AN EU BOOST TO SUSTAINABLE CORPORATE GOVERNANCE

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Summary

There are numerous initiatives to steer corporate decision-making towards the EU's sustainability objectives. The frontrunner seems to be the ESG movement – the setting of environmental, social and governance standards. Unfortunately, more and more inherent flaws of this approach are coming to light.

A far more promising route is the strengthening of corporate governance, and the EU Directive on Corporate Sustainable Due Diligence is an important step in the right direction. It is argued that its introduction will inevitably lead to more hands-on board involvement in corporate strategy in general, as sustainability cannot be separated from innovation, investment and commercial policies.

In turn, this will trigger a reset in the ways the two-tier governance system, in which a supervisory board both advises and oversees a management team, operates in practice. This paper presents an overview of desirable improvements.

It also puts forward that the Commission should accelerate this process by stimulating the use of the continental corporate law systems of the EU Member States. These systems put the company, and not the share- or stakeholders, centre stage and entail individual and joint responsibility of members of the board for the company.

Given the very sizable funds the Commission makes available to companies to facilitate their transition, both financial and governance due diligence are called for.

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This paper was written under the auspices of the programme. It follows Kalff's 2021 paper, *Enterprise models and the EU agenda* (CEPS, Brussels), identifying hurdles that both the share- and stakeholder models throw up in mobilising large companies in pursuit of the EU's twin transition objectives.

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Introduction

There is no doubt that large enterprises have a crucial role to play in the redesign of the European economy, as set out by the European Commission's Green Deal and the ambitious plans to enhance Europe's digital economy, in what is now termed the 'twin transition'. They must be encouraged to mobilise their vast financial and technical resources and to bring the expertise and creativity of their managers and employees to bear.

There have been numerous proposals to steer corporate decision-making in the desired new direction. The stimulation of corporate social responsibility (CSR) has a long history, but the introduction of CSR departments has not helped. The environmental, social and governance (ESG) community has produced 600 different frameworks, with consultants and accountants expanding their practices. That has confused investors, rather than motivate them. The OECD, the UN, the International Labour Organization, the International Accounting Standards Board and other international organisations have developed a range of standards. Academia has jumped on the bandwagon by introducing the 'purposeful enterprise'.

Momentum seems to have gathered for setting ESG standards, an unfortunate development for the following reasons:

- Many ESG initiatives have a stakeholder orientation, although it has been shown that both the shareholder and the stakeholder enterprise models are unsuited to pursuing the twin transition (Kalff, 2021).
- ESG standards cannot do justice to individual companies even within sectors. The ensuing target setting is bound to be suboptimal, as ambitious targets discourage laggards and are not ambitious enough for frontrunners. The ill-conceived emphasis on ranking is an invitation to all parties to aim for a just slightly better performance than average, leaving much potential unrealised.
- The setting of ESG standards is subject to many biases, due inter alia to differences in the availability and quality of data, company size and geography (Sipiczki, 2022).
- EU and international standardisation, if at all possible, will take years. Both the EU and foreign corporations can ill afford such a delay with 2030 just around the corner.
- The hidden costs are considerable. Choosing targets as well as introducing reporting and evaluation procedures are major efforts, and integration with existing financial and operational reporting is extraordinarily complicated. Not much will happen anyway unless the corporate remuneration system is brought in line with new priorities – managers are difficult to wean off of what they feel to be entitlements. Yet, these costs are dwarfed by choosing targets that do not help to steer in the desired direction and hence lead to the misallocation of capital.

Recently, the Commission has expressed concerns about the functioning of the ESG ratings market and ESG factors in credit ratings. A white paper has been published and a consultation round has been initiated among the many stakeholders. A licence system for rating agencies is under consideration but it is difficult to see how this could solve the structural problems listed above.

A far more promising route is the improvement of sustainable corporate governance. There is a strong case to be made for decentralisation in the pursuit of the twin transition. Only at corporate level can the portfolio of business models (or product market combinations) be evaluated against new regulations and the greening of customer demand. This will lead to a culling of some and a reorientation of others. It will also stimulate the development of fundamentally new models at the lowest possible cost and with optimal use of available resources, know-how and expertise. Business models drive investment. A rich source of value can be untapped as investment in new plants, equipment and information technology increases productivity and adds economic value, with every new generation of assets having a much smaller environmental footprint.

Figuratively speaking, only by gaining access to boardrooms can the course of company be changed.

A *Study on directors' duties and sustainable corporate governance* prepared for the European Commission in July 2020 calls for company boards 'to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy. This would require the identification of measurable, specific, time-bound, and science-based sustainability targets. It would also require disclosure of appropriate information'.

Recently, the Commission has made a significant step in increasing board responsibilities and accountability in the pursuit of EU priorities by proposing a directive on corporate sustainability due diligence. Enriques and Gatti (2022) assess the impact of the directive, noting that 'large companies operating in the EU market must identify, prevent and mitigate any actual or potential adverse human rights and environmental impact in their own operations, in their subsidiaries, and at the level of established direct or indirect business relationships in their value chain'.

Over time, this will inevitably lead the board to take *de jure* and *de facto* responsibility for corporate strategy at the expense of the mandate of the executive. There are four forces driving in this direction:

- Policies to reduce the corporate footprint cannot be separated from the obligation to ensure the continuity of the company by maintaining a sound balance sheet and by creating economic value to cover, at least, all costs including the cost of capital.
- Any judgement on the innovation and investment required to make the company more sustainable takes place in the context of a business model, and therefore brings all commercial aspects to the table.

- The board will be more and more engaged in the early stages of developing new business models to ensure the integration of economic and sustainability considerations from the outset. Improving sustainability down the line is costly and puts a lid on what could be technically achieved.
- Finally, the days of separating strategy and implementation are over, and board involvement remains crucial to the adaptation of plans when commercial, technical and regulatory circumstances change.

Such an expansion of responsibilities of the board would bring corporate strategy and entrepreneurship back to the top of the organisation.

As it turns out, the two-tier governance model that prevails in the EU is ill-suited to an enhanced role of the board. The basic legal tenet is that the executive takes the lead in developing the corporate strategy while the role of the board is limited to supervision of the executive and to approval of executive proposals. Moreover, several practical barriers can be observed for true board control over all the steps that need to be taken to make a company structurally more sustainable.

Barriers to sustainable corporate governance

Ambiguity

In large EU Member States, board members play two fundamentally different and incompatible roles. They are both supervisors and advisers. This makes them vulnerable to manipulation by the executive as controversial decisions will be offered first for advice and later, somewhat adapted, for approval.

To protect the company as a going concern and to monitor progress towards the Green Deal, it is of utmost importance that the external auditor, the internal auditor and the compliance officers report to the board and not to the executive. While some companies have made progress, many others have a long way to go.

Lack of time and resources

An expanded mandate of the board calls for full commitment. Board members are often engaged for a mere 2-3 days per month, generally spent around the 8-10 board meetings per annum. This is already insufficient to fulfil all the board's present legal obligations. Most board members hold several positions and many board members are CEOs of other companies and already fully committed. Boards lack their own staff and a budget sufficient to call in external advice to support their decision-making.

Adding corporate strategy to their mandate entails a quantum leap. Members of the board must stay abreast of ever-changing markets and of the competitive and technological pressures to which the company is exposed. They must have deep insight into all present regulation and monitor the emergence of new rules relevant to the company. As acknowledged in some corporate governance codes, the profile of board members would also need to change, as they would now need a technical and commercial background, including ICT experience, to provide sound leadership.

Lack of independence

Board members need to be totally independent to secure the continuity of the company and its present and future contributions to the twin transition. Board members who hold shares in the company or are affiliated with a special interest group are thus vulnerable.

Shareholders carry, by law, no responsibility for the company. Special interest groups concentrate, by definition, on certain aspects of the company but accept no accountability for the hidden cost or unintended consequences that result from meeting their demands.

The sharply lower number of board seats per member will help cut interlocking board membership and thus reduce informal give-and-take arrangements across corporate boundaries. Independence also means that remuneration is fixed and not dependent on a limited number of targets that are unlikely to encapsulate the entire mission of the company. Such fixed remuneration, however, is hardly seen.

The CEO

Starting in the 1990s, the European corporate landscape has evolved considerably. Most listed companies have embraced shareholder value as their prime target and have introduced a CEO. As a result, the balance of power between shareholders, the executive and the board has shifted significantly towards the executive and within the executive to the personal leadership provided by a CEO. The doctrine is that only individual leaders can inspire, can guarantee policy consistency and can be held accountable.

CEOs are the custodians of the status quo. On a day-to-day basis, CEOs are held accountable for the short-term financial and operational performance of the company. They are held responsible for all existing policies and their revision, from those on investment to public relations, human resources and intellectual property. They are besieged by the crises of the day and continually under pressure from share- and stakeholders, while coping with an array of corporate divisions and staff departments – all parties with short-term interests. CEOs cause bottlenecks in decision-making as too many dossiers land on their desk, adding to the pressure. All in all, it is a physically and intellectually impossible combination.

Moreover, individual leadership exposes the company to the prejudices and biases of a single person. Individual leadership is an enemy of the continuity and the long-term commitments that the Commission's twin transition require. Non-performing CEOs are difficult to unseat and the search for a successor takes time. The first step of a new CEO is to replace top management with loyalists and, often, a re-organisation is announced. Taken together these steps could cause years of paralysis in decision-making.

The decision-making process

In a two-tier system, board meetings are carefully orchestrated events based on very close cooperation and preparation by the chair of the board and the CEO. They set the agenda and agree on the desired outcome for each item They share views about possibly dissenting board members and how to overcome resistance. They select the supporting documentation to be made available to the board ahead of the meeting. The CEO has the clear upper hand given that the CEO, not the chair, has full knowledge of (and control over) all relevant information.

Such preparations have the intended or unintended effect that other board members, as well as top managers, are deprived of essential information. In addition, board members generally recognise that the agenda is often overloaded. There are indeed many formalities to be fulfilled and not enough time is available for in-depth discussions of important and invariably complicated issues. During the meetings, they may observe that deviating opinions are appreciated but not too many and not all from the same member.

Focus on profitability

The need to increase profitability is the guiding principle of listed companies. It is wrongly assumed that a constant (or even better, growing) rise in profit per share translates into a higher share price and therefore, in combination with dividend payments and share buy-backs, to an increase in total shareholder return on investment.

This is harmful both generally, as much capital and talent are misallocated, and specifically, as it undermines the twin transition. It puts a break on innovation, as bookkeeping conventions dictate that these expenditures are treated as a cost and not as an investment, and hence reduce profit. It puts a break on investment, as start-up costs also reduce profits. A lower investment rate eats into productivity growth but frees up cash for share buy-back programmes at the expense of corporate solvability. The emphasis is on defending lucrative market positions, often pushing the boundaries of the law. Takeovers are popular as they increase pricing power and create opportunities for cost reductions, both directly feeding into higher profits. In general, size facilitates the transfer of risk to customers, suppliers and partners.

The way forward

How could the proposed shift in the positioning of the board be realised and be enshrined to prevent backsliding? Here are four recommendations.

Let the company benefit from its European roots

Based on existing legislation in many Member States, the interests of the company, not those of shareholders or stakeholders, must take central stage. Obviously, the company needs to adapt to the policy, cultural and socioeconomic context in which it is operating today and expects to be operating in the future – which requires alignment with the twin transition. The best place to anchor the corporate economic and sustainability objectives, the way the company is governed and managed as well as the standards it wishes to uphold in conducting its business, is in the articles of association.

This approach comes with several advantages. The articles of association become the constitution of the company, informing policy making at all levels and in all arenas, from recruitment to investment policy and from the selection of commercial partners to sharing intellectual property. It also reduces the risk for financiers and banks with a genuine interest in sustainable development. And finally, it is in the common interest that large governmental subsidies to assist companies to make the transition land safely.

Enforcement of compliance has, unlike any other scheme or instrument to steer corporate behaviour, real teeth. Any party can take the board to court for acting in violation of the articles of association. Where co-determination remains anaemic in most companies, work councils can take on a new role as guardians of the 'corporate constitution'.

Introduce a one-tier board

Several EU jurisdictions allow for a choice between a one- or two-tier board for large public companies, and some also for private limited liability companies.

The structurally closer relationship of non-executives to corporate decision-making in comparison with members of a supervisory board makes it a small step to put the non-executives in charge of the corporate strategy in a hands-on manner and on a day-to-day basis. The (re-)positioning of the company, its financing, innovation, (dis-)investments, mergers, acquisitions and partnerships – all aiming to take the economic value of the company and its contribution to society to a structurally higher level – belong to the purview of the board. The executive is in charge of making the best possible use of all available assets, focusing on productivity and continuity within the mandate of the board.

Remuneration should be generous and commensurate with the board members' increased responsibilities and considerable additional efforts. A high rate of remuneration will also take away the need for other sources of income, which will prevent the (semblance of) conflict of interest. Board members should serve for at least 7 years in the interests of a long-term corporate orientation. They should only serve one term to prevent positioning for a second term. After resigning, board members should not be able to undertake consulting roles or a board position within the same sector for another 7 years.

Introduce an executive board

It is highly fortuitous, and one of Europe's hidden treasures, that several EU countries' corporate legal systems dictate that the chairman of the executive board is the first among equals, with each member individually and collectively responsible for the enterprise. Enforcement of the law will protect the enterprise against the institute of a CEO.

Apart from the disadvantages of a single executive, there are several other reasons to return to collegial decision-making by an executive board. It is important that the very considerable management burden to restructure a company and to implement innovation and investment policies is shared between several well-tested managers. Cooperation between many different partners is essential to pursuing the twin transition. There is a need for more managers who can represent the company at the highest level to third parties. And as the company enters unexplored territory, it is axiomatic that problems and opportunities are approached from different angles.

Introduce economic value added (EVA) accounting

A board and a management team that focus on the creation of economic value have many important advantages. The value of a company is nothing more or less than the sum of all future net cashflows (the difference between all income from all sources and all expenditures for all purposes) after tax, after correction for inflation and after an allowance for the cost of capital. This makes it clear where economic value is created and where it is destroyed. The orientation on long-term cash flows makes a company sensitive to structural external developments that could have a negative or a positive impact on it.

EVA does not penalise innovation and investment. Counterintuitively, a focus on economic value makes it far easier to integrate environmental costs into business models. EVA is the only economic rationale to base investment decisions on, as profitability is a very poor predictor of future success. EVA stands for transparency throughout the company and helps to steer managers and employees alike. Finally, EVA can serve as a common language of managers and government representatives working on the twin transition.

Conclusion

The Commission should recognise that enterprise, not shareholders or stakeholders, is an ally in achieving the twin transition. It should therefore defend EU continental corporate law that puts the company centre stage and calls for shared board responsibility for its continuity and development.

This Policy Insight argues that the one-tier governance model for a European company is superior to the two-tier model, and carves out a new and important role for the articles of association. This model will help the Commission go further down the path of enhanced accountability of corporate directors. The proposed directive on corporate sustainability due diligence could serve as the thin end of the wedge, as the issues raised in this context cannot be seen independently of corporate strategy.

The Commission has substantial leverage to bring this change about and should do everything it can to exploit this opportunity. In the coming years, the Commission will work closely with the corporate sector on large projects in support of the twin transition. A substantial part of the funding will be provided by the EU and Member States. It would be very reasonable to expect from corporate partners that they properly balance economic and environmental considerations and adjust their articles of association accordingly. It also stands to reason to subject potential corporate partners to a corporate governance due-diligence process to identify the risks associated with the share- and stakeholder models and call for remedies. And specifically to establish that the board takes responsibility for the design, implementation and monitoring of projects to change the company in a fundamental way.

By capitalising on its strong negotiating position, the Commission will be setting corporate governance standards for companies within the EU and beyond its borders.