field for both investors and other interests, moving beyond shareholder value model of company management and corporate governance.

Possible EU Policy options:

- **Company Law**: Enhancing duties of directors; better rules on equity capital management
- **Financial Accounting**: Better reporting on sustainability-related liabilities and commitments; better reporting on distributions and retained earnings

Our ELI Principles of Corporate Sustainability

A set of company law Principles concerned with company capital management in view to foster and facilitate sustainable business conduct.

Our Principles aim to restate and modernize well-established principles of European company law: on (i) distributions, (ii) equity capital maintenance and (iii) non-distributable reserves.

Our Principles aim to contribute to the ongoing EU debate on corporate sustainability (ESG considerations) by:

- ❖ Providing a frame of reference and analysis to understand corporate sustainability in the context of business and law;
- ❖ Pointing to specific issues which need to be addressed by EU law-makers and regulators;
- ❖ Providing a set of principles of company law that suggest possible solutions in order to cope with these issues.

Our Contribution to Better EU Law - EU Action Plan for Corporate Sustainability

The European Commission - EC 2018 Action Plan for ‘Financing Sustainable Growth’ has called for fostering **sustainable corporate governance** and **reducing short-termism driven by capital markets** (Action 10 – sustainable corporate governance), considering:

- “need to require corporate boards to develop and disclose a **sustainability strategy**, including appropriate due diligence throughout the supply chain, and measurable sustainability targets”;
- “need to clarify the rules according to which directors are expected to act in the company’s long-term interest”.

Accordingly, our ELI project is timely and especially concerned with three main areas of EU law and regulation that currently show different levels of development:

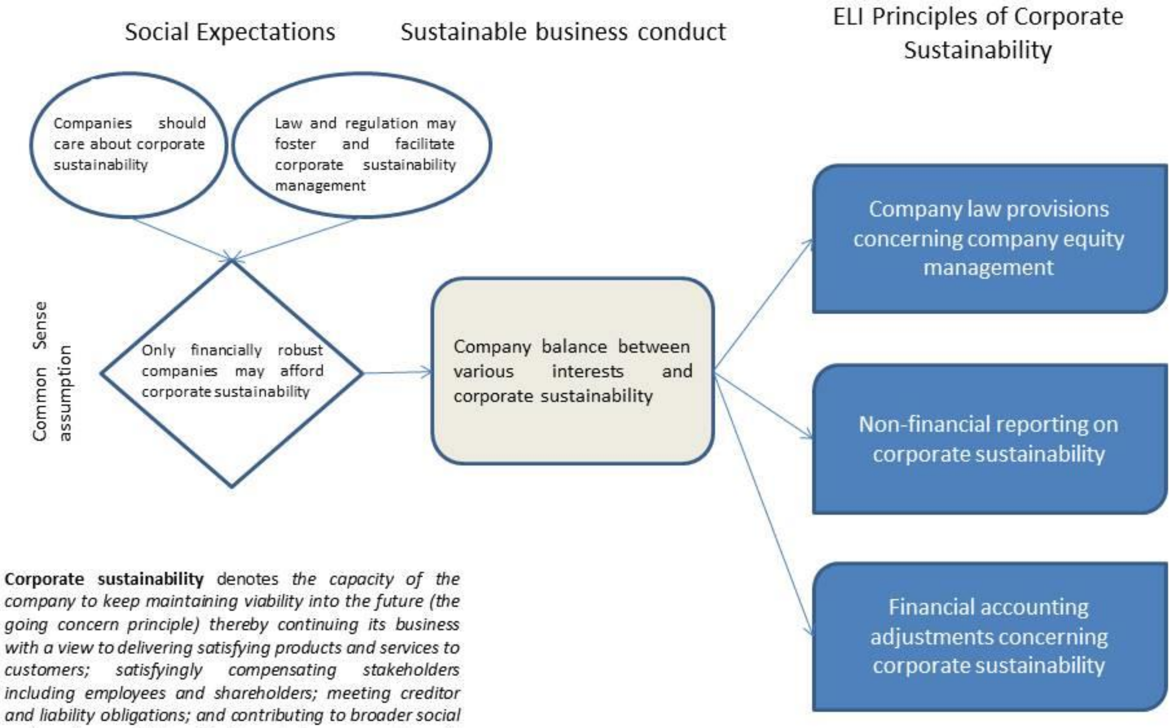
✓ Sustainable corporate governance;

✓ Company law provisions governing company capital maintenance in view to sustain the company as a going concern;

✓ Non-financial reporting, adding financial impact of, and risks for corporate sustainability.

ELI Principles of Corporate Sustainability – Sustainable Business Conduct

Our approach embeds sustainable business conduct between social expectations and regulatory frameworks and instruments



Corporate sustainability denotes *the capacity of the company to keep maintaining viability into the future (the going concern principle) thereby continuing its business with a view to delivering satisfying products and services to customers; satisfyingly compensating stakeholders including employees and shareholders; meeting creditor and liability obligations; and contributing to broader social and environmental benefits through the company's social and environmental responsibilities.*

Common sense assumption: only financially robust companies may afford corporate sustainability

ELI Principles of Corporate Sustainability – Content Highlights

Altogether, our Principles recommend the company to **enact prudent use of resources**, setting aside sufficient reserves to meet social and environmental commitments.

Our Principles aim at **better controlling distributions and provisioning** in view to foster corporate sustainability for company continuity and resilience, as well as financial stability and sustainable development. Received instruments and alternative solutions (solvency tests, etc.) proved ineffective.

Our Principles encourage **sustainable business conduct** over **longer-term horizons** and planning.

Specific attention to:

- ✓ **New kinds of distributions**: not only dividends, but also share buybacks and acquisition goodwill
- ✓ Limiting distributions of **non-realised gains** from fair value accounting

For instance:

- ✓ When a company commits to a long-term investment plan to achieve sustainability, our principles recommend setting aside a provision to cover for its costs;
- ✓ When a company recognises non-realised gains in financial reporting, our principles recommend putting them in a non-distributable reserve, to avoid distributions of paper profits.

Concluding Remarks

Our Principles aim to restate and modernize well-established principles of European company law: on (i) distributions, (ii) equity capital maintenance and (iii) non-distributable reserves.

Our Principles aim to contribute to the ongoing EU debate on corporate sustainability (ESG considerations) by providing a set of company law principles which suggest possible solutions in view to foster and facilitate sustainable business conduct.

Our Principles are especially concerned with three main areas of EU law and regulation that rank high in the EU law-making agenda:

- ✓ Sustainable corporate governance
- ✓ Company Law provisions governing company capital management (going concern principle)
- ✓ Non-financial reporting, adding financial impact of, and risks for corporate sustainability

Project Timeline for 2022

- ✓ September: Submission to the ELI Council (in line with expected deadline)
- ✓ Panel at the ELI 2022 Annual Meeting in Madrid
- ✓ Panel at the Zagreb U virtual Conference