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EC Corporate Governance Initiative Series: 'A Critique of the Study on Directors' Duties and Sustainable Corporate Governance Prepared by Ernst & Young for the European Commission'

14 Oct 2020

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OBLB Keywords Corporate governance, Directors' duties, Short-termism, Sustainability

In July 2020 the Directorate General for Justice and Consumers ('DG') published a report it had commissioned from the accounting firm, EY, on directors' duties and sustainable corporate governance (available [here](#)). This DG is, somewhat oddly, the one responsible for company law at EU level, having taken over some years ago from the arguably more appropriate internal market DG. The Abstract of the study states: 'The focus of corporate decision-makers on short-term shareholder value maximisation rather than on the long-term interests of the company reduces the long-term economic, environmental and social sustainability of European businesses. . . The study suggests that a possible future EU action in the area of company law and corporate governance should pursue the general objective of fostering more sustainable corporate governance and contributing to more accountability for companies' sustainable value creation.' A Table on page viii sets out some options for action by the Commission, including, under category 'C', some far reaching changes to corporate law.

The Commission has invited initial reactions to the study, but limited to 4000 characters, by October 8 (see [here](#)). The European Company Law Experts Group has posted the following comment.

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 demonstration. In lieu of hard data, the study rests heavily on reviews of existing literature, but overlooks non-supporting contributions.

More precisely, the study suffers from severe **methodological shortcomings**.

First, the study does not define key concepts such as 'short-termism' and 'short term financial return'. Also, it does not document nor examine in depth the relationship between short-termism and sustainability issues.

Second, its empirical component is based on a review of listed companies in 16 European countries including the UK. A significant portion of these undisclosed companies must be UK companies. This alone is unacceptable in a study which is intended to form the basis of legal reforms exclusively in countries other than UK.

Third, the web survey sample is small. The survey produced a mere 62 usable responses, the sources of which are self-recruited, and the 10 case studies seem to have produced rather scattered responses.

Fourth, the lack of disclosure about the structure and outcomes of the empirical research efforts is not in accordance with best practice:

- No profile of the companies making up the database in terms of nationality, size, business sector etc.
- No summary account of the responses to each of the questions in the questionnaire nor of the profile of the 62 respondents.
- No details about the design of the 10 case studies and no summary account of the outcome of each study.
- No nationality profile of the 48 interviews carried out for the assessment of the impacts of the options and no summary account of the outcome of these interviews broken down according to various respondent categories.

In addition, the study contains **analytical deficiencies**.

With 'short-termism', the study focuses on the evolution of the ratio between company pay-outs (dividends and buybacks) and net income. The chosen denominator does not include capital inflows through equity issuances and investments in the business. The assumption seems to be that distributed funds 'disappear'. This is not the case in a market totally dominated by long-term institutional owners. Funds paid out are

essentially re-deployed in new investments in the business community.

Alternative explanations for the findings remain unexplored. The observed modest increase in the pay-out ratio after the financial crisis could be due to the exceptionally favourable conditions in the credit markets, so that the increase in dividends and buy backs represents a replacement of equity by debt, not a sign of short-termism.

In sum, the study is a partial account of the role played by the capital markets in a dynamic economy.

The study concludes that it is the characteristics of company law which give rise to excessive pay-outs, especially the imprecise definition of the directors' core duty of loyalty. This argument ignores the point that such imprecision promotes managerial consideration of stakeholder interests. In any event, there is no legal system we know of which says managers must promote short-term profitability. Moreover, the risks associated with a politicised stakeholder-oriented definition of the corporate purpose are very superficially analysed.

Today, stock markets and the supply of risk capital is global. Europe's share of the global stock market is constantly falling, while the dominance of the US and China is growing. The total stock market value of EU listed companies today equals probably only one tenth of the global market value. In the initiative for a European capital market union, the COM expresses concern for the lack of efficient supply of risk capital in Europe. This is to us clearly irreconcilable with most of the EY study's proposals.

In short, this is not a document on which to base sustainable proposals for legislative action.

The European Company Law Experts Group (ECLÉ) 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 new OBLB Series: 'European Commission Initiative on Directors' Duties and Sustainable Corporate Governance'.

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