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Reforming Corporate Governance for Turbulent Times

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The continuing financial crisis makes it increasingly difficult to seriously deny that something went wrong. But is it also a failure of corporate governance? If so, what are the implications for the European reform agenda? Has the time come to revise the Commission's Company Law Action Plan of 2003? Or is it mostly a problem outside the scope of corporate governance? The author investigates these questions and more.
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Financial crises usually trigger off demands for stricter rules, better compliance and improved risk management. But this always comes at a cost. The American example teaches us that 'better' does not always mean 'more' and 'more' does not always equal 'better' – think, for example, of the controversial section 404 of the Sarbanes-Oxley Act requiring management and the external auditor to report on the adequacy of the company's internal control on financial reporting.

Enhancing transparency through extended requirements of financial, governance and environmental reporting comes at a cost. Imposing burdens with the view to improve internal control and risk management has much of the buying stability with the money of shareholders. But who are the shareholders? Dispersed shareholders may easily diversify their portfolios and by doing so, they can mitigate risk on their own. Controlling block-holders are incentivized enough to monitor the company and tend to avoid high risk exposure. Institutional shareholders frequently find themselves in an even more comfortable position, as they may theoretically enjoy the potential of doing both: diversification and monitoring. That is what the theory assumes. According to another piece of the same theory, things are looking different with regard to labour. Unlike shareholders, corporate executives' involvement is poorly diversifiable. This is a general characteristic of human capital as opposed to financial capital.

The above brief theoretical overview should leave us with a comforting conclusion: let us rely on the market efficiency. In theory, shareholders buy risk for prospects of future return while executive officers trade their possibly adventurous mindset against job stability and their managerial reputation. But the experience of the recent crisis shows us a different picture. This picture does not quite fit with the efficient market hypothesis. Even Richard Posner, a prominent representative of the neoclassical thought from the Chicago school of economics, quite a hardliner as regards belief in the forces of free markets, referred to the '2008 subprime crisis as *a failure of capitalism*'.[1] Today, we are witnessing the 'Occupy Wall Street' movement and we also fear more and more, with every passing day, whether sovereign states – not only Greece, but also for example, Italy, Spain, Portugal or Ireland – will be able to repay their debts.

After the recent experience of the subprime crisis, the financial crisis, the sovereign debt crisis and the News Corp. scandal, it has become increasingly difficult to seriously deny that something went wrong. But is it also a failure of corporate governance? What are the implications for the European reform agenda? Has the time come to revise the Commission's Company Law Action Plan (CLAP)[2] of 2003? Or perhaps it is mostly a problem outside the scope of corporate governance?

We witness a political debate on the sovereign debt crisis. Various ideas are being put forward to remedy the problem at the structural level, among them the call for the introduction of the European Union's (EU) finance minister coming up with the keyword *le gouvernement économique européen* not as a mere slogan but as an institutional reform proposal. Some high-profile politicians and economists[3] are in favour of the eurobonds, a new instrument designed for issuing public debt that would be collectively guaranteed by all the members of the eurozone. This

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1 R.A. Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (2009).

2 Communication from the Commission to the Council and the European Parliament - *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward* COM/2003/0284 final/.

3 E.g. J.von Weizsäcker & J.Delpla, *Eurobonds: The blue bond concept and its implications*, Bruegel Policy Contributions Issue 2011/02 (March 2011).

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would lead to the establishment of the *Haftungsgemeinschaft* – a community of joint liability, a creature that functionally comes close to sovereign bail-out, quite contrary to the explicit Treaty prohibition.[4]

Based on the experiences from the debt crisis, where banks and funds engaged in excessive buying of sovereign debt, a question could be raised whether any EU legislative action should be taken to impose limitations on financial institutions' investments in governmental bonds or whether any other actions are necessary to remedy the moral hazard problem that could possibly be attributed to the investment policies of (at least some of) the European financial institutions? Or perhaps it is less the problem of institutional investors but more the problem of the – so far – widely unregulated hedge funds and private equity industry? The controversies over and around the AIFMD[5] prove, quite illustratively, how difficult it is to reach a consensus, not only among stakeholders, but also among Member States and – notably – European institutions.[6] Notwithstanding the inherent controversies, the Commission acknowledges the need to further extend the regulatory realm over the – so far – less regulated markets (including derivatives markets) with the view to enhance their oversight and transparency. With this in mind, the European Commission announced their intent to revise the Markets in Financial Instruments Directive (MiFID).[7] According to the Commissions release of 20th October, *[t]hese proposals consist of a Directive and a Regulation and aim to make financial markets more efficient, resilient and transparent, and to strengthen the protection of investors.*

But all these, more or less, adequate institutional efforts do not exempt us from asking if there is any dimension of the debt crisis revealing an affinity to the domain of corporate governance and capital market regulations? Mainstream lawyers and economists grew up with appreciation of the shareholder value concept. But is this a valid concept today? Or perhaps the idea of shareholder value has turned passé? What are the usual alternatives? We see the 'enlightened' approach to the shareholder value or the (i) 'stakeholderism' becoming increasingly widespread, we witness a wave of the so-called (ii) 'economic patriotism' across Europe – fought back by the golden shares doctrine of the European Court of Justice, but the tendency is far from vanishing, we attach more and more importance to the (iii) 'corporate social responsibility', and we have recently turned to using the phrase (iv) 'sustainable companies' as seen in a broader societal and environmental context. A major European research project on sustainable companies led by the University of Oslo must be mentioned on this occasion.[8] A pivotal issue, at this point, is the changing notion of company's interest. The same notion has, for a long time, been at the very heart of a parallel discussion on corporate groups. There does not seem to be any settlement in view with regard to the question of how to adequately approach the governance problem of corporate groups. Poland is not the only country where this issue is currently high on the agenda. We all know there were times when the European Commission appeared committed to take legislative action at the Community level. But we are also aware of the unfortunate fate of the draft 9th Company Law Directive. However, with the abandoned Directive the issue did not turn irrelevant – we see it returning in the recent Report of the Reflection Group,[9] where there was a separate subgroup chaired by Pierre-Henri Conac to deal with management/oversight structures and groups of companies.[10] The question remains as to whether there is a need for a new European legislation on corporate groups? Since national laws on groups keep displaying manifest differences, this could possibly bring some progress at least in a cross-border setting. It is enough to be reminded of the multinationals operating across Europe via local subsidiaries – today they find themselves impeded in pursuing a uniform group policy or undertaking certain actions aimed at serving the group's interest, for example, cash-pooling. Or maybe the EU should avoid extensive 'thematic' regulation and instead focus on the usual suspects associated with group-related problems, such as related party transactions, self-dealing, unequal access to information or the liability of the shadow/de facto directors? European corporate directors keep expressing their interest in having more predictability and need for safe harbours. We still do not have enough clarity in that regard. The new consultation on the future of European Company Law launched on 20th February[11] again touches upon this issue, asking whether there is a case for an EU intervention in the field of law on corporate groups.[12]

Having said this, the question remains as to where we should see the most promising forces of corporate governance

4 W. Kösters, *Common Euro Bonds – No Appropriate Instrument*, Intereconomics 135 (2009).
5 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.
6 See E.Ferran, *The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis*, ECGI WP N°.176/2011 (Feb. 2011); for the earlier development and the emergence of the proposal see E. Wymeersch, *The regulation of private equity, hedge funds and state funds*, Financial Law Institute WP 2010-06 (2010).
7 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.
8 Project led by Prof. Beate Sjåfjell http://www.jus.uio.no/ifp/english/research/projects/sustainable-companies/.
9 Report of the Reflection Group on the Future of the EU Company Law (5 April 2011).
10 See Ch. 4 (59-75) of the Report mentioned *supra*.
11 http://ec.europa.eu/yourvoice/ipm/forms/dispatch?form=companylaw2012&lang=en.
12 See Question No. X.

enhancement. Was the CLAP not designed well enough to provide regulatory tools capable of facing challenges that came just a few years later, or was it rather a problem of implementation deficits? If we compare the list of the priorities as identified in the CLAP with what has actually been accomplished, we see a mixed picture – surely not all of the ambitious plan became a reality.[13] But the corporate governance reform is not a linear process. It is largely about learning from failure and many of the reform initiatives have had a reactive nature. But there is always a risk of regulatory overreaction and an inherent temptation – mostly on the part of politicians – to make opportunistic use of a crisis situation to achieve crisis-unrelated or loosely related objectives.[14] The past decade has already been the decade of increased transparency and disclosure requirements imposed on companies. Some scholars have expressed their doubts regarding whether the current disclosure-friendly mood of the European legislator does any good for the actual enhancement of market transparency.[15] Proposals to further expand reporting must be confronted with the possibly decreasing marginal utility of additional disclosure. Whatsoever new requirements are being proposed, the arguments in favour of new legislation must be balanced against increased reporting costs burdening companies. We should avoid the situation where we end up with information overkill effectively preventing investors from digesting all the data made available by issuers. Instead, more emphasis is necessary to introduce more uniformity in the manner, how the information is being served to its consumers, that is, the investors.[16]

For all the reasons discussed above, any future reforms need to be made cautiously. Therefore, I particularly welcomed not only the establishment of another expert group mandated by the European Commission, but also liked the group's name: the 'Reflection Group'. We all need reflection and the production of legislation should be just an iceberg of continuous conceptual work towards a better corporate governance framework. The involvement of stakeholders, especially via public consultations, is essential for the success of these endeavours.

It is said that corporate governance scandals are like earthquakes: you can never predict when they will occur, but you can predict pretty accurately where they will happen. A bookish example thereof was the highly publicized News Corp. scandal. The Corporate Library, a rating agency for corporate governance, rated News Corp. with an 'F', and this *only because there is no lower grade* – as a Corporate Library's representatives meaningfully framed it. The recent crisis proves that the same holds true for other types of crisis as well – think of the Greek debt crisis. If any regular economist was able to foresee the consequences of the rising Greek debt, could the lending banks and politicians not foresee it as well? And if they did, was it not a moral hazard on their part?

In Poland, we say *madry Polak po szkodzie* which means *hindsight is always better than foresight* or *it is easy to be wise after the event.*[17] Nowadays we see, it is not just a Polish phenomenon, but covers the rest of Europe as well. Our job – the job of academics, but equally the duty of the regulators and analysts – is to try to shift the cognitive experience from after to before – before the spectre of any future crisis becomes a reality. This may well be a never-ending duty.

13 K. J. Hopt, *The European Company Law Action Plan Revisited: An Introduction,* in K. J. Hopt & K. Geens (eds.), *The European Company Law Action Plan Revisited, Reassessment of the 2003 priorities of the European Commission* (Leuven U. Press 2010).

14 E.Ferran, *supra* n. 6.

15 K.E. Sørensen, *Disclosure in EU Corporate Governance – A Remedy in Need of Adjustment?* European Bus. Org. L. Rev. 10 255-283 (2009).

16 Cf. *supra*.

17 Literary: '*The Pole is wise only after the loss*'.