EC Corporate Governance Initiative Series: Comment by the European Company Law Experts Group on the European Commission's Consultation Document 'Proposal for an Initiative on Sustainable Corporate Governance'

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At the very end of July 2020 the Directorate General, Justice and Consumers, of the European Commission published a study it had commissioned from the accounting firm, EY, entitled '*Study on directors' duties and sustainable corporate governance*'. It invited immediate responses to the study, with a deadline of October 8 and with a space limit of 4000 characters (not words). The study set out a range of possible policy recommendations, divided between non-legislative, soft-law and hard-law options. Some of the hard-law options involved very radical legislative interventions into the sphere of corporate governance, radical not only in terms of existing EU law but in some cases radical in terms of existing law at Member State level.

Some of the responses were very critical of the EY Report. We ourselves characterised it as follows (OBLB post here):

> 'The study appears biased towards producing preconceived results rather than containing a dispassionate, impartial and comprehensive analysis. It proceeds by unsupported assertions—managers and investors are short-termist and corporate

> law is responsible for it—rather than rigorous demonstrations. In lieu of hard data, the study rests heavily on reviews of existing literature, but overlooks non-supporting contributions.'

We were not alone in perceiving very serious faults in the study. Others criticised its interpretation of the data, the fact that it ignored the highest quality studies in the field apparently because they did not support its conclusions, its conceptual shortcomings and its overall approach to the role of law in the field of corporate governance. See, for example, the responses of Edmans, '*Feedback to the European Commission*' (OBLB post here); Fried and Wang, '*Short-Termism, Shareholder Payouts, and Investment in the EU*'; Roe, Spamann et al, '*The European Commission's Sustainable Corporate Governance Report: A Critique*' (OBLB post here); Coffee, '*The European Commission Considers 'Short-Termism' (and 'What Do You Mean by That?')*' (OBLB post here); the Nordic Company Law Scholars, '*Response to the Study on Directors' Duties and Sustainable Corporate Governance by Nordic Company Law Scholars*' (OBLB post here). These scholars wrote up their criticisms at greater length than the Commission's invitation for comments permitted, so that they were available to the Commission in full.

Given the fundamental nature of these criticisms of the reasoning and methodology used in the EY Report, one might have thought the Commission would take pause for thought. Pause, however, it did not. The window for immediate comments closed on October 8 and on October 26 the Commission opened its ongoing public consultation on the EY Report's proposals and associated initiatives. Given the shortness of the period between these two dates, it is apparent that the Commission cannot have given serious attention to the criticisms advance of the EY Report. So, no thought as well as no pause. Rather, the Commission's consultation seems to endorse throughout the hotly contested conclusions of the EY Report.

This might not matter if the consultation were framed in such a way as to allow full expression of the divergent views held by those active or interested in this area. However, in our view this is not so. In fact, the consultation does not meet the standards one has the right to expect from one initiated by a public body. This affects the credibility of European commitments to 'better regulation', and in particular sends a negative signal about the usefulness of participating in public consultations. We think the answers to the consultation will not expose the full range of views held by stakeholders about the implementation of some of the more far-reaching proposals in the complex area of corporate governance. On the contrary, it is likely to lead to an incomplete set of results biased towards the legislative ideas to which the DG Justice and Consumers is already committed.

We think these consequences are likely to flow from the format of the questionnaire chosen by the DG and from its *execution* of the chosen format.

At the core of the *format* is a 'yes/no' choice. Certainly, there is the choice to be more or less strongly in favour or against, and a minority of questions are formulated on a multiple-choice basis. There is also space given to provide some narrative explanation of one's answers, but we know from prior experience that the Commission's presentation of the results of the questionnaire will focus on how the boxes have been ticked rather than the narrative explanations. This is understandable, given that the data provided by the box-ticking is much more tractable for analysis than that provided by narrative responses. But focussing on the easily presented data also risks hiding important responses from view. It is also somewhat ironic that the DG has adopted this format for its questionnaire, in the light of the criticisms usually advanced about 'box ticking' in the area of corporate governance.

Execution. Since the DG has adopted a format which highly constrains the way in which respondents answer the questions asked, it behoves the DG to formulate those questions in a way which permits all reasonable views in the area of corporate governance to be expressed in the answers taken as a whole. At a number of points, the questionnaire singularly fails to meet this basic standard and instead seems likely to suppress some common and widely held positions—or at least to cause these potential responses to be underweighted.

In fact, the drafters of the questionnaire have ignored an elementary principle of questionnaire design which is that it should aim to ensure that the answers to the questions asked reveal the full extent of social reality (in this case the full extent of the views held) rather than support the designers' preconceived notions of what that social reality is. The example that used to be given about how not to formulate a 'yes/no' question was this—assumed to be included in an anonymous questionnaire where all respondents will answer truthfully:

> Have you stopped beating your dog?

If the respondent answers 'yes', this implies that at some stage in the past the owner beat the dog. If the respondent answers 'no', this implies that the owner currently beats the dog. Dog beaters will have no difficulty in answering this question. However, non-beaters (ie those who do not beat their dogs in the present and have not done so in the past) will find that this form of the question is impossible for them to answer truthfully. Even worse, if the purpose of the question is to reveal the extent of dog-beating among the total population of dog owners, it will fail to do so. Non-beaters will either not answer the question at all or give an inaccurate answer. In other words, the answers to the question will hide an important truth about social behaviour.

Dog-beating may seem a long way from corporate governance and directors' duties, but the principle underlying the dog example applies equally where the reality which is being interrogated concerns views held rather than actions taken. It is a principle which

the designers of the DG questionnaire have not faithfully observed. Take the central Question 8:

> 'Do you believe that corporate directors should balance the interests of all stakeholders, instead of focusing on the *short-term* financial interests of shareholders, and that this should be clarified in legislation as part of directors' duty of care?' [emphasis added]

Suppose I share the widely held (but obviously not unanimous) view that social welfare is normally best advanced by focussing on the *long-term* interests of the shareholders. Thus, I am not in favour of either a stakeholder approach or a focus on the short-term interests of the shareholders. I cannot express my view through either a 'yes' or a 'no' answer to this question and so my view remains hidden. And if the incidence of the long-term shareholder view among respondents is anything like the incidence of non-beating behaviour among dog-owners, the question will have obscured an important set of views about corporate governance which are actually held. In other words, the drafters of the questionnaire have equated shareholder focus with short-termism, thus excluding any dissent on this point, even though the accuracy of the equation is hotly contested in theory and in practice and despite the obvious salience of the resolution of this issue to any legislative proposals which might be put forward.

One might also point out that Question 8 commits another simple error: it rolls two separate questions into one. Suppose I take a stakeholder view, but think that the 'clarification' of this point in directors' duty of care is the wrong way to implement it. For example, I might think that the clarification should be in the directors' duty of loyalty rather than in the duty of care or I might think that directors' duties are wholly ineffective in promoting stakeholder interests. If I answer 'no' to the question, I appear to be supporting a focus on short-term shareholder interests; if I answer 'yes', I appear to be in favour of re-formulating the duty of care. Again, neither answer corresponds to my actual view.

More subtle infringements of the 'dog' principle can be seen elsewhere in the questionnaire. For example, Question 1 refers to 'human rights violations, environmental pollution and climate change' and then asks:

> 'Do you think companies and their directors should take account of these interests in corporate decisions alongside financial interests of shareholders, beyond what is currently required by EU law?'

This is one of the multiple-choice questions. Suppose I think that these matters should be taken into account by directors and that a legal obligation to do so is appropriate. However, I also believe that law at the Member State level already achieves this result or could be developed so as to do so, so that I believe the role for EU law is either non-

existent or minimal. None of the four choices I am offered reflect this view because they all concern the substantive question (should directors be obliged to take these matters into account?) and none contain any element about the appropriate level of law-making (EU or Member State). Even 'do not know' hardly captures my true views. Since one imagines that rather few respondents will take the stance that directors should ignore these matters when making corporate decisions, the DG will be able to claim that there is strong support for a wide-ranging EU rule in this area. That indeed may be the right result, but the purpose of a consultation is, properly, to elicit respondents' views on fairly presented alternative courses of action, not to trap them into expressing views they may not have.

It is also pertinent to observe that Question 1, as with the remainder of the questionnaire, seems to have lost sight of the distinction drawn in the EY Report between hard law and soft law solutions. Nowhere in the document is the choice between these two ways forward laid open for comment. With the exception of Question 2 (where one possible response refers to 'existing guidelines and standards') the remaining questions are formulated on the basis of a hard law requirement ('should directors be required?'; should x or y be part of the duties of directors?; and the whole of Section III of the questionnaire where the due diligence duty is defined as a legal requirement).

Overall, we regard the Questionnaire as a disappointing document. It is disappointing not simply because it does not remotely meet the accepted standards for social survey design. It is disappointing because the underlying problem which the EY Report and the DG are seeking to address is of the utmost importance in modern society. This one may characterise as the problem of 'corporate externalities', meaning costs which corporate business imposes on third parties who cannot in practice bring those costs back to the company. It is not a new problem, of course. Environment regulation, for example, designed to bring the costs of pollution back to the polluting company is now well-established. But climate change takes the problem to new heights (or, better, depths). The question of what role corporate law and corporate governance can play in supporting regulation in the ESG area is now at the top of academic interest in corporate law—as it should be. This is a much bigger question that just the law of directors' duties.

In this connection one may wonder why neither the EY Report nor the consultation make any reference to the potential role of shareholders in steering the company in the preferred direction. As recently as 2017, with the amendments to the Shareholder Rights Directive, the Commission appeared to believe that shareholders have a role to play in this area. The EY Report and the Questionnaire present shareholders wholly as part of the problem, not part of the solution, despite the extraordinary rise in ESG investing by institutional investors since that date. What has changed since 2017 to warrant such a radically different outlook?

We fear that the EY Report and the Questionnaire represent a commitment on the part of the DG to a narrow, unproductive and possibly even counter-productive set of approaches to this problem. This issue will have to be hammered out in future debates. What we do say at this stage is that the answers to the DG's questionnaire are unlikely to reveal the full range of views in this area and, by the same token, the full range of possible solutions. The Questionnaire, like the EY Report itself, is a missed opportunity and one that has the potential to set EU law off down the wrong track.

The European Company Law Experts Group (ECLE) is comprised of Paul Davies (Oxford), Susan Emmenegger (Bern University), Guido Ferrarini (Genoa), Klaus Hopt (Max Planck, Hamburg), Adam Opalski (Warsaw), Alain Pietrancosta (Paris), Andrés Recalde (Autonomous University of Madrid), Markus Roth (Marburg), Michael Schouten (Amsterdam), Rolf Skog (Gothenburg), Martin Winner (Vienna University of Economics and Business), Eddy Wymeersch (Gent).

This post is part of the OBLB series: 'European Commission Initiative on Directors' Duties and Sustainable Corporate Governance'.

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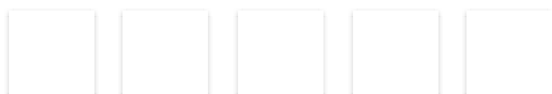

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