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EUROPEAN COMPANY LAW & CORPORATE GOVERNANCE:

CORPORATE PURPOSE IN THE DIGITAL ERA: TOWARDS REVISITING THE DIRECTORS DUTIES AND LIABILITIES

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The Journal collects the papers in the field of law and economics with an international focus, in particular papers issuing: legal and economic aspects of European Union and other market integrations, market freedoms and restrictions, competition law and intellectual property, company law and corporate governance, international trade and international private and public law.

The instructions for the authors and more detailed information on submitting, classification and reviews of the papers are available at http://www.efzg.unizg.hr/iele.

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EDITORIAL

Dear readers,

We are happy to present to you another, the third special issue of INTEREU-LAWEAST Journal on European Company Law & Corporate Governance. With the current issue, we would dare to say that it has become a well-recognized tradition of the Journal to follow the International Conference on European Company Law and Corporate Governance series and provide our readers with selected, and by Journal peer-reviewed, excellent papers, which deal with the latest and most current topics that form the very core of the Journal's scope of interest.

This issue contains the papers based on a presentation given at the 5th International Conference on European Company Law and Corporate Governance - "Corporate Purpose in the Digital Era: Towards Revisiting the Directors Duties and Liabilities". The Conference was organized by the Department of Law at the Faculty of Economics and Business University of Zagreb, in cooperation with the ELI Business & Financial Law SIG, Croatian Chamber of Economy, International Chamber of Commerce Croatia, PwC Croatia, and with the support of the ELI Croatian Hub and took place in Zagreb on 24 and 25 November 2022. This year's keynote speakers were Prof. Dr. Pierre-Henri Conac (University of Luxembourg and Max Planck Institute Luxembourg for International, European and Regulatory Procedural Law) and Prof. Dr. Edita Čulinović-Herc (Faculty of Law, University of Rijeka). The Conference gathered more than a hundred participants from the EU, the US, Ukraine, and Turkey, members of the academic community, corporate practice, judiciary, and students.

The papers contained in this issue are dealing with current problems in Company Law and Corporate Governance such as: share capital maintenance, disqualified directors in the EU, processing of personal data, sustainability and ESG reporting, the reach of shareholders' agreements, pros and cons of the AI implementation to the companies' operations, debate on the very purpose of the company and so on. Hopefully, the given selection of published topics will satisfy the taste of our readers and provide them with valuable information regarding Company Law and Corporate Governance.

Once again, we truly hope you will enjoy the reading and expand your horizons in European Company Law and Corporate Governance.

We wish you all a prosperous 2023!

Hana Horak, Editor in Cheif
Zvonimir Šafranko, Co Editor

Zagreb, December 2022.

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LARGE COMPANIES SAVING PEOPLE AND THE PLANET – REFLECTIONS ON THE PERSONAL SCOPE OF THE APPLICATION OF THE CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE *

Dionis Jurić **
Antonija Zubović ***
Edita Čulinović-Herc ****

ABSTRACT

On 23 February 2022, the European Commission adopted a proposal for a Directive on corporate sustainability due diligence (hereinafter: CSDD). It aims to foster sustainable and responsible corporate behavior throughout global value chains. Companies will be required to identify and, where necessary, prevent, end, or mitigate adverse impacts of their activities on human rights (e.g., child labor, exploitation of workers) and on the environment (e.g. pollution and biodiversity loss). The CSDD would apply both to the EU and non-EU companies reaching certain thresholds in terms of the number of employees and amount of net turnover, with minor exemptions when the non-EU companies are concerned. Lower thresholds apply if the EU companies are doing business in the high-risk sectors, while the higher apply if the companies are operating in the non-high risk sector. To comply with new due diligence rules, companies would be required to check whether their operations are aligned with human rights and environmental law conventions listed in the Annex of the CSDD, as well as the operation of its subsidiaries and all suppliers upstream

* This paper is written under support of the University of Rijeka project (uniri-drustv-18-43) 'Legal Aspects of Companies Restructuring and Transition Towards New Corporate Governance Culture'.
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and downstream in the value chain – with whom they have "established business relationship". Given the fact that the new set of duties is comprehensive and their non-compliance triggers the company's liability, the paper aims to compare these boundaries of the personal scope of the CSDD with criteria prescribed in similar national laws of the member states as well as to question defensive tactics of the target companies.

KEYWORDS*: corporate sustainability, global value chains, supply chains, human rights, environmental law, due diligence, the personal scope of the application, corporate sustainability due diligence directive, defensive tactics*

1. INTRODUCTION

The Rana Plaza tragedy of 2013, in which 1,135 workers from supplier factories of European and North American apparel multinationals died when their unsafe building collapsed, has highlighted the need for regulation that requires companies to take responsibility for practices along the supply chain. These and other outrageous working conditions and labor practices such as the abuse of child labor, migrant workers, and forced labor in many sectors, as well as irreparable environmental damage resulting from corporate activities, are among the reasons for calling for EU legislation requiring companies to act responsibly.

In a May 4, 2018, Report on sustainable finance,[1] the European Parliament called for the introduction of a mandatory due diligence framework based on the 2017 OECD Guidelines for Responsible Business Conduct[2] and the French Corporate Duty of Vigilance Law (hereinafter *Loi de vigilance*).[3] This request followed the mandate given by the European Commission in its Action Plan on Financing Sustainable Growth of March 8, 2018,[4] to address the same issue.

To address corporate social responsibility (CSR) issues, legislators initially tended toward disclosure. Initially, voluntary CSR disclosure regimes became

[1] European Parliament, Report on sustainable finance, Report - A8-0164/2018, 4 May 2018, [https://www.europarl.europa.eu/doceo/document/A-8-2018-0164_EN.html], accessed on 2/11/2022.

[2] OECD Due Diligence Guidance for Responsible Business Conduct, [https://www.oecd.org/investment/due-diligence-guidance-for-responsible-business-conduct.htm], accessed on 03/10/2022.

[3] Loi n° 399/2017 du 23 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, (JORF n° 0074 du 28 mars 2017).

[4] European Commission, Communication from the Commission Action Plan: Financing Sustainable Growth, COM(2018) 97 final, [https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018DC0097], accessed on 02/11/2022.

mandatory for large companies with the adoption of the Non-Financial Reporting Directive (NFRD) in 2014, which mandates the disclosure of non-financial and diversity information by large EU public-interest entities.[5] In 2017, the NFRD was supplemented by non-binding guidelines[6] and the latest guidelines on reporting climate-related corporate information.[7] As announced in the Green Deal for Europe,[8] the NFRD is currently under review as part of the strategy to strengthen the basis for sustainable investment.[9] In addition, the European Green Deal's ambition that „sustainability should be further embedded into the corporate governance framework",[10] is being pursued as part of the European Commission's Sustainable Corporate Governance Initiative.[11]

In January 2020, the European Commission launched the process to create a mandatory due diligence framework with a Study on due diligence requirements through the supply chain.[12] This Study was based on the French *Loi*

[5] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, (OJ L 330, 15/11/2014). The NFRD applies to large "public-interest entities" (i.e. EU companies listed on a regulated market in the EU; listed or nonlisted credit institutions, insurance companies or other entities designated as such by Member States) with an average number of employees exceeding 500 and to public-interest entities that are parent companies of a large group with an average number of employees in exceeding 500 on a consolidated basis.

[6] Communication from the Commission — Guidelines on non-financial reporting (methodology for reporting non-financial information), (OJ C 215, 05/07/2017).

[7] Communication from the Commission – Guidelines on non-financial reporting: Supplement on reporting climate-related information, (OJ C 209, 20/06/2019).

[8] European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, The European Green Deal, COM(2019) 640 final, 2019, [https://eur-lex.europa.eu/resource.html?uri=cellar:b828d165-1c22-11ea-8c1f-01aa75ed71a1.0002.02/DOC_1&format=PDF], accessed on 28/10/2022.

[9] The EU Commission put forward its proposal for a reform of the NFRD in April 2021. Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, (COM(2021) 189 final). Now proposed to be called the Corporate Sustainability Reporting Directive, including disclosure requirements for due diligence on sustainability issues and a proposal for European Sustainability Reporting Standards and assurance standards for sustainability reporting.

[10] European Commission, The European Green Deal, *op. cit.*

[11] European Commission, Sustainable Corporate Governance, [https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporategovernance_en], accessed on 10/11/2022.

[12] European Commission, Directorate-General for Justice and Consumers, Torres-Cortés, F., Salinier, C., Deringer, H. *et al.: Study on due diligence requirements through the supply chain:*

de vigilance. It concluded that voluntary regulations across Europe have not changed the way companies carry out their corporate governance responsibilities. As a result, the European Commission announced in April 2020 that new corporate legislation would be introduced for mandatory human rights and environmental due diligence.[13] The rationale for supporting mandatory due diligence duty at the EU level "includes a higher level of implementation, access to remedies, but also a leveling of the playing field, a single harmonized standard and legal certainty".[14] In July 2020, the European Commission published the report "Study on Directors' Duties and Sustainable Corporate Governance".[15] The report was criticized by academics and business associations[16] and twice rejected by the European Commission's Regulatory Scrutiny Board (RSB). The RSB stressed that there was no need to regulate directors' duties in addition to due diligence requirements and that companies in the EU already sufficiently consider sustainability aspects in their business strategies.[17]

final report, Publications Office, 2020, [https://data.europa.eu/doi/10.2838/39830], accessed on 30/10/2022.

[13] EU Commission publishes legislative proposal on corporate accountability, [https://www.business-humanrights.org/en/latest-news/eu-commissioner-for-justice-commits-to-legislation-on-mandatory-due-diligence-for-companies/], accessed on 02/11/2022.

[14] European Commission, Directorate-General for Justice and Consumers, Torres-Cortés, F., Salinier, C., Deringer, H., *et al*., *op. cit*., p. 154.

[15] European Commission, Directorate-General for Justice and Consumers: *Study on directors' duties and sustainable corporate governance: final report*, Publications Office, 2020, [https://data.europa.eu/doi/10.2838/472901], accessed on 28/10/2022.

[16] The main criticisms concerned the incorrect definition of the problem (conflating problems of time horizon (short-termism) with externalities and distributional issues), insufficient evidence of an increase in short-termism (use of gross payouts to shareholders instead of net payouts (gross payouts minus equity issuances)), biased use of the existing literature, and poorly thought-out reform proposals (the effectiveness of the proposed measures and the cost of their implementation). See in Roe, M. J.; Spamann, H.; Fried, J. M.; Wang, C. C. Y.: *The European Commission's Sustainable Corporate Governance Report: A Critique*, European Corporate Governance Institute - Law Working Paper 553/2020, Harvard Public Law Working Paper No. 20-30, Yale Journal on Regulation Bulletin, October 2020, [https://ssrn.com/abstract=3711652], accessed on 10/09/2022, p. 134-135. Some legal scholars argued for the use of additional procedural regulatory instruments (disclosure or consultation requirements). See in Möslein, F.; Sørensen, K. E.: *Sustainable Corporate Governance: A Way Forward*, Nordic & European Company Law Working Paper No. 21-03, European Corporate Governance Institute - Law Working Paper No. 583/2021, January 2021, [https://ssrn.com/abstract=3761711], accessed on 10/09/2022, p. 5-9.

[17] Regulatory Scrutiny Board Opinion on Proposal for a Directive of the European Parliament and of the Council on Sustainable Corporate Due Diligence and amending Directive (EU) 2019/1937, (SEC (2022) 95, 26/11/2021).

Taking into account the results of a public consultation that ended in February 2021 and the non-binding recommendations of the European Parliament in March 2021,[18] the European Commission published a new legislative Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence[19] (hereinafter CSDD) on February 23, 2022, which is described as "a real game changer in the way companies operate their business activities throughout their global supply chain" or "a watershed moment for human rights and the environment".[20] The CSDD aims to introduce mandatory and harmonized rules on sustainability due diligence in the European Economic Area, as voluntary measures by companies are insufficient and companies face regulatory chaos in their cross-border activities.[21]

An important issue is the identification of the companies that fall within the scope of the CSDD, as the personal scope of the regulatory regimes already adopted in the EU Member States varies and may do so even more in the future. In addition, other Member States may decide not to legislate in this area. As highlighted in the explanatory memorandum to the proposal for the CSDD this may result in certain companies with cross-border value chains already being subject to different requirements and likely to be subject to even more different requirements depending on where their registered office is located. At the same time, depending on how they structure their business in the

[18] European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)), (OJ C 474, 24.11.2021.). The Resolution has been criticised for not detailing the standards that companies are expected to meet, for the broad range of measures that companies are required to take to comply with the standards, and for the practical problems that can arise if the standards are not met. Davies, P.; Emmenegger, S.; Ferrarini, G. *et. al.*: *Commentary: The European Parliament's Draft Directive on Corporate Due Diligence and Corporate Accountability*, European Corporate Governance Institute, April 2021, [https://ecgi.global/news/commentary-european-parliament's-draft-directive-corporate-due-diligence-and-corporate], accessed on 12/10/2022, p. 6

[19] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, (COM/2022/71 final, 2022/0051(COD), 23/2/2022).

[20] Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives*, European Corporate Governance Institute - Law Working Paper No. 639/2022, [http://dx.doi.org/10.2139/ssrn.4083398], accessed on 13/10/2022, footnotes 35 and 36, where he quotes Didier Reynders, Commissioner for Justice and Richard Gardiner of Global Witness, in Aoife White, Alberto Nardelli, and Stephanie Bodoni, Unethical Firms Risk Massive Bills in EU Supply-Chain Crackdown, Bloomberg, 21 February 2022.

[21] As explained in the Explanatory memorandum of the Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, (COM/2022/71 final, 2022/0051(COD), 23/02/2022), p. 1-3.

internal market, some companies could be simultaneously subject to two or more different national legal frameworks dealing with sustainable corporate governance. This could pose some problems in practice, in particular the issue of legal certainty, compliance difficulties, duplicative requirements, and even incompatible parallel legal requirements. Conversely, some companies may fall outside the scope of a national legal framework simply because they do not have relevant links under national law to the jurisdiction of the Member State where the due diligence requirements apply, giving them an advantage over their competitors. [22]

To prevent and remove such obstacles the proposed CSDD would apply to both EU and non-EU companies that meet certain thresholds in terms of the number of employees and amount of net turnover. In addition, respective companies should consider not only their operations but also those of their subsidiaries and suppliers. As stated in the impact assessment, the comparative advantage of the CSDD proposal in respect of traditional EU environmental law is its application "to value chains outside the EU, where up to 80-90% of the environmental harm may occur".[23] An indirect business relationship means that the value chain extends beyond a contractual relationship within a group company.[24] However, this threatens legal certainty, makes it more difficult for EU companies to do business, and reduces their competitiveness.

As mentioned above, some national legislators have already addressed the issue of due diligence in the supply chain before the adoption of the proposal for the CSDD. The French legislator, which served as a model for the European legislator in regulating these issues, did so in 2017 with the adoption of the *Loi de vigilance*. German legislators regulated these issues with the Law on Corporate Due Diligence in Supply Chains[25] whose provisions will apply from January 1, 2023. Although the aims are similar, the German and French laws have some important differences in terms of the substance and scope of the due diligence requirement.

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[22] Explanatory memorandum of the Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, (COM/2022/71 final, 2022/0051(COD), 23/02/2022), p. 11.

[23] Commission Staff Working Document, Impact Assessment Report, Accompanying the document Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 (COM(2022) 71 final - SEC(2022) 95 final - SWD(2022) 38 final - SWD(2022) 39 final - SWD(2022) 43 final), p. 2.

[24] Davies, P.; Emmenegger, S.; Ferrarini, G. *et. al.*: *Commentary: The European Parliament's Draft Directive on Corporate Due Diligence and Corporate Accountability*, *op. cit.*, p. 11-12.

[25] Gesetz *über* die unternehmerischen Sorgfaltspflichten zur Vermeidung von Menschenrechtsverletzungen in Lieferketten (Lieferkettensorgfaltspflichtengesetz – LkSG) vom 16. Juli 2021, (BGBl. I, Nr. 46, 2959 ff).

In the paper, the authors provide an overview of the provisions of the CSDD and the approach of French and German legislators in regulating corporate due diligence in the supply chain. The central part of the paper is the analysis of the personal scope of application of the CSDD, the French *Loi de vigilance,* and the German *Lieferkettensorgfaltspflichtengesetz*. The authors compare the personal scope of application of the CSDD with the criteria prescribed in French and German law and point out open questions in their application.

2. OVERVIEW OF THE PROPOSAL FOR A DIRECTIVE ON CORPORATE SUSTAINABILITY DUE DILIGENCE

As mentioned earlier, the CSDD aims to promote sustainable and responsible corporate behavior throughout global value chains. Companies will be required to identify and, where necessary, prevent, end, or mitigate adverse impacts of their activities on human rights (e.g., child labor, exploitation of workers) and the environment (e.g., pollution and biodiversity loss). These new rules will provide legal certainty and a level playing field for enterprises as well as greater transparency for consumers and investors. The proposal introduces a corporate sustainability due diligence duty to address negative impacts on human rights and the environment at the EU level.

The CSDD lists applicable international conventions and guidelines for the protection of human rights and the environment. However, these international legal instruments set imprecise standards that need to be translated into binding rules for companies. The relevant standards must be determined by the CSDD, and another problem arises from their application in the process of drafting a due diligence policy and implementing it in a company. A company encounters the interests of various stakeholders who will be consulted in the process of creating a due diligence policy. However, the different interests of stakeholders will create conflicts and make it difficult for the company to create an appropriate due diligence policy.[26] The due diligence policy has to be carried out across the whole value chain of the company and not just to the company's or group's own operations. The company must take into account the possible infringements of its suppliers, customers, and subsidiaries.

The new due diligence rules apply to large EU companies and companies in defined impact sectors, as well as non-EU companies active in the EU (Arti-

[26] Davies, P.; Emmenegger, S.; Ferrarini, G. *et. al.*: *Commentary: The European Parliament's Draft Directive on Corporate Due Diligence and Corporate Accountability*, *op. cit.*, p. 7-11. Roe, M. J.; Spamann, H.; Fried, J. M.; Wang, C. C. Y.: *The European Commission's Sustainable Corporate Governance Report: A Critique*, *op. cit.,* p. 151.

cle 2 of the CSDD). Small and medium-sized enterprises (SMEs) do not fall directly within the scope of this proposal. Concerning non-EU companies,[27] the question arises as to how compliance with the CSDD should be supervised and which national administrative authority should carry out this supervision. These companies may withdraw from the EU market and transfer their operations to other markets or decide not to enter the market. In this way, the positive impact of the CSDD on third countries is mitigated.[28]

The CSDD applies to the company's own operations, its subsidiaries, and their value chains (direct and indirect established business relationships) (Article 3 of the CSDD). It is pointed out by some authors that the application of the CSDD should be limited only to direct business partners of the company.[29] To comply with the corporate due diligence duty, companies need to integrate due diligence into their policies and monitor, prevent, eliminate or minimize actual or potential adverse impacts on human rights and the environment (Articles 4-8 of the CSDD).[30] They must establish and maintain a complaints procedure, monitor the effectiveness of the due diligence policy and taken measures, and publicly communicate on due diligence (Articles 9-11 of the CSDD). Large EU companies need to have the plan to ensure that their business strategy is consistent with limiting global warming to 1.5 °C in line with the Paris Agreement (Article 15 of the CSDD). The mandatory climate plan has already become obsolete due to the war between Russia and Ukraine and the existing energy crisis.[31]

National administrative authorities appointed by Member States will be responsible for supervising these new rules and may impose fines in case of non-compliance (Articles 17-20 of the CSDD). In addition, injured parties will

[27] Non-EU companies must appoint an authorized representative (natural or legal person) who is established or has a residence in one of the Member States in which they operate. The competent authorities of the Member States shall address the authorized representative on all matters necessary for the receipt, compliance and implementation of legal acts issued in relation to the Directive (Article 16 of the CSDD).

[28] Davies, P.; Emmenegger, S.; Ferrarini, G. *et. al.*: *Commentary: The European Parliament's Draft Directive on Corporate Due Diligence and Corporate Accountability*, *op. cit.*, p. 19-20.

[29] Thomsen, S.; *Comments on the Corporate Sustainability Due Diligence Directive*, Online Policy Workshop - European Commission Directive on Corporate Sustainability Due Diligence, Stockholm School of Economics, European Corporate Governance Institute, 28-29 March 2022, [https://ecgi.global/sites/default/files/steen_thomsen_sustainability_due_dilligence_ecgi_29_march.pdf.], accessed on 10/10/2022, p. 8.

[30] It will be difficult for companies to identify actual and potential adverse impacts, especially with regard to indirect business partners. See in Davies, P.; Emmenegger, S.; Ferrarini, G. *et. al.*: *Commentary: The European Parliament's Draft Directive on Corporate Due Diligence and Corporate Accountability*, *op. cit.*, p. 12-14.

[31] Thomsen, S.; *Comments on the Corporate Sustainability Due Diligence Directive*, *op. cit.*, p. 11.

be able to take legal action for damages that could have been avoided with appropriate due diligence measures (Article 22 of the CSDD). An open question is which litigation regime shall be applied by the Member States.[32]

The CSDD introduces the duty of directors to establish and monitor the implementation of due diligence and to integrate it into corporate strategy. In fulfilling their duty to act in the best interests of the company, directors must consider the impact of their decisions on human rights, climate change, and the environment (Article 25 of the CSDD). The existing rules on directors' duties are sufficient for this purpose.[33] When directors receive variable remuneration, they should be incentivized to contribute to climate change mitigation by reference to the corporate plan (Article 15 of the CSDD). Such incentive schemes will be complex in practice.[34]

3. PERSONAL SCOPE OF THE APPLICATION OF THE CSDD

One of the key issues for the effectiveness of the proposed regulatory framework is the issue of the personal scope of application of the CSDD. Under the adopted provisions, the new due diligence rules will apply to both EU and non-EU companies.[35] EU companies (companies incorporated under the laws

[32] It is not clear to what extent Member States will apply their own liability rules or whether they will have to amend these rules in accordance with the CSDD. See in Thomsen, S.; *Comments on the Corporate Sustainability Due Diligence Directive*, *op. cit.*, p. 16. Roe, M. J.; Spamann, H.; Fried, J. M.; Wang, C. C. Y.: *The European Commission's Sustainable Corporate Governance Report: A Critique*, *op. cit.,* p. 152-153. Davies, P.: *Briefing: Due diligence in supply chains and net zero plans*, Online Policy Workshop - European Commission Directive on Corporate Sustainability Due Diligence, Stockholm School of Economics, European Corporate Governance Institute, 28-29 March 2022, [https://ecgi.global/sites/default/files/Presentation%3A%20Paul%20Davies.pdf.], accessed on 10/10/2022, p. 13-15.

[33] They already take these aspects into account when making decisions. See in Thomsen, S.; *Comments on the Corporate Sustainability Due Diligence Directive*, *op. cit.*, p. 8. Roe, M. J.; Spamann, H.; Fried, J. M.; Wang, C. C. Y., *op. cit.*, p. 145-146.

[34] It is proposed to adopt fixed remuneration for non-executive directors and long-term incentives for executive directors. The introduction of non-financial environmental, social and governance (ESG) metrics into remuneration schemes is problematic. These metrics need to be meaningful and measurable. A meaningful metric must be one that directors can directly influence and that is not already covered by other regulations. See in Thomsen, S.; *Comments on the Corporate Sustainability Due Diligence Directive*, *op. cit.*, p. 12., Roe, M. J.; Spamann, H.; Fried, J. M.; Wang, C. C. Y.: *The European Commission's Sustainable Corporate Governance Report: A Critique*, *op. cit.,* p. 149-150.

[35] The personal scope has been significantly reduced following the reflections triggered by the Board's comments on the description of the problem, in particular in relation to SMEs, and on the proportionality of the preferred option.

of a Member State) that fall within the scope of the CSDD can be divided into two groups.[36] The first group includes companies with an average of more than 500 employees that generated a worldwide net turnover of more than EUR 150 million in the last financial year for which annual financial statements were prepared. The second group includes companies that do not meet the thresholds of the first group, but have an average of more than 250 employees and generated a worldwide net turnover of more than EUR 40 million in the last financial year for which annual financial statements were prepared, provided that at least 50 % of these net turnover was generated in one or more of the defined high-impact sectors.[37] For these companies, the rules apply two years later than for the first group. In contrast to the 2011 United Nations Guiding Principles (UNGPs)[38] and the OECD Guidelines for Multinational Enterprises, which recommend their application to all companies, "regardless of their size, sector, location, ownership or structure",[39] even if this means modulating the intensity of the corresponding obligations to take these factors into account, the European proposal follows the more restrictive French model, particularly in terms of legal forms or company size, while setting the social thresholds much lower.[40]

[36] As regards the EU companies, the Member State competent to regulate matters covered in the CSDD shall be the Member State in which the company has its registered office. (Art. 2 par. 4 of the CSDD)

[37] The following sectors are covered: (i) the manufacture of textiles, leather and related products (including footwear), and the wholesale trade of textiles, clothing and footwear; (ii) agriculture, forestry, fisheries (including aquaculture), the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food, and beverages; (iii) the extraction of mineral resources regardless from where they are extracted (including crude petroleum, natural gas, coal, lignite, metals and metal ores, as well as all other, non-metallic minerals and quarry products), the manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (except machinery and equipment), and the wholesale trade of mineral resources, basic and intermediate mineral products (including metals and metal ores, construction materials, fuels, chemicals and other intermediate products). Methven O'Brien, C.; Martin-Ortega, O.: *Sustainable corporate governance: Submission to Consultation on European Commission's proposal for a Directive on corporate sustainability due diligence COM(2022)71 final*, [https://www.researchgate.net/publication/360845316_Sustainable_corporate_governance_Submission_to_Consultation_on_European_Commission's_proposal_for_a_Directive_on_corporate_sustainability_due_diligence_COM202271_final], accessed on 28/10/2022, p. 7, note that some sectors that pose a high risk to vulnerable rights-holders in Europe, such as social care, healthcare, hospitality and entertainment, construction, technology, cleaning, and beyond, are unlikely to be covered by this approach.

[38] The United Nations Guiding Principles on Business and Human Rights, 2011, [https://www.ohchr.org/sites/default/files/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf], accessed on 15/10/2022.

[39] See Principle 14 of the UNGPs on Business and Human Rights, *op. cit.*

[40] Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 25.

In terms of company form, the proposed legal framework for EU companies mainly includes joint stock companies and LLCs,[41] except for regulated financial entities.[42]

Regarding the calculation of the number of employees, the CSDD provides that the number of part-time employees is calculated on a full-time equivalent basis. Temporary agency workers are included in the calculation of the number of employees in the same way as if they had been employed directly by the company for the same period.

For non-EU companies (companies incorporated under the laws of a third country), the CSDD applies if the company meets one of the following conditions: a) generating a net turnover of more than EUR 150 million in the Union in the financial year preceding the last financial year, or b) generating a net turnover of more than EUR 40 million but not more than EUR 150 million in the Union in the financial year preceding the last financial year, provided that at least 50 % of its net worldwide turnover was generated in one or more of the listed high-impact sectors.

The criteria for defining the group of EU and non-EU companies covered are not the same. For non-EU companies, a net turnover threshold is used, but all turnover must be generated in the Union. The adopted solution is justified by the fact that it ensures a sufficient territorial link to the EU. EU companies, in turn, must have a prescribed net turnover generated worldwide and must also meet an employee criterion. The adopted solution is justified by the fact that there is no method for calculating the number of employees of third-country companies. Moreover, experience shows that in the absence of a common definition of the term "employees", the number of employees (worldwide) is diffi-

[41] As in France and in contrast to the German Due Diligence Act.

[42] Art. 3(a) of the CSDD provides a long list of legal persons or regulated entities that fall within the definition of company: (i) legal persons constituted as one of the legal forms listed in Annex I to Directive 2013/34/EU of the European Parliament and of the Council (joint-stock corporations and LLCs); (ii) legal persons constituted in accordance with the law of a third country in a form comparable to those listed in Annex I and II of that Directive; (iii) legal persons constituted as one of the legal forms listed in Annex II to Directive 2013/34/EU composed entirely of undertakings organised in one of the legal forms falling within points (i) and (ii); and (iv) regulated financial undertakings, regardless of its legal forms (credit institutions, investment firms, alternative investment fund managers (AIFMs), alternative investment fund (AIFs), undertakings for collective investment in transferable securities (UCITS), insurance and reinsurance undertakings, institutions for occupational retirement provision, pension institutions, central counterparties, central securities depositories, securitisation special purpose entities, payment institutions, electronic money institutions, crowdfunding service providers, crypto-asset service providers…).

cult to calculate, which complicates the identification of third-country companies falling within the scope and prevents effective enforcement.[43]

In contrast to French and German law, the wording of the CSDD seems to indicate that the thresholds for the number of employees and net turnover should be calculated individually for each company, as defined by Art. 3(a) of the CSDD, and not at the group level. This raises the question of the possibility of manipulating the thresholds by splitting the activities among structures.[44]

Based on the estimations of the Commission the CSDD will cover about 13,000 EU companies[45] and about 4,000 third-country companies.[46]

It should be noted that the review clause explicitly refers to the personal scope of the CSDD, which should be reviewed in light of practical experience with the application of the legislation.

4. THE APPROACH OF THE FRENCH AND GERMAN LEGISLATORS IN REGULATION OF CORPORATE DUE DILIGENCE IN THE SUPPLY CHAIN

With the adoption of the *Loi de vigilance*[47] in 2017, France was one of the first countries to regulate human rights and environmental due diligence in the supply chain. As mentioned above, the French model is an important milestone as it largely inspired the European Commission in its proposed directive on CSDD.

Loi de vigilance was the result of a four-year struggle by French Non-Governmental Organizations (NGOs) and trade unions and three deputies of the French Congress. The adoption of the Law was enabled by a combination of conditions: public outrage over the 2013 "Rana Plaza" tragedy, in which a textile factory in Bangladesh closely linked to French companies collapsed; France's national political culture (widespread expectation of state intervention; antiglobalization sentiment); a center-left government under the previous

[43] Explanatory memorandum of the Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, (COM/2022/71 final, 2022/0051(COD), 23/02/2022), p. 15.

[44] Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 25.

[45] 9,400 companies in the first group and 3,400 companies in the second group.

[46] 2,600 companies in the first group and 1,400 companies in the second group.

[47] Loi n° 399/2017 du 23 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, (JORF n° 0074 du 28 mars 2017).

president Hollande; and the appointment in 2016 of a minister of economy and industry who endorsed the Law.[48]

The *Loi de vigilance* went through four readings in the French National Assembly and three in the Senate, where the Law was weakened.[49] A comparison between the original legislative proposal submitted to the presidency of the National Assembly in November 2013 and the Law passed in March 2017 shows significant differences in the scope of application. The original proposal addressed all companies established in France and not just only those exceeding a certain number of employees. After the *Loi de vigilance* was passed, right-wing and liberal deputies from both chambers appealed to the Constitutional Council, arguing that the Law was unconstitutional and affected companies' freedom of trade and commerce. The Council decided that the *Loi de vigilance* was generally compatible with the Constitution, but objected to the possibility of a civil fine of up to thirty million euros.[50]

Many companies subject to the *Loi de vigilance* published their first vigilance plans in 2018 and reported on the implementation of these plans in 2019 and 2020. French civil society organizations have strongly criticized the first generation of vigilance plans, stating that the plans are very short and "do not allow us to understand exactly what risks have been identified by companies … let alone how companies are responding to those risks".[51] In addition, the plans address risks in very general terms, with no mention of specific subsidiaries, controlled entities, or production facilities.[52]

In addition to the *Loi de vigilance*, the PACTE Law[53] for the growth and transformation of companies, approved in May 2019, also goes in the same direction

[48] Schilling-Vacaflor, A.: *Putting the French Duty of Vigilance Law in Context: Towards Corporate Accountability for Human Rights Violations in the Global South?*, Human Rights Review, (22) 2021, [https://doi.org/10.1007/s12142-020-00607-9], p. 115.

[49] Rapport à Monsieur le Ministre de l'économie et des finances, Evaluation de la mise en œuvre de la loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, January 2020, [https://www.economie.gouv.fr/files/files/directions_services/cge/devoirs-vigilances-entreprises.pdf], accessed on 05/10/2022, p. 14.

[50] Schilling-Vacaflor, A.: *Putting the French Duty of Vigilance Law in Context: Towards Corporate Accountability for Human Rights Violations in the Global South?*, *op. cit.*, p. 116.

[51] Sherpa, Vigilance Plans Reference Guidance, [https://www.asso-sherpa.org/wp-content/uploads/2019/02/Sherpa_VPRG_EN_WEB-ilovepdf-compressed.pdf] , accessed on 02/11/2022.

[52] Schilling-Vacaflor, A.: *Putting the French Duty of Vigilance Law in Context: Towards Corporate Accountability for Human Rights Violations in the Global South?*, *op. cit.*, p. 117.

[53] Loi n° 2019-486 du 22 mai 2019 relative à la croissance et la transformation des entreprises, (JORF n° 0119 du 23 mai 2019).

by introducing the consideration of social and environmental aspects in corporate governance (Article 169 amending Article 1833 of the Civil Code).[54] However, these provisions have long been included in the Commercial Code, at least for listed companies since 2002 and for large companies since 2011, which must indicate in their management report (Article L225-102-1) "how the company takes into account the social and environmental consequences of its activities".[55]

The French *Loi de vigilance* is the law usually cited as the model for the German Law on Corporate Due Diligence in Supply Chains (*Gesetz* ***über*** *die unternehmerischen Sorgfaltspflichten zur Vermeidung von Menschenrechtsverletzungen in Lieferketten;* hereinafter: *Lieferkettensorgfaltspflichtengesetz*, LkSG), which was passed by the German Bundestag on June 11, 2021. It was followed by the approval of the Bundesrat on June 25, 2021.[56] The LkSG will enter into force on January 1, 2023.

The basis for the LkSG was the National Action Plan on Business and Human Rights (*Nationaler Aktionsplan Wirtschaft und Menschenrechte*, NAP), which was adopted in 2016.[57] However, a multi-year company survey conducted by the German government (NAP monitoring) revealed that currently only about one-fifth of all German-based companies with more than 500 employees sufficiently comply with their human rights due diligence obligations along their supply chains.[58] This shows that a voluntary commitment is not sufficient.

The NAP, the LkSG, and the *Law of vigilance* are based on the United Nations Guiding Principles on Business and Human Rights,[59] which are among the

[54] The PACTE Law is applicable to all companies registered in France, regardless of their form or size.

[55] The PACTE law also included two optional provisions that introduced two new concepts into French law: the "raison d'être" company's fundamental reason for being, that a company may define in its bylaws, to state its principles or core values and the "société à mission" ("mission-driven company"). See more in Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 3.

[56] The LkSG was published in the Federal Law Gazette on July 22, 2021. Gesetz *über* die unternehmerischen Sorgfaltspflichten zur Vermeidung von Menschenrechtsverletzungen in Lieferketten (Lieferkettensorgfaltspflichtengesetz – LkSG) vom 16. Juli 2021, (BGBl. I, Nr. 46, 2959 ff).

[57] Nationaler Aktionsplan Umsetzung der VN-Leitprinzipien für Wirtschaft und Menschenrechte 2016–2020, [https://www.auswaertiges-amt.de/blob/297434/8d6ab29982767d5a31d2e85464461565/nap-wirtschaft-menschenrechte-data.pdf], accessed on 21/06/2022.

[58] Monitoring des Nationalen Aktionsplans Wirtschaft und Menschenrechte: Ergebnisse der zweiten Erhebung, [https://www.auswaertiges-amt.de/de/aussenpolitik/themen/aussenwirtschaft/wirtschaft-und-menschenrechte/ergebnisse-2-umfrage-nap/2374446], accessed on 21/06/2022.

[59] The United Nations Guiding Principles on Business and Human Rights, *op. cit.*

most important internationally recognized standards of corporate responsibility for human rights.

The French *Loi de vigilance* and the German LkSG differ significantly in terms of personal scope, substantive requirements, and enforcement regime.

The *Loi de vigilance* consists essentially of two provisions incorporated into the French Commercial Code (Articles L. 225-102-4 and L. 225-102-5 of the Commercial Code). They require French companies to prepare, publish and implement a vigilance plan *(plan de vigilance)*, which must include reasonable vigilance measures to detect and prevent violations of human rights and fundamental freedoms, serious bodily injury, environmental damage, or health risks. They also provide for a range of sanctions in the event that the monitoring plan is prepared, published, or implemented properly or at all. Thus, the duty of vigilance goes well beyond due diligence. Due diligence may be limited to simply identifying risks, typically once a year, while the duty of vigilance requires companies to identify and monitor risks and respond to them through ongoing risk mitigation and prevention measures.[60] In addition, companies are required to publish the plan and the report on its effective implementation, and to include both in the company's annual management report.[61]

One of the core elements of the due diligence obligations under the German LkSG is the establishment of a risk management system to identify, prevent or minimize the risks of human rights violations and environmental damage. The LkSG specifies the necessary preventive and remedial measures makes complaint procedures mandatory and requires regular reports. The LkSG contains an exhaustive list of eleven internationally recognized human rights conventions.[62]

[60] Rühl, G.: *Towards a German Supply Chain Act? Comments from a Choice of Law and a Comparative Perspective*, European Yearbook of International Economic Law, 11 (2021), [https://ssrn.com/abstract=3708196], p. 12. Clerc, C.: *The French 'Duty of Vigilance' Law: Lessons for an EU Directive on Due Diligence in Multinational Supply Chains*, ETUI Policy Brief, European Economic, Employment and Social Policy, 1 (2021), [https://www.etui.org/publications/french-duty-vigilance-law], accessed on 22/06/2022, p. 3.

[61] According to the wording of the *Loi de vigilance*, it has been suggested that this obligation should be understood as requring that the plan and the report on its effective implementation be published (in the sense of made available to the public) and included in the company's annual management report. Savourey, E.: *France Country Report*, EC Study on due diligence requirements through the supply chain, Part III: Country Reports, January 2020, [https://op.europa.eu/en/publication-detail/-/publication/0268dfcf-4c85-11ea-b8b7-01aa75ed71a1/languageen/format-PDF/source-search], accessed on 11/10/2022, p. 64.

[62] These include, in particular, the prohibition of child labour, slavery and forced labour, the disregard of occupational health and safety regulations, the withholding of an adequate wage, the disregard of the right to form trade unions or workers' representations, the denial of access to food and water, and the unlawful appropriation of land and livelihoods.

With this new legislation, Germany and France join the group of countries such as the United Kingdom, the Netherlands,[63] Austria, Belgium, Denmark, Finland, Italy, Luxembourg, and Norway,[64] which have already enacted similar regulations.[65]

However, the LkSG and the *Loi de vigilance* have also attracted much criticism, not only from opponents of mandatory human rights due diligence obligations but also from proponents. While they welcome the creation of a legally binding framework to better protect human rights in global supply chains, they argue that the scope of the LkSG[66] and the *Loi de vigilance*[67] is too limited.

[63] Wet van 24 oktober 2019 houdende de invoering van een zorgplicht ter voorkoming van de levering van goederen en diensten die met behulp van kinderarbeid tot stand zijn gekomen, (Staatsblad 2019, 401).

[64] Lov om virksomheters åpenhet og arbeid med grunnleggende menneskerettigheter og anstendige arbeidsforhold (åpenhetsloven) (Act relating to enterprises' transparency and work on fundamental human rights and decent working conditions), (LOV-2021-06-18-99).

[65] Annex 8 of the Impact Assessment accompanying proposal for CSDD provides a detailed overview on Member State/EEA laws and initiatives. [https://eur-lex.europa.eu/resource.html?uri=cellar:c851d397-9584-11ec-b4e4-01aa75ed71a1.0001.02/DOC_2&format=PDF], accessed on 20/11/2022.

[66] Initiative Lieferkettengesetz, *What the new Supply Chain Act delivers – and what it doesn't*, [https://www.germanwatch.org/sites/default/files/Initiative-Lieferkettengesetz_Analysis_What-the-new-supply-chain-act-delivers.pdf], accessed on 18/06/2022, p. 5, points out that "the number of companies covered is too small. Instead of focusing on all large companies with more than 250 employees, as well as SMEs in sectors with particular human rights risks, the Law only covers companies with more than 3,000 employees (from 2024: with more than 1,000 employees). But even, SMEs can have significant negative impacts on human rights and environmental issues if they operate in a high-risk sector." Rühl, G.: Cross-border Protection of Human Rights: The 2021 German Supply Chain Due Diligence Act, in: Borg-Barthet, Živković *et. al.* (eds): *Gedächtnisschrift in honor of Jonathan Fitchen*, 2022, [https://ssrn.com/abstract=4024604], accessed on 15/06/2022, p. 4, points out that „given the personal scope, the reach of the due diligence obligations is further limited because the Supply Chain Act does not apply to all companies incorporated or active in Germany… Even though the scope of application will be extended to companies with at least 1,000 employees as of January 1, 2024, only a small fraction of companies based in Germany will have to comply with the already limited requirements of the Supply Chain Act."

[67] Clerc, C.: *The French 'Duty of Vigilance' Law: Lessons for an EU Directive on Due Diligence in Multinational Supply Chains*, *op. cit.,* p. 3, where he suggests that a much simplified version of the duty should apply to SMEs, that the scope of the Law should include all forms of companies, and that the Law should not be limited to companies whose legal seats are based in France but should also include foreign companies doing business in France.

4.1. THE PERSONAL SCOPE OF APPLICATION OF THE FRENCH LOI DE VIGILANCE AND GERMAN LKSG

To determine the personal scope of the application, it is crucial to establish the criteria according to which certain companies fall within the scope of the legal framework. These may be the company's registered office, its legal form, the activities that are the subject of the company's business and the number of employees, defining the term "employees", or which categories of employees are to be taken into account when calculating the threshold. In addition, net turnover may be one of the criteria for determining the personal scope.

Under the French *Loi de vigilance,* companies must meet a total of three criteria to be bound by the adopted legal framework. First, they must have their registered office *(siège social)* in France. However, this condition does not derive from the wording of Article L. 225-102-4 I of the Commercial Code but was confirmed by the French Constitutional Council immediately after the adoption of the *Loi de vigilance*.[68] It should also be emphasized that the *Loi de vigilance* applies to any company with its registered office in France, whether or not it is a subsidiary of a parent company with its registered office abroad, provided that it meets the criteria relating to the corporate form and the number of employees.[69]

Second, they must be organized in a specific corporate form, namely a public limited company (*société anonyme)*, a partnership limited by shares *(société en commandite par actions),* or a European Company *(société européenne).* The *Loi de vigilance* does not list these types of companies. They can only be identified by the position of the provisions of the *Loi de vigilance* in the French Commercial Code.[70] An open question was whether the Law applies to the *société par actions simplifiée* ('SAS'), as this form has become increasingly popular in France due to its flexible structure. Immediately after the adoption of the *Loi de vigilance*, different positions were taken.[71] Both the French gov-

[68] See Conseil constitutionnel, Décision no 2017-750 DC du 23 mars 2017, [https://www.conseil-constitutionnel.fr/decision/2017/2017750DC.htm], para. 3.

[69] Brabant, S.; Savourey, E.: *Scope of the Law on the Corporate Duty of Vigilance, Companies Subject to the Vigilance Obligations,* Revue Internationale de la Compliance et de l'Éthique des Affaires – Supplément à la Semaine Juridique Entreprise et Affaires (N° 50) 2017, [https://media.business-humanrights.org/media/documents/cc551474b8206d6a7b9c6a92c2a3fb280c881139.pdf], accessed on 10/10/2022, p. 2. Savourey, E.: *France Country Report*, *op. cit*., p. 63.

[70] Savourey, E.; Brabant, S.: *The French Law on the Duty of Vigilance: Theoretical and Practical Challenges Since its Adoption*, Business and Human Rights Journal, (6) 2021, p. 144.

[71] See more in Savourey, E.; Brabant, S.: *The French Law on the Duty of Vigilance: Theoretical and Practical Challenges Since its Adoption, op. cit.,* p. 144.

ernment[72] and the General Council of Economy[73] took the position that this form of company is also included in the scope of the application.

The third requirement is that, at the end of two consecutive financial years, 1) at least 5,000 employees work for the company and its direct and indirect French-registered subsidiaries, or 2) at least 10,000 employees work for the company and its direct and indirect French or foreign subsidiaries. Therefore, French subsidiaries of foreign groups may fall within the scope of the Law through their own French and foreign subsidiaries and thus be required to prepare a vigilance plan for their value chains. An exception exists for companies controlled by a company already covered (Art. L. 233-3 of the Commercial Code).[74]

Thus, the companies to be taken into account for determining the scope of the Law are, on the one hand, companies registered in France with at least 5,000 employees in the company itself and its subsidiaries, but only in the subsidiaries with their registered office in France, or, on the other hand, companies registered in France with at least 10,000 employees, including in their subsidiaries with their registered office abroad.

For the calculation of employees (*salariés*) in France, in the absence of specific rules, the usual social rules apply, i.e., the calculation of average employees in full-time equivalents for the year in question, applying the rules provided for in the French *Code du travail* (Articles L1111-2 and L1111-3).[75] For employees abroad, the calculation is more uncertain.

It should be noted that the scope of the French *Loi de vigilance* is not determined based on a turnover threshold. Moreover, in French law, it is important

[72] French Government, Observations du Gouvernement sur la loi relative au devoir de vigilance des sociétés
mères et des entreprises donneuses d'ordre (28 March 2017), [https://www.legifrance.gouv.fr/jorf/id/JORFTEXT000034290672/], accessed on 12/10/2022.

[73] Rapport à Monsieur le Ministre de l'économie et des finances, Evaluation de la mise en œuvre de la loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, *op. cit.,* p. 19.

[74] Article L. 225-102-4, I, paragraph 2 of the Commercial Code provides that: "subsidiaries or controlled companies which exceed the thresholds set out in the first paragraph are deemed to satisfy the obligations provided in this article when the company which controls them, within the meaning of article L. 233-3, establishes and implements a vigilance plan related to the activity of the company and all of the subsidiaries or companies which it controls".

[75] Brabant, S.; Savourey, E.: *Scope of the Law on the Corporate Duty of Vigilance, Companies Subject to the Vigilance Obligations, op. cit.,* p. 2, noting that „… the phrase "employees" (*salariés*) seems to exclude certain forms of employment in particular persons working for the company and its subsidiaries, in France and abroad, under a status other than salaried staff."

to distinguish between the companies that fall within the scope of the *Loi de vigilance* and are thus subject to the vigilance obligation and the companies that fall under the vigilance plan to be drawn up by the companies that fall within the scope of the *Loi de vigilance*.

The Report to the Minister of Economy and Finance on the evaluation of the *Loi de vigilance,* published in February 2020, emphasizes that it is impossible to draw up a reliable list of companies covered by the Law. As for the number of companies, a wide and non-definitive range between 200 and 250 can be given.[76] This number is quite low compared to the thousands of European and non-European companies potentially covered by the CSDD.

The General Council of Economy proposed to amend the scope of the *Loi de vigilance* to make it more precise and to simplify the identification of the companies covered by the Law. Among other things, it proposed extending the scope of application of the *Loi de vigilance* to additional types of companies and to include turnover and/or balance sheet thresholds in addition to the existing thresholds for the number of employees.[77]

Possibly influenced by the European approach, a French parliamentary committee proposed in February 2022 to redefine the scope of the French law by lowering the thresholds for employees and introducing an alternative trigger linked to turnover.[78]

From 2023, the LkSG will apply to companies that have their head office, principal place of business, administrative headquarters, registered office or branch office , and 3,000 employees in Germany. From 2024, it will also apply

[76] Rapport à Monsieur le Ministre de l'économie et des finances, Evaluation de la mise en œuvre de la loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, *op. cit.,* p. 19. Rühl, G.: *Towards a German Supply Chain Act? Comments from a Choice of Law and a Comparative Perspective*, *op. cit.*, p. 14, concluded that only 237 companies would have to comply with the requirements of the new French law. In 2020, the NGO Group (Sherpa and CCFD Terre Solidaire) published a report identifying 265 companies that they determined as falling within the scope of the Law. Out of those, the report indicated that 27% of the companies had not published a vigilance plan (including high-profile companies from French or foreign groups). Sherpa and CCFD Terre Solidaire, Le radar du devoir de vigilance, identifier les entreprises soumises à la loi, June 2021, [https://vigilance-plan.org/wp-content/uploads/2021/07/2021-07-05-Radar-DDV-Rapport-2021-1.pdf], accessed on 05/10/2022.

[77] Rapport à Monsieur le Ministre de l'économie et des finances, Evaluation de la mise en œuvre de la loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, *op. cit.,* p. 58.

[78] Rapport à Monsieur le Ministre de l'économie et des finances, Evaluation de la mise en œuvre de la loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, *op. cit.,* p. 57.

to companies with 1,000 or more employees in Germany. It is estimated that 2,900 German companies and 1,900 foreign companies with a branch in Germany will be covered by the LkSG.[79]

The LkSG applies to foreign companies with a German branch. This provision aims to prevent these companies from relocating their registered offices abroad. They cannot transfer their registered office and principal place of business abroad or convert their German location into a branch office[80] but must leave Germany completely.[81] Foreign companies with German branch offices and German companies are subject to the LkSG in their total value chain, not just in Germany.

The LkSG applies to companies in all industries, regardless of their legal form. The term company in the LkSG is a generic term for all forms of enterprises. It is neutral with regard to legal form. It does not matter whether the company is a limited liability company or a listed company. The LkSG does not impose any restrictions here, as the existence of human rights or environmental risks does not depend on the legal form chosen for a company.[82]

Economically active, publicly owned private-law legal entities fall within the scope of the other requirements of Section 1 LkSG are met. Public corporations that perform certain administrative tasks of a public body according to territorial criteria, on the other hand, do not fall within the scope of application as long as they are not economically active in markets. This must be examined on a case-by-case basis. In principle, hospitals also fall within the scope of the LkSG, provided they meet the employee threshold, are economically active in markets, offer healthcare services in return for payment, bear the associated financial risks, and are purchasers (e.g. of medical equipment). They must also

[79] Grabosch, R.: *The Supply Chain Due Diligence Act, Germany sets new standards to protect human rights,* [http://library.fes.de/pdf-files/iez/18755.pdf], accessed on 21/06/2022., p. 5.

[80] According to Section 13d of the German Commercial Code (Handelsgesetzbuch – HGB), a branch office is an independent entity, not just a representative office, warehouse or sales outlet, in which essential corporate functions such as human resources, finance and accounting, purchasing and sales are performed at least in part. A branch office can easily be converted into a subsidiary. As long as it is not converted, it is not an independent legal entity, cannot enter into contracts with others and is not subject to the legal requirements of the LkSG. Foreign companies conduct their business in Germany through their branch office. They must make their branch offices public and register in the German Commercial Register. See more in Grabosch, R.: *The Supply Chain Due Diligence Act, Germany sets new standards to protect human rights, op. cit.,* p. 5.

[81] Grabosch, R.: *The Supply Chain Due Diligence Act, Germany sets new standards to protect human rights, op. cit.,* p. 5.

[82] See more at Federal Ministry of Labour and Social Affairs, Business and Human Rights, Supply Chain Act, Frequently Asked Questions, [https://www.csr-in-deutschland.de/EN/Business-Human-Rights/Supply-Chain-Act/FAQ/faq.html#doc3a956fcc-c35e-4655-a96a-6a39a1a0a2cfbodyText1], accessed on 20/06/2022.

exercise due diligence.[83] According to the LkSG's explanatory memorandum, financial services are also covered by the LkSG, since investing a larger sum or granting a larger loan triggers further production processes.

According to the German LkSG, the *per capita* principle is used to determine the number of employees. In addition, the general definition of the term "employee" in Section 611a of the German Civil Code (*Bürgerliches Gesetzbuch – BGB) applies*. However, the BGB does not distinguish between part-time and full-time employees. It must be examined whether the respective employee is of significance for the relevant size of the company. This is the case if the duration of employment is at least six months.[84]

According to Section 1 para. 1 sentence 1 no. 2 LkSG, only the employees "normally/usually" (*in der Regel*) employed are relevant. The number of "normally/usually" employed workers is to be determined by way of a retrospective and a forecast of future personnel development. The length of the reference period depends on the individual case but should generally be based on the business year.[85] In assessing the future development of the workforce, the circumstances characterizing the development of the business in the individual case must be determined. This includes, in particular, concrete change decisions by the employer, e.g. whether a continuous reduction of the workforce to

[83] Federal Ministry of Labour and Social Affairs, Business and Human Rights, Supply Chain Act, Frequently Asked Questions, *op. cit*.

[84] In addition to regular full-time and part-time employees, the following employees are included in full (*per capita*): employees posted abroad, temporary agency workers if the period of employment with the user company exceeds six months, senior staff, the following special groups of employees: employees on probation, home workers, dependent commercial agents, employees participating in a short-time work scheme, or employees absent due to maternity leave. The number of employees therefore also includes employees of foreign subsidiaries working in Germany. The following are not *included: temporary agency workers if the duration of the assignment to the user company does not exceed six months, freelancers and self-employed persons, board members of legal entities in general, shareholders of legal entities (exception: any person who is both a non-managing shareholder and an employee of the company), all persons whose primary obligations under the employment contract were suspended for more than six months during one business year (e. g. early retirees, persons in the passive phase of partial retirement, employees on parental leave), civil servants and soldiers (these are employment relationships under public law), trainees,* retrainees within the meaning of the German Vocational Training Act (Berufsbildungsgesetz – BBiG), interns and persons undergoing journalistic training. See more at Federal Ministry of Labour and Social Affairs, Business and Human Rights, Supply Chain Act, Frequently Asked Questions, [https://www.csr-in-deutschland.de/EN/Business-Human-Rights/Supply-Chain-Act/FAQ/faq.html;jsessionid=51E30CD8D538C077B4018324F81ECDC5.delivery2-replication#doc3a956fcc-c35e-4655-a96a-6a39a1a0a2cfbodyText3], accessed on 18/10/2022.

[85] Germany's New Supply Chain Act – Part 4 of 4 – FAQs, [https://www.jdsupra.com/legalnews/germany-s-new-supply-chain-act-part-4-8086307/], accessed on 18/06/2022.

a certain level is planned for the future. It is necessary that this decision has been made by the responsible body of the company and that there is nothing significant to prevent the implementation of the decision.

5. EXPANDING THE SCOPE OF APPLICATION ON SUBSIDIARIES / SUPPLIERS / ESTABLISHED BUSINESS RELATIONSHIPS

Due diligence applies not only to a company's own operations but also to the actions of a contractor and the actions of other subcontractors and suppliers. This means that a company's responsibility no longer ends at its factory gate but applies along the entire supply chain. Therefore, the proposed legal solutions are also relevant for companies that are not directly affected. They may be indirectly affected, for example as suppliers or subcontractors of a company.

According to the CSDD, companies should take appropriate steps to establish and conduct due diligence on their own operations, their subsidiaries, and their established direct and indirect business relationships along their value chains. To determine which business relationships are covered, it is important to define the terms subsidiary, value chain, business relationship, and established business relationship.

According to the CSDD, a subsidiary is a legal entity through which the activities of a "controlled undertaking" within the meaning of Article 2(1)(f) of Directive 2004/109/EC of the European Parliament and the Council are carried out. The CSDD thus explicitly states that a subsidiary must be a legal entity without prescribing its legal form. It must therefore be assumed that it can have any legal form. There is also no indication that the subsidiary must have its registered office in the EU. It is also clear that subsidiaries are included whether they are part of the parent company's value chain. However, for the identification of subsidiaries, the CSDD[86] refers to the definition of „controlled undertaking" in the Transparency Directive. This provision includes entities in which (i) the parent company holds a majority of the voting rights, (ii) the parent company is a shareholder and has the right to appoint or remove a majority of the members of the administrative, management, or supervisory body, (iii) the parent company is a shareholder and controls a majority of the voting rights of the subsidiary through an agreement entered into with other shareholders of the subsidiary, and (iv) over which the parent company has the power to exercise, or does exercise, dominant influence or control.[87]

[86] Article 3(d) of the CSDD.

[87] Zubović, A.: *Stjecanje glasačke kontrole nad uvrštenim društvom (doktorska disertacija),* Zagreb, 2012., p. 6. Čulinović-Herc, E.; Jurić, D.: *Disclosure of Beneficial Ownership – From*

One of the open questions to which the CSDD does not provide a clear answer is whether indirect subsidiaries are included, e.g., a subsidiary controlled by a subsidiary of the company. These are covered by the definition in the Transparency Directive as per the addition of Article 2(1)(f) to the definition in Article 2(2). However, as the CSDD does not refer to the article in the Transparency Directive, indirect subsidiaries do not appear to be covered.[88] Indirectly controlled subsidiaries may, however, be part of the company's value chain and thus included in the due diligence process. This could lead to companies changing their group structure and operations to avoid the obligations imposed on them if the proposed CSDD is adopted.

The approach adopted in the CSDD has several shortcomings. First, if a group is headed by a parent company that has neither the number of employees nor the turnover required by the CSDD, the parent company is not required to conduct due diligence on its subsidiaries. However, if a subsidiary has the size required by the CSDD, that subsidiary must conduct due diligence in its operations and in its subsidiaries. Other subsidiaries owned by the parent company may escape this obligation.[89] In addition, groups can speculate and thus avoid applying the CSDD, or at least avoid applying it to those group companies most likely to be associated with human rights and environmental risks.

According to Article 3(1)(g) of the CSDD, the term "value chain" means the activities related to the production of goods or the provision of services by a company, including the development of the product or service and the use and disposal of the product, as well as the related activities of upstream and downstream established business relationships of the company. Concerning regulated financial undertakings as defined in Article 3(1)(a)(iv) of the CSDD, the "value chain" about the provision of these specific services includes only the activities of the clients receiving the such loan, credit, and other financial services and of other companies belonging to the same group whose activities are linked to the contract in question. The value chain of such regulated financial undertakings does not include the SMEs that receive loans, credits, financing, insurance, or reinsurance from such entities. The doctrine takes the position that, despite the scope of the definition, only B-to-B relationships should be covered.[90]

EU Major Shareholdings Directive to EU new Transparency Directive – What needs to be changed in Croatian Securities Markets Act?, 5th International Conference „Economic integrations, competition and cooperation", Rijeka, 2005., p. 12-18

[88] Sørensen, K. E.: *Corporate Sustainability Due Diligence in Groups of Companies*, Nordic & European Company Law Working Paper No. 22-02, [https://ssrn.com/abstract=4141862], accessed on 03/11/2022, p. 5.

[89] *Ibid.,* p. 2.

[90] Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 33.

It is also important to distinguish between the terms „subsidiary“ and “value chain” because, although some associated undertakings and joint ventures are not considered subsidiaries, they may still be part of the company’s value chain if they engage in activities related to the company’s operations.[91] The main requirement for determining the value chain is the existence of an “established business relationship”. According to Art. 3(1)(f) of the CSDD, “established business relationship” means a direct or indirect business relationship which is, or which is expected to be lasting, in a view of its intensity or duration and which does not represent a negligible or merely ancillary part of the value chain. This differs from the UNGPs, which specify that human rights and environmental due diligence are carried out throughout the value chain, and do not include a restriction to “established business relationships”.

For purposes of the CSDD business relationship means a relationship with a contractor, subcontractor, or any other legal entities (“partner”): (i) with whom the company has a commercial agreement or to whom the company provides financing, insurance, or reinsurance, or (ii) that performs business operations related to the products or services of the company for or on behalf of the company. Therefore, Article 3(e)(i) of the CSDD states that a business relationship is part of the value chain even if it is not related to the company’s business operations if the company either has a commercial agreement with the company or provides financing or insurance. Although the latter provision is primarily aimed at financial institutions, it could be interpreted to include non-financial institutions that invest in affiliated companies or joint ventures.

The French *Loi de vigilance* extends due diligence obligations to third parties (Article L. 225-102-4 I para. 3 of the Commercial Code). Companies covered by the *Loi de vigilance* must ensure that controlled companies *(sociétés directement ou indirectement controllées*), subcontractors *(sous-traitants)* and suppliers *(fournisseurs)* do the same. The vigilance plan must therefore cover: the activities of the companies that fall within the scope of the *Loi de vigilance* and are therefore responsible for drawing up the vigilance plan, the activities of the companies that are directly or indirectly controlled by the company falling within the scope of the *Loi de vigilance* as defined in Article 233-16-II of the Commercial Code, and the activities of subcontractors or suppliers with whom an established commercial relationship exists if these activities are related to that relationship. These provisions raise a number of questions, as the key terms used to determine the value chain are not explicitly and clearly defined in national legislation.

[91] Sørensen, K. E.: *Corporate Sustainability Due Diligence in Groups of Companies, op. cit.*, p. 4.

In French law, subsidiaries or controlled companies are explicitly mentioned in three provisions about the fulfilment of vigilance obligations. The first provision establishes the personal scope of the *Loi de vigilance*. Therefore, in order to determine whether a company falls within the scope of the Law, its "direct and indirect subsidiaries" must be identified. This identification of subsidiaries is thus an essential prerequisite for counting employees. However, the definition of the scope of the Law does not clearly define the term "subsidiary". In the absence of clarification by the *Loi de vigilance*, the question arises whether this means that the definition of a "subsidiary" under Article L. 233-1 of the Commercial Code applies. According to this article, a subsidiary is a company in which more than half of the company capital is held by another company. The doctrine also seems to favor of a positive answer to this question.[92] Both the OECD Guidelines and the UNGPs favor a broad interpretation of the concept of control.[93]

Another provision that explicitly mentions both subsidiaries and controlled companies is the one that provides for exceptions to the vigilance obligation. The term "controlled companies", which is not mentioned in determining the scope of the Law, appears in the scope of the exemptions. They are defined by reference to Article L. 233-3 of the Commercial Code which contains various hypotheses of control, including joint control and the presumption of control. Thus, the question is whether this exemption mechanism is mandatory or optional for subsidiaries and controlled companies. What happens if the parent company or its subsidiary wants the subsidiary to be bound by the vigilance obligations? The use of the words "are deemed" by the legislator could appear to introduce a non-rebuttable presumption (*présomption irrefragable*) resulting from the parent company's compliance with the vigilance obligations for its subsidiaries and controlled companies. This mechanism does not seem to be a flexible and adaptable tool and is likely to promote the management/distribution of responsibility within groups. In any case, when applying this exemption, it is important that the parent company ensures the application of procedures and indicators in the exempt companies when preparing its vigilance plan and its subsequent effective implementation. In this way, the effective implementation of the plan is ensured.[94]

The third provision prescribes the content of the vigilance plan, which must include, among other things, appropriate due diligence measures arising from the activities of the controlled companies. The controlled companies whose

[92] Brabant, S.; Savourey, E.: *Scope of the Law on the Corporate Duty of Vigilance, Companies Subject to the Vigilance Obligations, op. cit.*, p. 6.

[93] See Principle 14 of the UNGPs on Business and Human Rights, *op. cit.*

[94] Brabant, S.; Savourey, E.: *Scope of the Law on the Corporate Duty of Vigilance, Companies Subject to the Vigilance Obligations, op. cit.*, p. 8.

activities must be included in the vigilance plan are determined by reference to Article L. 233-16-II of the Commercial Code, as outlined in the *Loi de vigilance*. The control provided for in Article L. 233-16-II is classified as "exclusive control" because it allows the company to exercise decision-making power, in particular over the financial and business policies of another company. This control may be exercised in different ways: legal control, when it results from the direct or indirect holding of the majority of the voting rights in another company (art. L. 233-16, II, 1° of the Commercial Code), *de facto* control, when it results from the right to appoint, for two consecutive financial years, the majority of the members of the administrative, management or supervisory bodies of another company (art. L. 233- 16, II, 2° of the Commercial Code) or contractual control (art. L. 233-16, II, 3° of the Commercial Code), when a company is contractually or legally entitled to „use or determine the use of the assets of another company in the same manner" as it controls its assets. This concept of exclusive control significantly expands the number of companies to be included in the scope of the plan, especially since such control may be direct or indirect, as specified in the *Loi de vigilance*.[95]

In France, subsidiaries appear to be covered even if they are not part of the parent company's supply chain since they do not contribute to the production of the parent company's goods and provision of its services. Unlike French law, which uses an impersonal formulation, the European reference to the value chain of „the company "[96] may raise doubts as to whether the value chain of the subsidiaries should be included.[97]

The term subcontractor is defined in the Law of December 31, 1975, as follows „subcontracting is the operation whereby a contractor entrusts to another person, called a subcontractor (*sous-traitant*), through a subcontractee (*sous-traité*) and under the latter's responsibility, the execution of all or part of the service or procurement contract concluded with the principal (*maître de l'ou-*

[95] The European Commission emphasizes that the French *Loi de vigilance* "is also innovative because it recognizes that control can be exercised through contracts". Commission Staff Working Document, Impact Assessment Report, Accompanying the document Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, (SWD(2022) 42 final, Brussels, 23/02/2022), p. 25. See more in Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 26.

[96] Art. 1(1) of the CSDD.

[97] This kind of ambiguity reflects the difficulties of the transition from soft law to hard law. It is significant that the 2011 UNGPs make no reference to "subsidiaries" and are explained only in terms of "business enterprises". See more in Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 22-23.

vrage)".[98] While the concept of a subcontractor is defined and relatively limited, the opposite is assumed for the concept of a supplier.[99]

However, the French *Loi de vigilance* does not require companies to avoid all human rights violations, but only those that are considered serious *(atteintes graves)*. Moreover, human rights due diligence do not extend to all companies in the supply chain. According to Article L. 225-102-4 I (3) of the Commercial Code, only subcontractors, and suppliers with whom there is an established commercial relationship *(relation commercial etablie)* must be included in the vigilance plan if this relationship is related to the activities in question.[100] The term "established commercial relationship" refers to former Article L 442-6-I of the Commercial Code (now Article L. 442-1-II of the Commercial Code), which prohibits the sudden termination of commercial relationships when they are established.[101] The question of whether there is an established commercial relationship is subject to case law, which takes into account the duration, frequency, and growth of the commercial relationship. Indirect relationships with subcontractors and suppliers up to an undetermined rank in the usual supply chain must also be considered. Because the *Loi de vigilance* does not clearly specify the entities for which the existence of an established commercial relationship must be determined, the question arises as to whether and to what extent this type of relationship is limited to first-tier partners or whether it also extends to cascading partners, potentially extending the duty of vigilance to millions of companies.[102] In answering this question, the doctrine refers to the

[98] Loi n° 75-1334 du 31 décembre 1975 relative à la sous-traitance, (JORF du 3 janvier 1976), art. 1. See more in Brabant S.; Michon, C.; Savourey E.: *The Vigilance Plan - Cornerstone of the Law on the Corporate Duty of Vigilance*, Revue Internationale de la Compliance et de l'Éthique des Affaires – Supplément à la Semaine Juridique Entreprise et Affaires (N° 50) 2017, [https://media.business-humanrights.org/media/documents/ba571b7294311e42b3605af-7cc4eeaad149c33b2.pdf], accessed on 06/10/2022.

[99] See more in Brabant S.; Michon, C.; Savourey E.: *The Vigilance Plan - Cornerstone of the Law on the Corporate Duty of Vigilance*, *op. cit.*

[100] The concept of „established commercial relationship" was preferred to the originally proposed concept of „decisive influence" on the activities of subcontractors or suppliers for reasons of effectiveness and clarity. Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 26. Rühl, G.: *Towards a German Supply Chain Act? Comments from a Choice of Law and a Comparative Perspective*, *op. cit.*, p. 14. Brabant S.; Michon, C.; Savourey E.: *The Vigilance Plan - Cornerstone of the Law on the Corporate Duty of Vigilance*, *op. cit.*

[101] For the purposes of French law, an "established commercial relationship" is a regular and stable relationship, with or without a contract, which has a certain volume of business and can reasonably be expected to last.

[102] Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 27.

Constitutional Court's decision confirming that subcontractors and suppliers fall within the ambit of the vigilance plan if they have an established commercial relationship with the parent company or the companies it controls.[103]

The supply chain as defined in Section 2(5) of the LkSG refers to all products and services of a company. It includes all steps in Germany and abroad that are necessary for the manufacture of products and the provision of services, beginning with the extraction of raw materials and ending with delivery to the end customer, and includes the actions of a company in its own business, the actions of direct suppliers and the actions of indirect suppliers. The due diligence obligations under Section 2(5) sentence 2 of the LkSG, therefore, extend not only to actions in the company's business area, but also to the actions of all direct and indirect suppliers, and to the entire supply chain. Thus, for the first time in German history, the LkSG introduces due diligence obligations that require companies to pay attention to what other, legally independent companies are doing. This also applies to the use of necessary services, such as the transport or temporary storage of goods. This risk assessment obligation is activated whenever the company "must expect a significantly changed or significantly expanded risk situation in the supply chain, for example, due to the introduction of new products, projects or a new business field".[104] Changes in business operations require an *ad hoc* review of identifiable, typical risks in the supply chain.

Own business includes all activities of the company to achieve the business objective. This includes any activity for the creation and exploitation of products and services, regardless of whether it is carried out at a location in Germany or abroad. In the case of affiliated companies, the parent company's business operations include a group company if the parent company exercises a decisive influence over the group company.[105]

As mentioned above, the business relationships and production methods of direct suppliers must be taken into account in addition to the company's business area. For the purposes of the LkSG, a direct supplier is a partner in a contract

[103] Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit*., p. 27., where he refers to the decision of the Constitutional Court of March 23, 2017, prec., § 11, which states that „the group of economic partners of the company subject to the obligation to draw up a plan [...] includes all the companies directly or indirectly controlled by that company, as well as all the subcontractors and suppliers with which it has an established commercial relationship, regardless of the nature of the activity of those companies, their workforce [effectifs], their economic weight or the place of establishment of their activities."

[104] Section 5(4) of the LkSG.

[105] Section 2(6) of the LkSG.

for the supply of goods or the provision of services whose supplies are necessary for the production of the company's product or the provision and use of the relevant service.[106] Furthermore, if a company has factual indications that suggest a violation of human rights or environmental obligation by an indirect supplier, it must take appropriate measures without delay. An indirect supplier within the meaning of the LkSG is any company that is not a direct supplier and whose supplies are necessary for the manufacture of the company's products or the provision and use of the relevant service.[107] It should be emphasized, however, that these requirements of the LkSG only extend to indirect suppliers if a company gains "substantiated knowledge" of human rights violations or environmental violations at this level (Section 9(3) LkSG).[108] This knowledge can come from a variety of sources, such as complaints received through the complaints procedure, reports from NGOs and trade unions, or tips from government authorities.[109]

As a lack of regulation, it is pointed out that companies have to comply with Sections 3 et seq. of the LkSG only when manufacturing products and providing services, while other business relationships are excluded.[110] As a result, risks associated with suppliers responsible for ancillary services (e. g., building cleaning and office catering) can often be completely disregarded or addressed with little effort, either because there is no causal contribution (see Section 4(2) LkSG) or because the causal contribution is insignificant (see Section 5(2) LkSG). It is also emphasized that the intensity of the due diligence obligations decreases along the supply chain. In fact, they only apply to the company's own business and its relationships with its direct suppliers. Concerning indirect suppliers, companies are only required to conduct a risk analysis if they receive "substantiated knowledge" indicating the possibility of a human rights violation or environmental damage. If this is the case, companies are only required to set up the complaint mechanism required by Section 9 of the LkSG.

[106] Section 2(7) of the LkSG.

[107] Section 2(8) of the LkSG.

[108] Initiative Lieferkettengesetz, *What the new Supply Chain Act delivers – and what it doesn't, op. cit.,* p. 4, points out that this is one of the shortcomings of the legal framework, as this restriction is not compatible with the preventive idea of the UN Guiding Principles. Furthermore, it emphasises that it is well known that a large proportion of human rights violations occur precisely at the beginning of supply chains, i.e. in the area of indirect suppliers. In order for companies to be able to adequately prevent these, a systematic and forward-looking analysis of possible risks is required, including those that are not publicly known.

[109] Grabosch, R.: *The Supply Chain Due Diligence Act, Germany sets new standards to protect human rights, op. cit.,* p. 5.

[110] Rühl, G.: *Towards a German Supply Chain Act? Comments from a Choice of Law and a Comparative Perspective*, *op. cit.*, p. 3.

This means, in particular, that there is no obligation to establish a human rights risk management system or to conduct regular risk analyses with respect to the more distant links in the supply chain.[111]

With regard to affiliated companies, the German legislator has taken the position that all forms of affiliated companies as defined in Section 15 of the German Stock Corporation Act (*Aktiengesetz* – AktG) are covered by the LkSG. The parent company must count the employees of its subsidiaries, etc., if the parent company, its subsidiaries and the subsidiaries of its subsidiaries are affiliated companies within the meaning of Section 15 of the AktG. Counting is always done from "bottom to top", i.e. the employees of the subsidiaries count for the parent company. However, the employees of the parent company are not counted for the subsidiary.[112]

Own business operations include not only the company itself but also affiliated companies in Germany and abroad. The prerequisite for this is that the parent company exercises a decisive influence over the other companies in the group. It must be able to exercise this influence under the applicable law. Whether a decisive influence is possible is determined by an overall consideration of the business, personnel, organizational and legal interrelationships between the subsidiary and the parent company. Indications are a large majority shareholding in the subsidiary, a group-wide compliance system, responsibility for controlling key processes in the subsidiary, a similar business area, or overlapping personnel.[113] Thus, if the German parent company has a decisive influence on a foreign subsidiary, it must fulfill all due diligence obligations concerning the subsidiary, regardless of whether the subsidiary operates in Germany or exports to Germany.

The group of consolidated companies of Section 1(3) of the LkSG only covers group divisions located in Germany and all possible cases are listed in section 15 of the AktG. Employees of a foreign parent company or foreign subsidiaries of a domestic parent company are not taken into account. In this context, we must distinguish between several scenarios.

The first scenario is the case where both the parent company and the subsidiary are covered by the LkSG, but there is no decisive influence of the parent

[111] *Ibid*., p. 3. Krajewski, M.; Tonstad, K.; Wohltmann, F.: *Developments in the Field Mandatory Human Rights Due Diligence in Germany and Norway: Stepping, or Striding, in the Same Direction?*, Business and Human Rights Journal, 6(3) 2021, p. 550-558.

[112] Federal Ministry of Labour and Social Affairs, Business and Human Rights, Supply Chain Act, Frequently Asked Questions, *op. cit*.

[113] Federal Ministry of Labour and Social Affairs, Business and Human Rights, Supply Chain Act, Frequently Asked Questions, [https://www.csr-in-deutschland.de/EN/Business-Human-Rights/Supply-Chain-Act/FAQ/faq.html#doc3a956fcc-c35e-4655-a96a-6a39a1a0a2cf-bodyText1], accessed on 20/06/2022.

company on the subsidiary. In this case, both companies must comply with the due diligence obligations for their business and supply chains. Separate implementation is to be assumed.[114] If the subsidiary is also a direct supplier of the parent company, then the parent company must also fulfill its due diligence obligations for direct suppliers concerning this subsidiary.

The second scenario is the case where both the parent company and the subsidiary are covered by the LkSG, but there is a decisive influence of the parent company on the subsidiary. In this case, the parent company must comply with the due diligence obligations for its business area and supply chains. This also applies to the business area and supply chains of the subsidiary. The responsibility extends to the commercial activities of the subsidiary in relation to the manufacture and exploitation of products and the provision of services. It does not matter whether a subsidiary supplies its products or services to the parent company or sells them to third parties. Depending on individual risk susceptibility, the subsidiary's risk management system may be set up in the parent company itself or the subsidiary. The subsidiary itself is also responsible for ensuring that due diligence obligations are met in its business area and supply chains.[115]

The third scenario is the case where only the parent company of the group, but not the subsidiary, falls within the scope of the LkSG. In this case, the parent company must fulfill the due diligence obligations for its business area and supply chains. This also applies to the business area and supply chains of a subsidiary if the parent company exercises a decisive influence over the subsidiary. In cases where the influence is not decisive, the parent company only has to review the subsidiary's risk management activities in accordance with the requirements of the LkSG if the subsidiary is a (direct) supplier of the parent company. In these cases, the subsidiary itself is not legally required to implement or report on the due diligence measures itself.[116]

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[114] Thus, both must publish their own reports under Section 10 (2) of the LkSG. Independently of this, the companies can coordinate the measures they take. For example, the subsidiaries can adopt suitable measures from the parent companies (e.g., policy statements/training, etc.) and implement them on their own responsibility. This can then be presented in the required report. Federal Ministry of Labour and Social Affairs, Business and Human Rights, Supply Chain Act, Frequently Asked Questions, *op. cit.*

[115] In these cases, it may be appropriate to reduce the parent company's obligations to mere monitoring obligations to the subsidiary. Another possibility is that the subsidiary must prove that the parent company has fulfilled its obligations. This depends on the structure of the group and the respective risk exposure of the parent company and its subsidiaries. Federal Ministry of Labour and Social Affairs, Business and Human Rights, Supply Chain Act, Frequently Asked Questions, *op. cit.*

[116] However, the German government expects companies that do not fall within the scope of the law to comply with their human rights due diligence obligations as set out in the National

The fourth scenario is the case where only the subsidiary, but not the parent company, falls within the scope of the LkSG (e.g., subsidiary of a U.S. parent company). In this case, the subsidiary must conduct due diligence for its business area and supply chains, but not for the entire group. The activities of the parent company do not have to be taken into account by the subsidiary.[117]

With regard to the LkSG, it is crucial that (subsidiary) companies comply with the legal requirements. This can be achieved through a uniform risk management system at the group level or through a risk management system designed by the German subsidiary itself.

6. EFFECTS OF THE CSDD, *LOI DE VIGILANCE,* AND LKSG ON SMALL AND MEDIUM-SIZED ENTERPRISES (SMES)

The literature on the impact of due diligence regulations on SMEs shows that SME companies can be directly and indirectly affected by such measures. Many studies distinguish between the impact on SMEs that fall directly within the scope of the regulations, e.g., publicly-listed SMEs in the case of the EU's NFRD (now CSRD), and SMEs that are affected by second-round effects, e.g., small businesses that must report relevant information to corporate clients or suppliers that are directly affected by the regulation.[118] It is noted that there are currently about 24 million companies in the EU, of which about *80 % are limited liability companies*. About *98-99 % of limited liability companies are SMEs*.[119]

According to the CSDD, SMEs, which include microenterprises are exempt from due diligence. The chosen solution is justified by the fact that for this category of companies, the financial and administrative burden of implementing and carrying out due diligence would be relatively high, as they do not already have due diligence mechanisms in place, do not possess the know-how, and do not have specialized personnel. However, they will be exposed to some of the costs and burdens through business relationships with companies that fall

Action Plan for Business and Human Rights. Federal Ministry of Labour and Social Affairs, Business and Human Rights, Supply Chain Act, Frequently Asked Questions, *op. cit*.

[117] Federal Ministry of Labour and Social Affairs, Business and Human Rights, Supply Chain Act, Frequently Asked Questions, *op. cit*.

[118] European Commission, Directorate-General for Justice and Consumers, Torres-Cortés, F., Salinier, C., Deringer, H. *et al.: Study on due diligence requirements through the supply chain: final report*, op. cit., p. 319.

[119] European Parliament, Fact Sheets on the European Union, [https://www.europarl.europa.eu/factsheets/en/sheet/35/company-law], accessed on 10/11/2022.

within the scope, as the CSDD indirectly applies to SMEs that are part of the value chains of larger companies. Therefore, companies whose business partner is an SME are required to assist them in complying with due diligence requirements if such requirements would jeopardize the viability of the SME.[120] However, the financial sector value chain does not include SMEs that receive loans, credits, financing, insurance, or reinsurance.[121]

Under French law, SMEs do not fall directly within the personal scope of the *Loi de vigilance*. In practice, however, as subcontractors or subsidiaries of the company fall within the scope of the law, they are likely to feel its effects. This effect may occur through contractual clauses in B2B business contracts and other measures.

In France, it is estimated that „80% of French SMEs and midcaps (which do not fall within the scope of French law) are asked by their contractors on CSR issues to sign a charter or code of conduct, to commit to complying with key social and environmental standards (health/safety, waste management, business ethics or human rights), sign clauses in their contracts or undergo an extra-financial audit."[122]

As a rule, companies that do not fall within the scope of the German LkSG must also comply with their due diligence obligations under the National Action Plan on Business and Human Rights (NAP), which sets out corresponding expectations for all companies based in Germany and has already been in force since 2016.

In addition, if companies outside the scope of the LkSG are direct suppliers to companies covered by the LkSG, they may be required to comply with due diligence obligations as part of their contractual relationship (which may include, for example, provisions setting out human rights-related expectations). However, due to their nature, the obligations of the LkSG cannot simply be shifted to suppliers. This applies, for example, to reporting obligations to the authority and the public. In addition, companies subject to the LkSG remain responsible for keeping track of their supply chains and complying with obligations to conduct a risk analysis and take preventive and remedial action.

[120] Preamble of the CSDD, p. 47.

[121] Explanatory memorandum of the Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, (COM/2022/71 final, 2022/0051(COD), 23/02/2022), p. 14.

[122] Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 26. Commission Staff Working Document, Impact Assessment Report, *op. cit.,* p. 27.

In both France and Germany, there are initiatives proposing to extend the scope of due diligence/vigilance obligations to SMEs. It is argued that SMEs can also have significant negative impacts on human rights and environmental issues if they operate in a risk sector.[123] One of the proposals is to impose a much-simplified version of due diligence obligations on SMEs.[124] The same position is taken by some scholars regarding the scope of application of the CSDD. They propose to extend the scope to SMEs, defining it by size or sector.[125]

7. CONCLUSION

The Commission's proposal on CSDD, published on February 23, 2022, is inspired by and built on the French model. The two articles of the French Commercial Code are expanded in the EU proposal to some thirty articles setting out the due diligence obligations to be imposed on a broader range of companies, including non-European companies operating in Europe, concerning actual and potential adverse human rights and environmental impacts, about their own operations, the operations of their subsidiaries, and the value chain of operations carried out by entities with which the companies have established direct or indirect business relationships.[126] Companies must monitor adverse human rights and environmental impacts not only by themselves and their subsidiaries but also by entities that are part of their value chain and with which they have an established business relationship, regardless of where they are incorporated or located.

A comparison of the French and EU texts shows that, despite the general inspiration and direction, there are significant differences between the two models in terms of scope, the content of obligations, and enforcement. The European proposal appears more comprehensive, extensive, detailed, and threatening to the corporate status quo. It contains several technical references that should be clarified or corrected during the negotiation process for the final text. It also contains a number of policy choices that differ from those in French law. These include 1) application to a broader range of companies, including non-

[123] Initiative Lieferkettengesetz, What the new Supply Chain Act delivers – and what it doesn't, *op. cit.,* p. 5

[124] Clerc, C.: *The French 'Duty of Vigilance' Law: Lessons for an EU Directive on Due Diligence in Multinational Supply Chains*, *op. cit.,* p. 3.

[125] Methven O'Brien, C.; Martin-Ortega, O.: *Sustainable corporate governance: Submission to Consultation on European Commission's proposal for a Directive on corporate sustainability due diligence COM(2022)71 final*, *op. cit.*, p. 7.

[126] Pietrancosta, A.: *Codification in Company Law of General CSR Requirements: Pioneering Recent French Reforms and EU Perspectives, op. cit.,* p. 22.

EU companies operating in Europe, 2) provisions on climate change, and 3) the introduction of a general duty of care for directors on various social and environmental issues, which is likely to face strong national opposition.[127] Compared to the French system, the European proposal is much more specific and detailed. It clearly attempts to respond to the criticism that has been levelled at it and at the European Parliament's March 2021 resolution.[128]

With the LkSG, which will come into force on January 1, 2023, the German legislator has also regulated the issue of due diligence in the value chain. Compared to French law, the German LkSG is much more detailed. The German solution also differs from the French solution and the CSDD in terms of personal scope. While the LkSG and its obligations only apply to companies with more than 3,000 employees in Germany (the LkSG provides for an extension of the personal scope to companies with more than 1,000 employees in Germany from 2024), the CSDD has a broader personal scope.

The extended personal scope, which prescribes due diligence in the upstream and downstream value chain worldwide and provides for liability for having established business relationships with business partners who do not comply with human rights and environmental law conventions, is assessed as extraterritorial, a kind of „Brussels effect" for companies outside the EU.

It is specifically noted that non-EU parent companies operating in the EU through their subsidiaries would be indirectly affected by the application of the CSDD.[129] For example, if an EU subsidiary of a non-EU parent is subject to the CSDD because it exceeds the required quantitative (and possibly qualitative)[130] thresholds, the non-EU parent would have to adjust accordingly. This is because the parent company's business is part of the subsidiary's value chain that falls under the regulatory umbrella. Therefore, the non-EU parent would have to comply with the international conventions listed in Annexes 1 and 2 of the CSDD. Otherwise, its non-compliance could be considered non-compliance at the subsidiary level, as the parent company is part of the subsidiary's supply chain. However, under the domestic law of the non-EU parent, a particular international convention might not be part of the hard law, either because it has been ratified but is subject to a reservation, or because it has not been

[127] *Loc. cit.*

[128] *Ibid.*, p. 32.

[129] Enriques L.; Gatti M: *Extraterritorial Impact of the Proposed EU Directive on Corporate Sustainability Due Diligence: Why Corporate America Should Pay Attention,* [https://blogs.law.ox.ac.uk/business-law-blog/blog/2022/04/extraterritorial-impact-proposed-eu-directive-corporate], accessed on 10/11/2022.

[130] i.e. high sector

ratified at all. Enriques and Gatti[131] cite as an example the 1949 ILO Convention on the Right to Organise and Collective Bargaining, which has not been ratified in the United States. As a result, the labor practices of the U.S. parent company may not meet international standards and could be considered to have an „adverse impact on human rights" making the EU subsidiary liable for non-compliance. Sanctions imposed on the subsidiary would also impact the U.S. parent company. Companies under the umbrella of the CSDD should monitor not only themselves and their subsidiaries, but also companies that are part of their value chain and with which they have an established business relationship, for adverse human rights and environmental impacts, regardless of where they are incorporated or located. In addition, the CSDD requires that the target company first prevent these "adverse impacts". If that is not possible, it should bring them to an end. And if that is not possible, Member States must ensure that companies minimize the extent of these impacts (Article 8(2) of the CSDD).

Another problem is the definition of the legal concept of sustainability. Sustainability as a legal concept is defined in many provisions of human rights and environmental law conventions, listed in Annexes 1 and 2 of the CSDD. Because of the general wording regularly used in international conventions, directors may have difficulty identifying the precise obligations of companies. The provisions of these conventions were originally directed at signatory countries, not companies. However, companies and their directors could face very harsh sanctions if they breach these very generally defined obligations. These new obligations and liabilities could cause directors to become fearful and defensive. The insurance market will certainly grow as new liability risks need to be covered. Another concern is the cost of these new due diligence obligations. Although it could be argued that target companies can afford these costs because of the amount of their net turnover, sustainability due diligence extends far beyond the company itself. It also extends to established customers and suppliers upstream and downstream in the value chain. A new set of obligations will therefore increase compliance costs. As a result, target companies may be at a competitive disadvantage compared to companies outside the scope of the CSDD. This will affect the speed of their adaptation, which is crucial for the survival of the company.

By indirectly imposing EU-accepted standards and values in several areas that are critical to business operations, the CSDD would extend the extraterritorial reach of EU law in areas that are both highly politically sensitive and critical to a country's decisions about how to ensure the international competitiveness

[131] Enriques L.; Gatti M: *Extraterritorial Impact of the Proposed EU Directive on Corporate Sustainability Due Diligence: Why Corporate America Should Pay Attention, op. cit.*

of its businesses.[132] Thus, non-EU companies that have a substantial part of business in Europe will thus have to decide whether to move out of the EU or comply with EU rules.

As Pargendler[133] noted, the CSDD departs from its predecessor, the NFRD, because the relevant thresholds in the CSDD, which are based on a minimum number of employees and net turnover are measured at the entity level rather than at the group level. Thus, the CSDD departs from the approach adopted in the NFRD, which defines the relevant thresholds on a group-based and consolidated basis. Thus, the current text offers the company a relatively easy way to circumvent the CSDD,[134] as a sort of defensive tactic. Targeted companies could segment their businesses by founding new subsidiaries and ensuring that they never exceed the thresholds. In particular, they can ensure that their high-risk business operations, which are subject to lower threshold, are restructured into scalable corporate forms that do not exceed the thresholds.

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[132] *Loc. cit.*

[133] Pargendler M.; *The EU Proposal on Corporate Sustainability Due Diligence and the Mystique of Complete Corporate Separateness*, [https://blogs.law.ox.ac.uk/business-law-blog/blog/2022/04/eu-proposal-corporate-sustainability-due-diligence-and-mystique], accessed on 10/11/2022.

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58. Zubović, A.: *Stjecanje glasačke kontrole nad uvrštenim društvom (doktorska disertacija),* Pravni fakultet, Sveučilište u Zagrebu, 2012.

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GRANULARITY AND SPECIFICITY OF CONSENT AND IMPLICATIONS THEREOF FOR THE DATA CONTROLLER IN THE LIGHT OF THE PRINCIPLE OF 'PURPOSE LIMITATION'

Juanita Goicovici *

ABSTRACT

The study discusses the problematics of the granularity and specificity of the data subject's consent, in the light of the principle of 'purpose limitation' when collecting and processing personal data while distinguishing between the imperatives deriving from the principle of purpose limitations (i) form those arising from the incidence of the principle of storage limitations (ii). These issues remain highly important in litigious hypotheses of processing personal data of customers collected and stored unlawfully, including in terms of post-verification of the processing purposes. Secondly, the study focuses on the limits of the purpose limitation principle, set out in Article 5 para. (1), (b) of the GDPR, including bifurcated components: personal data must, on the one hand, be collected for determined, explicit, and legitimate purposes, and, on the other hand, not to be further processed in a manner which becomes incompatible with the initial collecting purposes. We argue that the mentioned principle aims to delimit as clearly as possible the use of personal data by ensuring a balance between respect for the fundamental rights of data subjects in terms of privacy and data protection and the recognition of certain flexibility in favor of the operator in the management of such data, as imposed by digitalization and its inherent risks. In its second component, which is of particular interest to us in the present study, the purpose limitation principle seeks to define the extent to which personal data collected for a particular purpose may be reused by companies, since any processing after collection must be considered as 'further processing' and must therefore meet, with certain exceptions, the purpose-compatibility requirements.

KEYWORDS*: specificity of consent, the principle of accountability, granular consent, personal data, purpose limitation, GDPR.*

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1. INTRODUCTORY REMARKS

The problematics of the specificity of consent for the processing of consumers' personal data, especially in terms of complying with the granularity rules applicable to the collecting of consumers' consent, continue to generate provocative controversies, mainly from the perspective of detailing the data processing purposes and operations taxonomy for the personal data controller[1]. Firstly, the study approaches the limitations related to the sequencing of processing purposes, in situations where the collecting and processing of personal data are based on the existence of consumer consent; the "stratification" of personal data processing purposes, as well as the "stratification" of consent for each type of processing operation represent special requirements arising from the condition of granular consent, implying that consumer's consent requested in general terms will not be valid, "for any personal data processing operation" or the so-called "purposes related to the execution of the contract", without an explicit statement and distinct from each of the data processing purposes (so-called "sequencing of the processing purposes"). Secondly, the granularity rule[2] is discussed about the exigencies of the principle of 'purpose limitation' when collecting and processing personal data, while distinguishing between the imperatives deriving from the principle of purpose limitations (i) from those arising from the incidence of the principle of storage limitations (ii), including in terms of post-verification of the processing purposes[3].

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[1] See, for further details, Brunessen, B.: *Protection des données personnelles et nouveaux modes de production du droit*, Bruylant, Bruxelles, 2022, pp. 84-96; Cellina, E.: *La commercialisation des données personnelles. Aspects de droit contractuel et de protection des données*, Schulthess, Geneva, 2020, pp. 37-41; Martial-Braz, N., Rochfeld, J.: *Droit des données personnelles. Les spécificités du droit français au regard du RGPD*, Dalloz, Paris, 2019, pp. 96-102; Mattatia, F.: *RGPD et droit des données personnelles*, 5e édition, Eyrolles, Paris, 2021, pp. 117-121; Maxim, M.: *Răspunderea civilă contractuală în domeniul protecției datelor cu caracter personal în contextul noului Regulament general (UE) privind protecția datelor 2016/679*, Universul Juridic, București, 2021, pp. 323-338.

[2] Claeys, I., Terryn, E.: *Digital Content and Distance Sales*, Intersentia, Bruxelles, 2017, pp. 92-104; Cremona, E., Laviola, F., Pagnanelli, V. (eds.): *Il valore economico dei dati personali tra diritto pubblico e diritto privato*, Giappichelli Editore, Torino, 2022, p. 117-123.

[3] Custers, B., Vrabec, H., Friedewald, M.: *Assessing the Legal and Ethical Impact of Data Reuse,* European Data Protection Law Review 5 (3) 2019, pp. 317-337, DOI: https://doi.org/10.21552/edpl/2019/3/7.

Thirdly, the study focuses on the limits of the purpose limitation principle, set out in Article 5 para. (1), (b) of the GDPR, including bifurcated components: personal data must, on the one hand, be collected for determined, explicit, and legitimate purposes, and, on the other hand, not to be further processed in a manner which becomes incompatible with the initial collecting purposes. We argue that the mentioned principle aims to delimit as clearly as possible the use of personal data by ensuring a balance between respect for the fundamental rights of data subjects in terms of privacy and data protection and the recognition of certain flexibility in favor of the operator in the management of such data, as imposed by digitalization and its inherent risks[4]. In its second component, which is of particular interest to us in the present study, the purpose limitation principle seeks to define the extent to which personal data collected for a particular purpose may be reused by companies[5], since any processing after collection must be considered as 'further processing' and must therefore meet, with certain exceptions, the compatibility requirement. The latter reflects the exigencies of a concrete, logical, and sufficiently close link between the purpose of data collection and further processing, requiring that this processing must not be disconnected from or contradict the original purpose of the data collection, and its content must be reconcilable with the rationale of the collection, regardless of any temporality issues. As it has been previously emphasized, the principle of purpose-related limitations is not a mere reflection or an expression of the principle of proportionality, unlike the principle of storage-related limitations set out in Article 5, para. (1), (e) of the GDPR. Particularly, the granularity of data processing agreements[6]

[4] Haas, G.: *Guide juridique du RGPD. La réglementation sur la protection des données personnelles*, 3e édition, ENI éditions, 2022, pp. 94-102; Desgens-Pasanau, G.: *La protection des données personnelles. Les principales clés de décryptage du RGPD*, 5e édition, LexisNexis, Paris, 2022, pp. 71-83.

[5] Rabagny-Lagoa, A.: *Fiches de droit du traitement et de la protection des données personnelles*, Ellipses, Paris, 2022, pp. 127-131; Raimondo, L.: *La protection des données personnelles. 100 questions-réponses pour comprendre et mieux se protéger*, Ellipses, Paris, 2021, pp. 67-83; Riccio, G. M., Scorza, G., Belisario, E. (eds.): *GDPR e normativa privacy. Commentato*, Editore IPSOA Gruppo di Wolters Kluwer Italia, 2018, pp. 112-117; Săvescu, A. (ed.): *RGPD – Regulamentul general privind protecția datelor cu caracter personal. Comentarii și explicații,* Hamangiu, Bucharest, 2018, pp. 134-147.

[6] Alboaie, L.: *Interpretarea principiilor privacy by design în era cloud computing*, Analele Științifice ale Universității „Alexandru Ioan Cuza" din Iași, Seria Științe Juridice, LXIII (2) 2017, pp. 21-32.

requires a separation of information on the data processing agreement for the rest of the information provided to consumers in the pre-contractual stage, as well as the implementation of the opting-in system for requesting consumer consent[7], since General Regulation (EU) 2016/679 establishes the exigencies for an opting-in system, which excludes the validity of consent[8] where passive behavior or lack of consumer reaction could be speculated by data controllers in the sense of assuming the consent of the data subject to the collecting and processing of personal data[9]. The absence of the consumer's reaction, as well as the failure to initiate an action on the data subject's part or the simple omission of selecting the options regarding the processing of personal data, do not represent legal grounds for the respective operations, and the consumer's consent, in this case, is practically inexistent. On the other hand, the valid consent expressed for the processing of personal data requires an unambiguous expression of will using an unequivocal statement or a clear affirmative action of the data subject, which implies that the data subject has taken a deliberate action to consent to each type of data processing (tacit or implicit consent based on consumer's silence or inaction of the data subject does not in itself constitute unequivocal consent to personal data collecting and processing). While analyzing the specific conditions for the validity of consent to the processing of personal data, the study aims at potentially answering questions such as: which elements are characteristic for collecting consumer's consent, based on which the free and untainted nature of the consumer's consent

[7] Dalla Corte, L.: *On proportionality in the data protection jurisprudence of the CJEU*, International Data Privacy Law, 2022. [https://academic.oup.com/idpl/advance-article-abstract/doi/10.1093/idpl/ipac014/6647961?redirectedFrom=fulltext], accessed on 28/11/2022, DOI: https://doi.org/10.1093/idpl/ipac014; Davies, S.: *The Data Protection Regulation: A Triumph of Pragmatism over Principle?*, European Data Protection Law Review 2 (3) 2016, pp. 290-296, DOI: https://doi.org/10.21552/EDPL/2016/3/5; Davola, A.: *Fostering Consumer Protection in the Granular Market: The Role of Rules on Consent, Misrepresentation and Fraud in Regulating Personalized Practices*, Technology and Regulation, Special Issue: Should Data Drive Private Law, 2022, pp. 76-86, [https://techreg.org/article/view/11177/12407], accessed on 28/11/2022.

[8] Kuner, Ch., Bygrave, L. A., Docksey, Ch., Drechsler, L., Tosoni, L. (eds.): *The EU General Data Protection Regulation: A Commentary/Update of Selected Articles*, Oxford University Press, 2021, pp. 45-48, available at SSRN: https://ssrn.com/abstract=3839645 and http://dx.doi.org/10.2139/ssrn.3839645, accessed on 19/01/2023.

[9] Böröcz, I.: *Risk to the Right to the Protection of Personal Data: An Analysis Through the Lenses of Hermagoras*, European Data Protection Law Review 2 (4) 2016, pp. 467-480, DOI: https://doi.org/10.21552/EDPL/2016/4/6.

to the processing of personal data by trade and service professionals in B2C contracts can be estimated? Are the provisions of Article 4, 11th par. of General Regulation (EU) 2016/679 sufficient for such elements to be deduced?

Particularly, it can be argued that: (a) consumer's freedom to opt for choosing or refusing[10] the collecting and processing of personal data implies the controller's respecting of the real choice prerogatives[11] and the possibility of exercising real control by data subjects over the collected data (since the data subject's consent may be discretionarily withdrawn[12]; (b) in cases where the data subject does not benefit from a real choice or feels constrained to accept to the data processing by the controller or there is a fear that the data subject will suffer negative consequences should the latter refuse the data processing[13], the consent will not be validly expressed; similarly, a 'blank' acceptance of the general terms and conditions cannot be seen as a clear affirmative action of consenting to the use of personal data[14]; (c) the provisions of General Regulation (EU) 2016/679 do not allow personal data controllers to provide pre-checked boxes or methods such as self-exclusion or 'voluntary exclusion' of consumers from the processing of personal data (opting-out consent), while prohibiting the means of presuming the existence of data subject's tacit consent, which require an intervention by the data subject to refuse the agreement (opt-out boxes) and

[10] Dobrilă, M.-C.: *Aspecte teoretice şi jurisprudenţiale privind respectarea GDPR la încheierea şi executarea unui contract,* Analele Științifice ale Universității „Alexandru Ioan Cuza" din Iași, Seria Științe Juridice, vol. LXVII, Supliment 2, 2021, pp. 93-106; Dobrilă, M.-C.: *Particularități privind noțiunea de date cu caracter personal necesare pentru încheierea sau executarea unui contract la care persoana vizată este parte*, Analele Științifice ale Universității „Alexandru Ioan Cuza" din Iași, Seria Științe Juridice, vol. LXVII, Supliment, 2021, pp. 211-225, DOI: https://doi.org/10.47743/jss-2021-67-3-15.

[11] Bercea, L.: *Standardul „consumatorului mediu" și consimțământul pentru prelucrarea datelor cu caracter personal*, Revista Română de Drept Privat (1) 2018, pp. 26-51.

[12] Netter, E.: *Regards sur le nouveau droit des données personnelles*, Éditions du Centre de droit privé et de sciences criminelles d'Amiens, Amiens, 2019, pp. 41-49; Ploeșteanu, N.-D., Lăcătușu, V., Farcaș, D.: *Protecția datelor cu caracter personal și viața privată – Jurisprudența CEDO și CJUE*, Universul Juridic, Bucharest, 2018, pp. 112-119.

[13] Caravà, E.: *Personal Data Kept in Companies Registers: The Denial of the 'Right to be Forgotten'*, European Data Protection Law Review 3 (2) 2017, pp. 287-292, DOI: https://doi.org/10.21552/edpl/2017/2/26.

[14] Van Alsenoy, B.: *Data Protection Law in the EU: Roles, Responsibilities and Liability*, Intersentia, Bruxelles, 2019, pp. 128-136.

which rely on the silence or data subject's passivity / non-assertively acceptance[15].

Finally, the study emphasizes the fact that there is no perfect synonymy between the 'granularity' of the processing purposes rule and the principle of 'specificity' of consent to the processing of personal data. Certainly, the condition of the specificity of the data subject's consent[16] cannot be understood in the absence of an analysis of the notion of 'granularity' of consent, which significantly enhances the significance of the first. Yet, are they synonymous, or do the two phrases cover distinct, autonomous, and conjugately applicable conditions in assessing the validity of the consumer's consent to the processing of personal data? We argue that the answer to the question in the final section can only be negative. Without being synonymous, the two expressions cover two distinct attributes that the consent required of the consumer to process personal data must meet. The specificity of consent[17] is the opposite of generalizing or admitting as valid the consent to the processing of personal data for unspecified purposes (i), while the granularity of consent implies that data subjects have the freedom to choose the purpose they accept, without being forced to accept the 'full package' of purposes for the data processing and to be able to exclude some of these purposes (ii). Moreover, in hypotheses in which the procedure for obtaining

[15] Drexl, J.: *Data Access and Control in the Era of Connected Devices. Study on Behalf of the European Consumer Organisation BEUC,* The European Consumer Organisation – Bureau Européen des Unions de Consommateurs (BEUC), Bruxelles, 2018, [https://www.beuc.eu/publications/beuc-x-2018-121_data_access_and_control_in_the_area_of_connected_devices.pdf], accessed on 28/11/2022; Duivenvoorde, B.: *The Liability of Online Marketplaces under the Unfair Commercial Practices Directive, the E-commerce Directive and the Digital Services Act*, Journal of European Consumer and Market Law 11 (2) 2022, pp. 43-52, [https://kluwerlawonline.com/journalarticle/Journal+of+European+Consumer+and+Market+Law/11.2/EuCML2022009], accessed on 28/11/2022.

[16] Chiara, P.: *The Balance Between Security, Privacy and Data Protection in IoT Data Sharing*, European Data Protection Law Review 7 (1) 2021, pp. 18-30, DOI: https://doi.org/10.21552/edpl/2021/1/6.

[17] Goicovici, J.: *Consimțământul consumatorului la prelucrarea datelor personale în contractele business to consumer – condiția consimțământului granular*, Analele Universității de Vest din Timișoara, Seria Drept (2) 2019, pp. 7-24; Goicovici, J.: *Portabilitatea datelor cu caracter personal, prin prisma dispozițiilor RGDP şi ale Directivei 2019/770: este gambitul reginei mutarea de deschidere adecvată?,* Analele Științifice ale Universității „Alexandru Ioan Cuza" din Iași, Seria Științe Juridice, Vol. LXVII, Supliment 2, 2021, pp. 57-80; Goicovici, J.: *Clauzele privind drepturile consumatorilor în contractele de servicii cloud computing*, Revista Română de Drept Privat (2) 2019, pp. 399-415.

consent does not allow the data subjects to give separate consent for the various personal data processing operations or different purposes of the processing, the very requirement of freely expressed consent would be seriously affected, due to the element of constraint which becomes present in such hypotheses[18]. As a corollary of the freedom of consent and the specificity of the data subject's consent[19], the granular nature of consent is seen an important condition[20] when processing personal data for multiple purposes, requiring the solution to meet the conditions of validity of consent in terms of respecting the granularity of consumer's agreement and obtaining separate consent, for each of the processing purposes panoply mentioned by the data controller[21].

2. DATA CONTROLLER'S INFORMATIVE TASKS TOWARD CONSUMERS

2.1. COLLECTING CONSENT FOR MULTIPLE PURPOSES OF PERSONAL DATA PROCESSING

In terms of establishing the consumer's capacity to adequately understand the multiple purposes of personal data processing[22], it should be emphasized that, as resulting from the CJEU's decision from November 11, 2020, in case C-61/19[23], the data controller must demonstrate that

[18] Enzmann, M., Selzer, A., Spychalski, D.: *Practitioner's Corner – Data Erasure under the GDPR – Steps towards Compliance,* European Data Protection Law Review 5 (3) 2019, pp. 416-420, DOI: https://doi.org/10.21552/edpl/2019/3/17.

[19] *Ibidem*.

[20] *Idem*, p. 418.

[21] van Eijk, N., Hoofnagle, J. C., Kannekens, E., *Unfair Commercial Practices: A Complementary Approach to Privacy Protection,* European Data Protection Law Review 3 (3) 2017, pp. 325-337, DOI: https://doi.org/10.21552/edpl/2017/3/7.

[22] Dimitrova, D.: *The Right to Explanation under the Right of Access to Personal Data*, European Data Protection Law Review 6 (2) 2020, pp. 211-230, DOI: https://doi.org/10.21552/edpl/2020/2/8.

[23] In case C-61/19, it has been retained that "A contract for the provision of telecommunications services which contains a clause stating that the data subject has been informed of, and has consented to, the collection and storage of a copy of his or her identity document for identification purposes is not such as to demonstrate that that person has validly given his or her consent, as provided for in those provisions, to that collection and storage, where:
– the box referring to that clause has been ticked by the data controller before the contract was signed, or where:

"the data subject has, by active behavior, given his or her consent to the processing of his or her personal data and that he or she has obtained, beforehand, information relating to all the circumstances surrounding that processing, in an intelligible and easily accessible form, using clear and plain language, allowing that person easily to understand the consequences of that consent, so that it is given with full knowledge of the facts."

Nevertheless, it should be emphasized that, as regards, more specifically, the adequacy of the collecting of the data subject's consent, especially in terms of avoiding (by design) any potential opacity when enunciating the purposes of data storage and processing, the data subject must have 'unambiguously' given his or her consent, which implies that the controller bears the burden of proof relating to the existence of valid consent, namely in hypotheses where personal data processing is based on consent, and that controller must be able to demonstrate that the data subject has consented to the processing of his or her data.

In the mentioned case, it resulted that during the procedure for concluding the contracts at issue in the main proceedings, the data controller's sales agents did not inform the customers concerned, before concluding the contracts, on each of the purposes of collecting and storing copies of the identity documents and their choice as to that collection and storage, before obtaining their consent to that collection and storage operations. As a factual element, it has been retained that the box relating to the storage of copies of identity documents was pre-ticked by the company's representatives solely based on a so-called 'presumed consent' of the individuals in terms of agreeing to the so-called 'implied purposes' of data storage, such as the storage of personal data to further enforce

– the terms of that contract can be misleading for the data subject as to the possibility of concluding the contract in question even if he or she refuses to consent to the processing of his or her data, or where:
– the freedom to choose to object to that collection and storage is unduly affected by that controller, in requiring that the data subject, in order to refuse consent, must complete an additional form setting out that refusal."; the text of the CJEU's decision in case 61/19 is available at https://curia.europa.eu/juris/document/document.jsf?text=&docid=233544&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=23109, accessed on 29/11/2022. The main problematics, in the mentioned case, were centered not on the 'granularity of consent' principle, but rather on the issue of the necessity of an assertive acceptance (through the mechanisms of an opting-in consent) from the data subject regarding the collecting and processing of specific personal data.

the creditor's rights against the debtor in the eventuality of payment unjustified delays[24].

On the other side of the discussion, in situations where the processing of the consumer's personal data is aimed at direct marketing, the data subject has the right to object at any time to the processing for this purpose of the personal data concerning the data subject, including the creation of profiles, insofar as it is related to direct marketing operations[25]. We note that, if the consumer objects to the processing for the purpose of direct marketing, the personal data can no longer be processed for this purpose[26]. As it has been accurately emphasized, in the cases where the processing of personal data for direct marketing purposes is mentioned in a standard clause, to the extent that this type of clause directly relates the conclusion of the contract on the expressing of consent to the future permission to use personal data to put in practice several marketing techniques directed at the targeted person, then such a clause must be considered invalid, which represents a solution justifiable through the probable lack of transparency[27] and the creation of an immediate imbalance between the rights and obligations of the parties, to the detriment of the consumer.

The adequacy of granular consent remains crucial for the validity of consumer consent, as the data operator / authorized representative of the data controller, the company's agents must ensure that they offer the data subjects, in the informative message presented at the time of col-

[24] For further analyses on the ethical reverberations, see Hijmans, H.: *How to Enforce the GDPR in a Strategic, Consistent and Ethical Manner?,* European Data Protection Law Review 4 (1) 2018, pp. 80-84, DOI: https://doi.org/10.21552/edpl/2018/1/10.

[25] de Hert, P., Lazcoz, G.: *When GDPR Principles Blind Each Other: Accountability, Not Transparency, at the Heart of Algorithmic Governance,* European Data Protection Law Review 8 (1) 2022, pp. 31-40, DOI: https://doi.org/10.21552/edpl/2022/1/7; de Hert, P., Papakonstantinou, V., Malgieri, G., Beslay, L., Sanchez, I.: *The Right to Data Portability in the GDPR: Towards User-Centric Interoperability of Digital Services,* Computer Law & Security Review, 2018, [https://www.sciencedirect.com/science/article/pii/S0267364917303333], accessed on 29/11/2022.

[26] Graef, I., Clifford, D., Valcke, P.: *Fairness and Enforcement: Bridging Competition, Data Protection and Consumer Law,* International Data Privacy Law 8 (3) 2018; Hahn, I.: *Purpose Limitation in the Time of Data Power: Is There a Way Forward?,* European Data Protection Law Review 7 (1) 2021, pp. 31-44, DOI: https://doi.org/10.21552/edpl/2021/1/7.

[27] Voigt, P., von dem Bussche, A.: *The EU General Data Protection Regulation (GDPR): A Practical Guide*, Springer International Publishing, 2017, pp. 56-59, DOI: https://doi.org/10.1007/978-3-319-57959-7.

lecting their personal data, a distinctive, punctual and sequential review of the purposes for which each category of personal data is collected (i) and that the purpose/purposes for which the data were initially collected will not be altered, nor expanded at a later moment, without the prior information of the concerned data subjects and without going through all the transitional steps necessary to obtain the consent of the consumer, when appropriate.

In terms of establishing the existence of company's liability, consumers' consent represents one of the six grounds of legality on which the processing of personal data can be based, as these grounds are listed in Article 6 of Regulation (EU) 2016/679 (the other five possible grounds referring to: (b) the processing necessary for the execution of a contract to which the data subject is a party or to take steps at the request of the data subject before concluding a contract; (c) the processing necessary to fulfill a legal obligation incumbent on the operator; (d) the processing necessary to protect the vital interests of the data subject or another natural person; (e) the processing necessary to fulfill a task that serves a public interest or that results from the exercise of the public authority with which the operator is vested; (f) the processing necessary for the purpose of the legitimate interests pursued by the operator or a third party, except in the case where the interests or fundamental rights and freedoms of the data subject prevail).

To the extent that they initiate activities or operations that involve the processing of personal data, the company, in its capacity of the data controller, must always evaluate to what extent the consent of the data subject (regardless of their consumer status) represents or not the appropriate legal basis for the processing of the collected personal data; otherwise, it is necessary to identify another legal basis. As pointed out, in business-to-consumer contracts, the consumer's consent can represent the appropriate legal basis only in situations where the data subject has been given control and the possibility of a real and effective choice between accepting or rejecting the terms conferred by the data operator[28].

[28] Kaiser E.: *The Concept of 'Freely Given, Specific and Informed' Consent under the Scrutiny of the European Court of Justice,* European Data Protection Law Review, Vol. 6, Issue 4 (2020), pp. 607-610, DOI: https://doi.org/10.21552/edpl/2020/4/19.

2.2. REVERBERATIONS OF THE 'PURPOSE-LIMITATION' PRINCIPLE

Defined in Article 5(1)(b) of the General Data Protection Regulation (GDPR), the 'purpose-limitation'[29] is notably seen as being the second principle related to the processing of personal data, which finds its normative expression[30] in the data subject's right to be properly and non-evasively informed on the multitude of purposes regarding the data collecting and processing. Moreover, the purpose-limitation meta-rule relates closely to the first principle of data protection, which relates to the lawfulness, fairness,[31] and transparency[32] of data collecting and processing and which requires that, fundamentally, a specific and legitimate reason is needed for any personal data that is collected based on the data subject's consent, since the personal data can only be used for the specified reasons[33] (obviously, exceptions could be made if further processing is meant for purposes such as archiving in the public interest, scientific or historical research, statistical reasons implying anonymized data, yet not implying pseudonymized data, which still permit individual traceability).

In the perimeter of establishing companies' liability for improper sequencing of personal data processing purposes, the concept of functional separation of processing purposes is likely to play a key role, and the extent to which this may be achieved could be an important

[29] Jasserand, C.: *Subsequent Use of GDPR Data for a Law Enforcement Purpose: The Forgotten Principle of Purpose Limitation?,* European Data Protection Law Review 4 (2) 2018, pp. 152-167, DOI: https://doi.org/10.21552/edpl/2018/2/6.

[30] *Ibidem.*

[31] Jarovsky, L.: *Improving Consent in Information Privacy through Autonomy-Preserving Protective Measures (APPMs),* European Data Protection Law Review 4 (4) 2018, pp. 447-458, DOI: https://doi.org/10.21552/edpl/2018/4/7; Jasmontaite, L., Kamara, I., Zanfir-Fortuna, G., Leucci, S.: *Data Protection by Design and by Default: Framing Guiding Principles into Legal Obligations in the GDPR,* European Data Protection Law Review 4 (2) 2018, pp. 168-189, DOI: https://doi.org/10.21552/edpl/2018/2/7.

[32] Hinsch, W.: *Differences That Make a Difference: Computational Profiling and Fairness to Individuals*, in Voeneky, S., Kellmeyer, P., Mueller, O., Burgard, W. (Eds.): *The Cambridge Handbook of Responsible Artificial Intelligence: Interdisciplinary Perspectives,* Cambridge University Press, Cambridge, 2022, pp. 229-251, DOI:10.1017/9781009207898.019.

[33] Jabłonowska A.: *Consumer Protection in the Age of Data-Driven Behaviour Modification*, Journal of European Consumer and Market Law 11 (2) 2022, pp. 67-71, [https://kluwerlawonline.com/journalarticle/Journal+of+European+Consumer+and+Market+Law/11.2/EuCML2022012], accessed on 29.11.2022.

factor in deciding whether further use of the data for (marketing or another purpose) research can be considered compatible. In these cases, data controllers need to guarantee the confidentiality and security of the data and take all necessary technical and organizational measures to ensure functional separation of processing purposes and to transparently inform the consumer of the existence of these purposes before the consenting.

The second potential set of reverberations arises from the data controller specifically wanting to extrapolate initial data processing purposes to further processing such as personalized marketing-oriented profiling techniques, which analyze or predict the personal preferences, behavior, and attitudes of individual customers, and which will subsequently motivate marketing strategies and personalized pricing[34] decisions that are taken concerning those consumers.

Especially, in these cases, namely in the hypotheses of intending to expand the initial purposes of data collecting as to comprise the profiling operations, there is a crucial need for respecting the free, specific, informed, and unambiguous opting-in consumer consent, which would almost always be required, otherwise further expanded use of personal data (initially collected for limited purposes) cannot be considered compatible with the 'purpose-limitations' principle. Importantly, such opting-in consent remains required for tracking and profiling for purposes of direct marketing, including the use of behavioral advertisement techniques, data-brokering, location-based advertising, or tracking-based digital market research, which all require explicit, granularly-given consent from the data subjects upon transparent informing on the existence of the multi-layered processing purposes[35]. Avoidance of oversimplification and the adding of sufficient granularity will be needed[36] to ensure that all the different data-processing purposes are sufficiently

[34] Li, Z.: *Affinity-Based Algorithmic Pricing: A Dilemma for EU Data Protection Law*, Computer Law & Security Review, Vol. 46 (2022), [https://ssrn.com/abstract=4144571] and [https://www.sciencedirect.com/science/article/pii/S0267364922000528], accessed on 28.11.2022; Wachter, S., Mittelstadt, B.: *A Right to Reasonable Inferences: Re-Thinking Data Protection Law in the Age of Big Data and AI,* Columbia Business Law Review (2) 2019, [https://ssrn.com/abstract=3248829], accessed on 28/11/2022.

[35] Veale, M., Nouwens, M., Santos, C.: *Impossible Asks: Can the Transparency and Consent Framework Ever Authorise Real-Time Bidding After the Belgian DPA Decision*?, Technology and Regulation, 2022, DOI: https://doi.org/10.26116/techreg.2022.002.

[36] *Ibidem*.

transparent[37] for the consumers, while renouncing the opaque and evasive enouncing of these purposes, which risk to be unintelligible to the data subjects, especially when the data controller intends to expand the initial substantial sphere of the data-collecting purposes[38].

2.3. CONSUMER'S OPTIONAL RIGHT OF WITHDRAWAL

The rules enounced in Regulation (EU) no. 679 of April 27, 2016, on the protection of natural persons concerning the processing of personal data, which regulates the civil liability of personal data operators and their representatives, do not remove the incidence of the provisions of national law on civil liability for the damage caused to data subjects, while not having an evasive effect on the rules of domestic law regarding civil liability[39], which represents an aspect that is also reiterated in the text of recital (146) of the GDPR. It is worth noticing, in this context, that the rules of Regulation (EU) 2016/679 generate a dual effect, both horizontally applicable since these rules can be invoked by the concerned data subjects directly against other natural/legal persons, as well as a vertical effect, arising from the prioritized application of the General Regulation on the processing of personal data.

The company's liability may also be retained for ignoring of the consumer's optional right to withdraw the consent to data processing. The consent issued by the consumer for processing his or her personal data can be withdrawn at any time, without the possibility of applying penalties, without further sanctions, in a non-onerous and discretionary manner, and without limits regarding the reasons for withdrawal. Generally, the exercise of the right to consent withdrawal must be engaged in a similarly facile manner as that in which its consent was requested by the data controller. Nonetheless, the withdrawal of consent regarding the processing of personal data can, in turn, be sequential, the consumer's withdrawal being able to target one or more of the processing purpos-

[37] *Ibidem.*

[38] Viterbo, F. G.: *The 'User-Centric' and 'Tailor-Made' Approach of the GDPR Through the Principles It Lays down,* The Italian Law Journal 5 (2) 2019, pp. 631-672.

[39] Karjalainen, T.: *All Talk, No Action? The Effect of the GDPR Accountability Principle on the EU Data Protection Paradigm*, European Data Protection Law Review 8 (1) 2022, pp. 19-30; Koch, B. A.: *Liability for Emerging Digital Technologies: An Overview,* Journal of European Tort Law 11 (2) 2020, pp. 115-136, DOI: https://doi.org/10.1515/jetl-2020-0137.

es stated initially, with the maintenance of consent for one or more of these purposes, depending on the consumer's decision.

3. FEATURES OF COLLECTING SEQUENTIAL CONSENT

3.1. CONSUMER'S CONSENT TO THE AUTOMATED PROCESSING OF PERSONAL DATA AND AUTOMATIC PROFILING

The right of the data subject to oppose the automated processing of personal data and automatic profiling[40] is stated in Article 22, 1st para. of Regulation (EU) 2016/679, as being a response of the European legislator to the dangers that may result for the person whose personal data have been collected, from the provoking aspects of traceability of automated decision-making (ADM) and of processing personal data in order to implement ADM techniques. Significantly relevant in this context remains the explanation provided in Recital (71) GDPR, which mentions the data subject's right to oppose an automated decision, when it produces legal effects that concern the data subject or similarly affects his or her legitimate expectations of a significant extent.

As highlighted in the specialized literature[41], the need for specific consent for the processing of personal data, in conjunction with the notion of 'limitation of the purpose of processing' provided for in art. 5, 1st para. (b) of Regulation (EU) 2016/679 functions as a genuine guarantee against attempts to gradually increase the categories of operations involved in data processing or to significantly blur the clarity of the purposes for which the collected personal data are processed, after the moment when the data subject agreed with the initial collection of data and with their processing for certain previous purposes which were clearly mentioned by the data operator. Obviously, the phenomenon described, also known under the name of 'distortion of the processing function', presents significant risks for the persons concerned, as it can lead to the use of personal data by the operator that could not be anticipated by the consumer or to the use of

[40] Gräf, E.: *When Automated Profiling Threatens Our Freedom*, European Data Protection Law Review 3 (4) 2017, pp. 441-451, DOI: https://doi.org/10.21552/edpl/2017/4/6; Spiecker Genannt Döhmann, I., Tambou, O., Bernal, P., Hu, M., Molinaro, C. *et al.*: *Multi-Country – The Regulation of Commercial Profiling – A Comparative Analysis*, European Data Protection Law Review 2 (4) 2016, pp. 535-554, DOI: https://doi.org/10.21552/EDPL/2016/4/12.

[41] Karjalainen, T., *op. cit.,* p. 29.

personal data by third parties for purposes that were not initially consented to and, therefore, to the loss or significant reduction of control of the data subjects over the processing of personal data.

Similarly, it is worth noticing, as already mentioned in the previous sections, that there is no perfect synonymy between the 'granularity' of processing purposes and the 'specificity' of consent to the processing of personal data. Notably, the condition of the specificity of the consent of the person concerned cannot be fully understood in the absence of the notion of 'granularity' of consent, which significantly enhances the meanings of the firstly mentioned meta-rule. Yet, the two expressions cover two distinct attributes that the consumer's consent to the processing of personal data must cover; moreover, the specificity of consent is antonymic to the generalization of processing purposes or to the considering of the consumer's acceptance as validated as consent regarding the processing of personal data for unspecified purposes. Nevertheless, while the granularity of consent implies that data subjects have the freedom to choose the purpose they accept, without being forced to accept non-stratified processing purposes or to consent to a package of processing purposes and to be able to exclude some or others of these purposes, the procedure for obtaining consumer's consent at the pre-contractual stage must allow the data subjects to grant separate consent for the various personal data processing operations or the various purposes of the personal data processing.

Moreover, if a data operator seeks to initiate personal data processing operations that are necessary for the execution of the contract itself, it is most likely that the legal basis for this processing is represented by the provisions of art. 6, 1st para. (b) of Regulation (EU) 2016/679 (execution of the contract as the basis of personal data processing, and not the consumer's consent). In this case, it is obvious that, for the data operator[42], it is not necessary (nor possible) to use another legal basis, such as the consent of the person concerned[43], since there is already a legal basis for the processing of personal data[44], namely the contract whose execution requires the processing of the respective personal data[45].

[42] Viterbo, F. G., *op. cit.*, p. 632.

[43] See, for further details, Goicovici, J.: *Consimțământul consumatorului la prelucrarea datelor personale (…), cit. supra,* pp. 21-22.

[44] *Idem*, p. 19.

[45] *Idem*, p. 23.

3.2. CONSUMER'S FREELY EXPRESSED CONSENT AND ASSUMPTIONS OF COERCION

In cases in which the consumer feels compelled to accept several purposes selected by the data controller for justifying the personal data collecting and further processing, the very requirement of freely expressed consent is seriously affected, due to the element of coercion present in such assumptions. As a corollary of the freedom of consent and the specificity of the consent of the data subject, the granular nature of the consent remains a necessary condition when the processing of personal data aims at multiple purposes since the solution to fulfill the conditions of the validity of the consent consists in the granularity of the consent of the consumer, namely in the separation of these purposes from those which remain unselected by the data operator when obtaining separate consent, for each of the data processing purposes. As follows from Recital (47) of Regulation (EU) 2016/679, the legitimate interests of a personal data operator, including those of a data controller to whom the personal data may be disclosed or of a third party, may constitute a basis legal for the processing of this data (yet not in the absence of a clear action by the consumer in the sense of consent to the processing), provided that it selects the situations where the interests or the fundamental rights and freedoms of the person concerned do not prevail over the interest of the operator; the latter aspect will be evaluated, as follows from Recital 47, the second thesis, of the General Regulation on the protection of personal data, taking into account the reasonable expectations of the data subjects based on their relationship with the data controller. This legitimate interest could exist, for example, as the European legislator specifies in the text of the cited recital when there is a relevant and appropriate relationship between the data subject and the data controller, such as in the case where the data subject is a customer of the data operator (a consumer of services or products marketed by the data controller in a B2C contractual context). However, the existence of a legitimate interest of the data operator that makes the request for the consumer's consent dispensable would require a careful assessment, which also establishes whether a data subject can reasonably expect, at the time and in the context of the collection of personal data, that the collected personal data will be processed for that respective purpose (personalized marketing strategies, for example) by the data operator.

Is it possible for the data controller to rely on distinct and multiple legal grounds to justify the processing of personal data collected from consumers of services and/or products if the processing of the data in question takes place for multiple purposes? In our opinion, the answer to this question is affirmative, given that each purpose of the processing must be supported by a legal basis. However, as pointed out in the previous section, the data operator must identify these purposes and related legal bases before starting the processing of personal data, and not afterward. Moreover, it is worth mentioning that the legal basis for processing personal data cannot be changed during these later-on strategized processing operations. Consequently , after data collection and processing has been initiated, the operator cannot 'switch' from one legal basis of processing to another. For example, the retroactive use of the legitimate interest by a personal data operator to justify the processing of these data is not allowed, in cases where problems have been encountered regarding the validity of the data subject's consent. Therefore, under the rules set out by the provisions of art. 5, 1st para. and of art. 6, 1st para. of Regulation (EU) 2016/679, generally data controllers who request the consent of the persons concerned for the processing of personal data, should not be able to rely on another legal basis for processing from those mentioned in art. 6 of the General Regulation, as a back-up plan when they cannot demonstrate the validity of the consent of the concerned person or if his/her valid consent was subsequently withdrawn. Given the obligation to disclose the legal grounds on which the operator acts at the time when personal data is collected, the company must decide before the initiation of data collection[46], which are the legal grounds applicable to each of the purposes of personal data processing[47] and, should the data controller intend a later-on envisaged expansion of the initially-selected categories of processing purposes, based on consumer's consent[48], the further requesting of consumer's specific (granular) consent remains essential[49].

Especially relevant in contracts from the business-to-consumer category remains the fact that the personal data operator can base its processing operations on the provisions of art. 6 1st para. (b) GDPR to process

[46] *Idem*, p. 18.

[47] *Ibidem*.

[48] *Ibidem*.

[49] *Idem*, p. 20.

personal data when, according to the obligations of responsibility under art. 5 2nd para., the company may establish that the processing takes place in the context of a valid contract concluded with the data subject (i) and that the processing is necessary to execute that contract with the data subject (ii). If the data operators cannot demonstrate: (a) the existence of the contract, (b) the fact that the said contract is valid and concluded according to the applicable national law in the field of contracts and (c) the fact that the processing of the contractual partner's personal data is objectively necessary for the execution of the contract, the data operator will have to consider another legal basis for data processing. It is also highlighted that the simple reference or mention regarding data processing inserted by trade/service professionals in a B2C adhesion contract is not *per se* sufficient to consider the said data processing as falling within the scope of the provisions of art. 6, 1st (b) of the GDPR. It should also be emphasized that the processing of personal data may be objectively necessary even if it is not specifically mentioned in the respective contract, yet the data operator must fulfill its obligations arising from the principle of transparency of personal data processing. From this point of view, in situations where a personal data operator aims to invoke the fact that the processing of this data is based on the execution of a B2C contract concluded with the data subject, it is important to evaluate the various nuances of what represents, in that respective context, the so-called 'necessary objective for the execution of the contract'. The phrase 'processing necessary for the execution of the contract', from the perspective of the substantial applicability of the provisions of art. 7, 4th para. Of the GDPR, which concerns the validity of the data subject's consent, it is necessary to make an explicit distinction between the processing activities necessary for the execution of a contract (i) and the clauses that address the provisions on the contractual performance and to the consumer's consent to the entering into the paradigm of certain data-processing activities which are not actually necessary for the performing of the business-to-consumer contract (ii).

Guided by the premise of an asymmetric distribution of control over the information necessary to issue a free and unadulterated consent, the mechanism provided for in the General Regulation on the protection of personal data for the granular collection of the data subject's consent is based on the need for transparency felt by the data subjects at the time of the collecting of these data. The specific requirements arising for personal data operators from the perspective of detailing the

collection purposes and the stratification of the operations involved in the processing of consumers' personal data continue to raise questions for legal practitioners, especially if the processing of personal data is based on the consent of the consumer since the data operator must be able to demonstrate that the data subject has given specific consent for the multifaceted processing of personal data. The granular consent requirement implies, among other aspects, that, if the consumer's consent to the processing of his/her personal data is given in the context of a statement that also refers to other contractual aspects, the consent request must be presented in a form that differentiates it clearly from the other legal aspects, in a form intelligible to the consumer, while using clear language, and avoiding excessively technical terms which would be considered opaque by the uninstructed consumer.

4. CONCLUDING REMARKS

To conclude, it must be emphasized that, certainly, when establishing the existence of a company's liability for the opaque selecting of personal data processing purposes, the condition of the specificity of the data subject's consent cannot be understood in the absence of an analysis on the notion of 'granularity' of consent, which significantly enhances the meanings of the first. Yet, are they synonymous or do the two phrases cover distinct, autonomous, and conjugately applicable conditions in assessing the validity of the consumer's consent to the processing of personal data? We argue that the answer to the question in the final section can only be negative. Without being synonymous, the two expressions cover two distinct attributes that the consent required of the consumer to process personal data must meet.

The specificity of consent is the opposite of generalizing or admitting as valid the consent to the processing of personal data for unspecified purposes (i), while the granularity of consent implies that data subjects have the freedom to choose the purpose they accept, without being forced to accept the 'full package' of purposes for the data processing and to be able to exclude some of these purposes (ii).

The granularity of data processing agreements and the separation of information regarding the data processing agreement from the rest of the information provided remain crucial in B2C relations; especially, the necessity for an opting-in system when requesting consumer's consent

to each of the data-collecting purposes, which excludes the validity of the data subject's consent in cases in which the passive behavior or lack of reaction of the consumer could be speculated by data operators in the sense of presuming the existence of the consent of the data subject to the collection and processing of data with personal character. The absence of the consumer's assertive response, as well as the non-initiation of an action or the simple omission of demarcation of the options regarding the processing of personal data, do not represent legal grounds for the respective operations, and the consumer's consent in these hypotheses is practically non-valid or inexistent, as a legal ground for data processing. On the contrary, the valid consent expressed for processing personal data requires an unambiguous manifestation of will by means of an unequivocal statement or through a clear affirmative action of the data subject, which implies that the data subject has taken a deliberate action to consent to that data processing. Therefore, in the context of the provisions of Regulation (EU) 2016/679, of consent-based data processing, companies may be held liable for deducing the consumer's consent from the silence or inaction of the data subject, or from conduct which does not constitute *per se* unequivocal consent.

Specific conditions for the validity of consent to the processing of personal data include the prerequisites of granular consent and those of stratified consent to multiple-purposed processing. What are the elements based on which the free and untainted nature of the consumer's consent to the processing of his personal data by trade and service professionals can be assessed, in business-to-consumer contracts? From the text of art. 4 para. (11) of Regulation (EU) 2016/679, a set of five salient elements can be deduced from Regulation (EU) 2016/679:

(a) the collecting of the data subject's freely-expressed consent to the processing of personal data implies a real choice and the possibility of exercising real control on the part of the data subjects over the collected data; on the other hand, in the cases where the data subject does not benefit from a real choice or he feels obliged to accept the processing of personal data by the data controller or there is a fear that the consumer will suffer negative consequences, should the data subject refuse to express the agreement regarding data processing, the consumer's consent will not be validly expressed; likewise, if the processing agreement personal data is requested based on a non-negotiable clause within B2C general business terms and conditions unilaterally drawn up by the pro-

fessional, it is presumed that the consumer's consent is not expressed freely, especially when the data subject is placed in the impossibility of refusing or withdrawing it without suffering material damage;

(b) in the hypotheses in which the consumer has given consent specifically for the data collection/processing operations for the purpose/purposes initially selected and declared by the data controller, it remains crucial that the companies respect the 'granularity of consent' prerequisites since the consumer cannot be forced to accept a package of data processing operations for which consent has not been requested individually, i.e. for each type of operation separately; the same rule applies to the plurality of purposes of personal data processing;

(c) when the data subject's consent has been given with knowledge of the existence of multi-stratified processing purposes, which imply the complete, correct, and transparent information of the data subject by the data operator concerning the type of processing operations, with each of the purposes of the processing and with regard to the right discretion to withdraw this consent at a later moment, violations of consumer's right of withdrawal may constitute a legal ground for engaging company's liability for the prejudicial conduct causing the consumers' damage;

(d) the unambiguous expression of the data subject's consent by which he/she accepts (through an opting-in statement or an unequivocal action), that the personal data concerning him/her will be processed, represents a salient prerequisite for sequestrating multiple-purposes-based data processing; it is worth mentioning, in the perimeter of the analyzing of the 'granularity of consent' rule, that from the text of art. 7, para. (4) of Regulation (EU) 2016/679, it results that, when the personal data operators are tempted to 'associate' the consent to the processing of personal data with the consumer's consent to the acceptance of the general terms and contractual conditions, without the latter being necessary for the execution of that contract or the provision of the respective B2C relations, the mentioned type of commercial practices are considered to be undesirable, as representing a violation of the principle of freedom of consent to the processing of personal data; there is an absolute, irrefutable presumption that for the processing of the consumer's personal data, the consent was not freely expressed (by the requirements resulting from Recital 43 of Regulation 2016/679). Simultaneously, data operators must ensure that the purpose of processing consumers' personal data is not disguised or requested in an indissociable manner with the

services owed based on a business-to-consumer contract for the execution of which the personal data were initially collected.

(e) Similarly, the provisions of art. 7, para. (4), and of art. 4, para. (11) of Regulation (EU) 2016/679 are insisting on the idea that the processing of personal data for which the data subject's consent is requested should nevertheless, directly or indirectly, become a consideration for the execution of the contract, and the request for consent to data processing personal data should not be lacking in clarity; requesting consent to take place through opting-in mechanisms, and not through the means of an opting-out system of collecting consumers' consent to multiple-purposed data processing (through a statement or through an unequivocal action, excluding options for pre-checking the options by the operator), as it has been highlighted in the previous sections, remains essential for the consumer's consent to be considered valid, should the data subject exercise a real choice and to the extent that there is no risk of malicious or willfully non-transparent behavior on the part of the data operator, a risk of coercion of the consumer or the risk of bearing some significant negative consequences (for example, substantial additional costs) associated with the refusal of consent to the processing of personal data. Special attention should be devoted, in these cases, to the fact that the consumer's consent will not be freely given unless there is no room left for any element of coercion, pressure, or inability to freely exercise the will of the person concerned. From the provisions of art. 4 par. (11) from Regulation (EU) 2016/679 the need for an opting-in option can be deduced, which excludes the opting-out options for requesting the consumer's consent for the collecting and processing of personal data by the companies in B2C contractual relations.

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REGULATORY SANDBOXES UNDER THE DRAFT EU ARTIFICIAL INTELLIGENCE ACT: AN OPPORTUNITY FOR SMES? *

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ABSTRACT

More than a year after the European Commission submitted the Proposal for the Artificial Intelligence Act (AI Act), the EU institutions are still working on adopting this groundbreaking regulation. The Draft AI Act contains a uniform set of horizontal rules for the development, marketing, and use of AI systems in conformity with the Union values, applying the proportionate risk-based approach. The aim is to avoid regulatory friction and fragmentation and to create a well-functioning internal market for AI systems and technologies. However, the policy and regulatory choices should not obstruct the innovative potential and transformative impact of AI systems and technologies on the society and economy. The Draft AI Act, therefore, introduces AI regulatory sandboxes, as a testing ground for deciding what to regulate and how. This is a novel regulatory approach, fostering innovation, development, and testing of AI systems under strict regulatory oversight before these systems are placed on the market. The proposed solution from the Draft AI Act has caused both excitement and criticism in the legal doctrine and industry. This paper will explore the benefits and challenges of AI regulatory sandboxes. The draft provisions will be critically evaluated, drawing from the experience in the FinTech industry, especially considering the effect on SMEs. The EU's ambition is to set up a robust and disruption-resilient, yet flexible, innovation-friendly, and future-proof regulatory framework for AI, and the intuitive appeal of AI regulatory sandboxes for both regulators and innovators deserves an in-depth examination.

KEYWORDS*: Artificial Intelligence Act, regulatory sandboxes, SMEs*

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1. INTRODUCTION

Regulating AI has become a key political priority in the EU. Developing responsible AI, with a human-centric approach, is the ultimate objective and the bottom line of all policy and regulatory initiatives in this area.[1] Disruptive technologies, such as AI, require a timely and appropriate regulatory response. At the same time, they present a challenge to the traditional regulatory paradigm.[2] The importance of "structured experimentalism"[3] and "smart regulation"[4] when it comes to regulating AI technologies is crucial for allowing their innovative character to come through for the benefit of society, while at the same time curbing their potential risks. The result of the ongoing legislative process for the adoption of the Artificial Intelligence Act[5] will show whether the EU will succeed in finding the right balance between the interest of setting up and preserving the EU's technological leadership, on the one hand, and the protection of Union values, fundamental rights and principles to the benefit of its citizens, on the other. The Draft AI Act contains a uniform set of horizontal rules for the development, marketing, and use of AI systems in conformity with the Union values, applying the proportionate risk-based approach. The aim is to avoid regulatory friction and fragmentation and to create a well-functioning internal market for AI systems and technologies. One of the proposed solutions which try to incorporate the innovative or experimental approach to law-making is the introduction of AI regulatory sandboxes. This is a novel regulatory regime and a policy instrument aimed at fostering innovation by

[1] On the importance of human rights-centered design for AI see more in: Yeung, K.; Howes, A.; Pogrebna, G.: AI governance by human rights-centered design, deliberation, and oversight. An end to ethics washing, in: Dubber, M. D.; Pasquale, F.; Das, S. (eds.): *The Oxford Handbook of Ethics of AI*, Oxford, 2020, pp. 77 – 106.

[2] Barfield, W.: Towards a law of artificial intelligence, in: Barfield, W.; Pagallo, U., *Research Handbook on the Law of Artificial Intelligence*, Cheltenham - Northampton, 2018, pp. 2- 39, p. 22; Liu, H.-Y. *et al.*: *Artificial intelligence and legal disruption: a new model for analysis*, Law, Innovation and Technology, 12(2) 2020, pp. 205-258, DOI: 10.1080/17579961.2020.1815402; Brummer, C.; Yadav, Y.: *Finntech and the innovation trilemma*, The Georgetown Law Journal, 107(2) 2019, pp. 235 – 307, p. 282.

[3] Zetzsche, D. A. *et al.*: Regulating a revolution: From regulatory sandboxes to smart regulation, in: Fordham Journal of Corporate & Financial Law 23(1) 2017, pp. 31-103, p. 64, 91; see also Wischmeyer, T.; Rademacher, T. (eds.): *Regulating Artificial Intelligence*, Cham, 2020.

[4] Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 91; see also Leenes, R. *et al.*: *Regulatory challenges of robotics: some guidelines for addressing legal and ethical issues*, Law, Innovation and Technology, 9(1) 2017, pp. 1 - 44, p. 41, 43, DOI: 10.1080/17579961.2017.1304921.

[5] European Commission: Proposal for a Regulation of the European Parliament and of the Council laying down harmonised rules on Artificial Intelligence (Artificial Intelligence Act) and amending certain Union Legislative Acts, COM(2021) 206 final, 21.4.2021. Further referred to as the Draft AI Act.

allowing the development and testing of AI systems under strict regulatory oversight before these systems are placed on the market. The proposed solution from the Draft AI Act has caused both excitement and criticism in the legal doctrine and industry. This paper aims to explore the benefits and challenges of AI regulatory sandboxes under the Draft AI Act.

To provide a background for our discussion, we will start by identifying the regulatory challenges associated with AI in general (2). We will then proceed with analyzing the concept of a regulatory sandbox, as a form of experimental law-making. We will outline its origins, objectives, forms, organization, and impact (3.1). The comparison with FinTech regulatory sandboxes, which are already implemented in various jurisdictions, will serve to evaluate the impact of regulatory sandboxes on SMEs (3.2). These findings will be put in perspective by providing a background for the concept of regulatory sandboxes at the EU level (4.1.) and analyzing the solution under the Draft AI Act (4.2). This is followed by an in-depth examination of the benefits and challenges of AI regulatory sandboxes to answer whether they are fit for purpose and whether their intuitive appeal for both regulators and innovators is justified (4.3). We conclude by offering some remarks and suggestions to feed into the ongoing and future discussions (5).

2. REGULATING AI

There are numerous issues associated with the regulation of AI and AI systems already identified in the literature.[6] The most obvious challenge is how to define AI, as a concept and technology. We have dealt with this question elsewhere,[7] and there is abundant academic literature dedicated to finding a workable definition of AI, especially focusing on the intersection between law and technology.[8] For the purpose of our discussion here, we can rely on a broad

[6] See e.g. Wischmeyer, T.; Rademacher, T. (eds.): *op. cit.* (fn. 3); Custers, B.; Fosch-Villaronga, E. (eds.): *Law and Artificial Intelligence. Regulating AI and Applying AI in Legal Prac*tice, The Hague, 2022.

[7] See Pošćić, A.; Martinović, A.: Towards a regulatory framework for Artificial Intelligence: An EU approach. In: Drezgić, S. *et al.* (eds.): *Contemporary Economic and Business Issues*, Rijeka, 2021, pp. 49 – 62, p. 50 – 51; Pošćić, A.: *Postoji li potreba pravnog uređenja umjetne inteligencije u Europskoj uniji – razlozi za i protiv*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, 42(2) 2021, pp. 385-404, DOI:10.30925/zpfsr.42.2.7.

[8] See e.g. Russel, S. J. and Norvig, P.: *Artificial Intelligence: A Modern Approach*, 3rd Ed., New Jersey, 2010; Nilsson, N. J.: *The Quest for Artificial Intelligence: A History of Ideas and Achievements*, Cambridge, 2010; Stone, P. *et al.*: *Artificial Intelligence and Life in 2030. One Hundred Year Study on Artificial Intelligence: Report of the 2015-2016 Study Panel*, Stanford University, Stanford [http://ai100.stanford.edu/2016-report], accessed: 18/11/2022; Pei, W.: *On*

and all-encompassing definition of AI as "a collection of technologies that combine data, algorithms and computing power"[9], whether they are purely software-based or embedded in hardware devices.[10] This approach to defining AI seems to be the most widely accepted by EU institutions.[11] Finding and relying on a workable definition of AI, despite the multi-layered complexity associated with its various applications, is necessary for creating a coherent legal framework for its use.[12]

The complexity associated with regulating AI arises from the described definitional problem, but also from the fact that AI is a source of potential public risk, with distinctive features differentiating it from other public risks and thus making it more difficult to regulate.[13] Scherer frames these distinctive features in terms of the discreetness problem, the diffuseness problem, the discreteness problem, the opacity problem, the foreseeability problem, the narrow control

defining Artificial Intelligence, Journal of Artificial General Intelligence 10(2), 2019, pp. 1-37, DOI: 10.2478/jagi-2019-0002.

[9] European Commission: White paper on Artificial Intelligence - A European approach to excellence and trust, COM(2020) 65 final, Brussels, 19.2.2020, p. 2.

[10] European Commission: Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, Artificial Intelligence for Europe, COM(2018) 237 final, Brussels, 25.4.2018.

[11] See European Commission: Artificial Intelligence for Europe, *op. cit.* (fn. 10), p. 1; European Commission, White Paper on Artificial Intelligence – A European approach to excellence and trust, *op. cit.* (fn. 9), p. 2. Compare with the definition of the 'AI System' from Article 3(1) (1) of the Draft AI Act: "AI system means software that is developed with one or more of the techniques and approaches listed in Annex I and can, for a given set of human-defined objectives, generate outputs such as content, predictions, recommendations, or decisions influencing the environments they interact with", and the definition proposed by the Independent High-Level Expert Group on Artificial Intelligence defining AI systems as "…software (and possibly also hardware) systems designed by humans…". See Independent High-Level Expert Group on Artificial Intelligence (HLEG): A definition of Artificial Intelligence: Main capabilities and disciplines, Brussels, 2018, p. 4 [https://digital-strategy.ec.europa.eu/en/library/definition-artificial-intelligence-main-capabilities-and-scientific-disciplines], accessed 18/11/2022.

[12] For a broader discussion see Renda, A.: *Artificial Intelligence. Ethics, governance and policy challenges*. Report of a CEPS task force, Brussels, 2019, p. 8 – 13. An analysis of stakeholders' position on the definition of AI proposed by the European Commission reveals that it is either perceived as too broad, or to narrow. See European Commission: Study to Support an Impact Assessment of Regulatory Requirements for Artificial Intelligence in Europe, Final report (D5), Luxembourg, 2021, p. 105 – 106.

[13] Scherer, M. U.: *Regulating Artificial Intelligence Systems: Risks, Challenges, Competencies and Strategies*, Harvard Journal of Law and Technology 29(2) 2016, pp. 353 – 400, p. 358; see also Chesterman, S.: *We, the robots? Regulating Artificial Intelligence and the limits of the law*, Cambridge, 2021, p. 13 and following.

problem, and the general control problem.[14] Whereas discreetness, foreseeability, discreteness, and opacity are related mostly to the field of AI research and development, when combined with foreseeability, the narrow and the general control problem, which are mostly associated with liability issues, create specific regulatory challenges for *ex ante* regulation. To put it plainly, it is difficult to regulate (and foresee all potential consequences of) something which can be developed by anyone with a computer or smartphone and an Internet connection i.e. without substantial resources and infrastructure (discreetness problem), when a single component can be devised by individuals located far away from one another (diffuseness problem), in different locations, at different times and without any conscious coordination (discreteness problem), where the technologies underlying the AI will be opaque to most regulators and may not be susceptible to reverse engineering (opacity problem)?[15] Building on those features is the liability gap because AI systems are designed to be autonomous and their operation may not be foreseeable even for the original programmers (foreseeability), which can lead to the loss of control by the humans who are legally responsible for their operation and supervision (narrow or local control problem), or by any human (loss of general control).[16] This description perfectly encapsulates the inherent dilemma in regulating AI: while *ex ante* regulation might be difficult, *ex post* regulation might be ineffective.

Nevertheless, the potential of AI systems to cause individual, collective, and societal harm, and the need to address this issue, is well established.[17]

The innovative potential of emerging digital technologies, such as AI and machine learning, automated decision-making, distributed ledger technology, 5G, quantum computing, etc. naturally collides with the existing norms in place. Law has a way of adapting to continuous social, economic, scientific, and technological developments. The "resilient fragility"[18] of law remains a constant, even in the face of rapidly evolving new technologies. However, AI is a disrup-

[14] Scherer: *op. cit.* (fn. 13), p. 359.

[15] *Ibid.*, p. 363 – 365.

[16] *Ibid.*, p. 366.

[17] Smuha, N. A.: *Beyond the individual: governing AI's societal harm*, Internet Policy Review 10(3) 2021 [https://doi.org/10.14763/2021.3.1574], p. 4. On the analysis of the risk-based approach in the EU regulation of digital technologies see De Gregorio, G.; Dunn, P.: *The European risk-based approaches: Connecting constitutional dots in the digital age*, Common Market Law Review 59(2) 2022, pp. 473–500.

[18] Pasquale, F.: Foreword. The resilient fragility of law, in: Deakin, S.; Markou, C.: *Is law computable? Critical Perspectives on law and Artificial Intelligence*, Oxford – New York, 2020, pp. v – xvi. On legal system's adaptive complexity see: Ruhl, J. B., *Law's complexity: A primer*, Giorgia State University Law Review, 24(4) 2008, pp. 885 - 912.

tive technology,[19] amplifying the well-known Collingridge dilemma[20] in the societal control of technology, or even "accelerating the pace of a pacing problem",[21] as highlighted by the techno-libertarians.[22] As Collingridge succinctly put it, regulating technology is difficult, in the early stages because its impact cannot be easily predicted, and by the time it reaches advanced stages and undesirable consequences are discovered, technology has become so entrenched that intervention is expensive or impossible.[23] For some, this is a reason to renounce anticipatory governance and *ex ante* hard law solutions, because technological innovation outpaces the ability of laws and regulations to keep up.[24] In this view, legislators are unable to cope with the crowding-out effect of tech regulation, because "by the time policymakers start to understand one tech problem, another more pressing one crowds it out."[25]

[19] As a disruptive technology, AI introduces "radical changes with the possibility of rendering obsolete previous ways of performing tasks or making products". See Liu, H.-Y.: *The power structure of artificial intelligence*, Law, Innovation and Technology, 10(2) 2018, DOI: 10.1080/17579961.2018.1527480, pp. 197 – 229, p. 197. It is necessary to develop a general holistic model to respond to the legal disruption caused by new technology, because it is evident that reactive, domain-specific regulatory focus on certain activity areas is not appropriate. See Liu, H.-Y. *et al*.: *op. cit*. (fn. 2), p. 10.

[20] Collingridge, D.: *The Societal Control of Technology*, New York, 1980: "The social consequences of a technology cannot be predicated early in the life of the technology. By the time undesirable consequences are discovered, however, the technology is often so much part of the whole economics and social fabric that its control is extremely difficult."

[21] Thierer, A.: *Governing Emerging Technology in an Age of Policy Fragmentation and Disequilibrium*, American Enterprise Institute, 2022, available at SSRN [https://ssrn.com/abstract=4099605] or [http://dx.doi.org/10.2139/ssrn.4099605], accessed 18/11/2022; Thierer, A.: *The Pacing Problem, the Collingridge Dilemma & Technological Determinism*, 16 August 2018 [https://techliberation.com/2018/08/16/the-pacing-problem-the-collingridge-dilemma-technological-determinism/], accessed 18/11/2022.; Hagemann, R., Huddleston Skees, J.; Thierer, A.: *Soft law for hard problems: The governance of emerging technologies in an uncertain future*, Colo. Tech. L. J. 17(1) 2018.

[22] Marchant, G. E.: The Growing Gap Between Emerging Technologies and the Law, in: Marchant, G. E.; Allenby, B. R.; Herkert, J. R. (eds.): *The Growing Gap Between Emerging Technologies and Legal-Ethical Oversight. The Pacing Problem*, Dordrecht, 2011; Thierer, A.: *Permissionless Innovation. The continuing case for comprehensive technological freedom*, Revised and expanded edition, Arlington, 2016.

[23] Leenes, R. *et al*.: *op. cit*. (fn. 4), p. 35.

[24] Thierer, A.: Permissionless Innovation, *op. cit*. (fn. 22), p. 110.

[25] Thierer, A.: Governing Emerging Technology in an Age of Policy Fragmentation and Disequilibrium, *op. cit*. (fn. 21), p. 3.

However, many ways are showing that the law can (and must attempt to) cope with this regulatory challenge. The "technological push"[26] requires a smart and experimental regulatory approach.[27] For example, the principles of technological neutrality and functional equivalence are applied to overcome some of these difficulties in regulation. The principle of technological neutrality requires the adoption of neutral rules concerning technology, to be able to accommodate any future development without further legislative work,[28] as well as not to discriminate against any particular type of technology.[29] In the latter sense, it has been in application in the EU since the early 2000s.[30] Increasingly, however, the principle of technological neutrality is understood in its former sense, as "future-proof" legislation.[31] Any piece of legislation should strive to be "future-proof", but this standard is as desirable, as it is elusive when it comes to regulating rapidly advancing new technologies with unpredictable impacts. Legal futureproofing is thus just part of the formula for an antidote to legal disruption. A prerequisite for technological neutrality is the functional equivalence principle, which is based on non-discrimination and the require-

[26] When technological innovation is taken as a solution to all societal (and economic) problems, a strong technology push entails uneasy trade-offs between values and affects the established safeguards (e.g., more security – less privacy, etc.). See Leenes, R. *et al.*: *op. cit.* (fn. 4), p. 33.

[27] Cortez argues that regulators should adapt the regulatory toolkit for disruptive innovation, and use experimental rules, regulatory sunsets, or rulemaking deadlines to calibrate their approach to novel technologies or business practices. See Cortez, Nathan, *Regulating Disruptive Innovation*, Berkeley Technology Law Journal, 29 2014, pp. 175 – 228, p. 199 and following.

[28] See e.g., UNCITRAL Model Law on Electronic Commerce [https://uncitral.un.org/en/texts/ecommerce/modellaw/electronic_commerce], accessed 18/11/2022.

[29] I.e. the regulator should not be the one to pick technological winners and losers. In the EU regulatory framework "technology neutrality" should be understood as the freedom of individuals and organisations to choose the most appropriate and suitable technology for their needs. See also Ducuing, C.: *Legal principles behind technical complexities*, 9 April 2019 [https://www.law.kuleuven.be/citip/blog/legal-principles-behind-technical-complexities-the-proposal-from-the-commission-for-a-c-its-delegated-regulation/], accessed 18/11/2022.

[30] Kamecke, U.; Körber, T.: *Technological Neutrality in the EC Regulatory Framework for Electronic Communications: A Good Principle Widely Misunderstood*, European Competition Law Review 5 2008, pp. 330 – 337, p. 331.

[31] Future-proofing is identified as the primary benefit of technology neutral legislation. See Puhakainen, E.; Väyrynen, K.: *The Benefits and Challenges of Technology Neutral Regulation - A Scoping Review*, Twenty-fifth Pacific Asia Conference on Information Systems, Dubai, UAE, 2021 [https://www.researchgate.net/publication/353143124_The_Benefits_and_Challenges_of_Technology_Neutral_Regulation_-A_Scoping_Review], accessed 18/11/2022, p. 5. Leenes et al. warn that technology-neutral norms potentially offer less legal certainty, because they tend to be more abstract than technology specific norms. See Leenes, R. *et al.*: *op. cit.* (fn. 4), p. 43.

ment for the same legal validity of digital and non-digital transactions, i.e. equivalence between different modes of activity, as well as the non-discrimination between technologies with equivalent effects.[32] Apart from that, in delivering future-proof and innovation-friendly legislation, the EU institutions are guided by the 'Innovation Principle', which entails taking into account the impact on research and innovation in the process of developing and reviewing regulation in all policy domains.[33] (Structured) flexibility and experimentation are recognized by the EU institutions as tools for regulatory learning and creating "an agile, innovation-friendly, future-proof, evidence-based, and resilient regulatory framework" to respond to disruptive challenges in the digital age.[34]

[32] Koops, B.-J.: Should ICT Regulation be Technology-Neutral?, in: Koops, B.-J. et al. (eds.): *Starting points for ICT Regulation. Deconstructing Prevalent Policy One-Liners*, The Hague, 2006, pp. 77 – 108; Tsokou, M.: *The insufficiency of technology neutrality and risk-based approaches: The necessity of adopting a human-rights lens when regulating AI*, [https://assets.ctfassets.net/iapmw8ie3ije/1fdlLSILUSek4D7en9eR0s/87b83b77ff283335f81e1b99e5b7c360/MyDataIsMineAward_MachiTsokou.pdf], accessed 18/11/2022; Veerpalu, A.: *Functional equivalence: An exploration through shortcomings to solutions*, Baltic Journal of Law & Politics 12(2) 2019, pp. 134–162.

[33] See Council of the European Union: Better Regulation to strengthen competitiveness, Brussels, 26 May 2016, 9580/16. The innovation principle compliments the precautionary principle and highlights the importance of innovation in all phases of the policy cycle. A successful innovation principle seeks to find the right balance between information, flexibility and stringency. It relies on various tools, such as research and innovation tool, innovation deals and foresight and innovation scanning, recognising that well-designed regulation can promote innovation to the benefits of society, whereas badly designed regulation can harm innovation. See European Commission: Study supporting the interim evaluation of the innovation principle, Luxembourg, 2019, p. 5, 7 [https://op.europa.eu/en/publication-detail/-/publication/e361ec68-09b4-11ea-8c1f-01aa75ed71a1]. See also European Commission: Towards an Innovation Principle Endorsed by Better Regulation, EPSC Strategic Notes (14) 2016, p. 6.

[34] Council of the European Union: Conclusions on Regulatory sandboxes and experimentation clauses as tools for an innovation-friendly, future-proof and resilient regulatory framework that masters disruptive challenges in the digital age, Brussels, 16 November 2020, 13026/20. Tool #22 of the Commission's Better Regulation Toolbox provides guidelines for analysing the interaction between EU initiatives and innovation in line with the innovation principle and ensures that the innovation dimension is considered when preparing and implementing EU legislation. In the preparation stage, the instruments of adaptive regulation include experimentation clauses, outcome-oriented legislation, sunset clauses, test of alternatives, top-runner approach, or any combination thereof. In the implementation stage, innovation deals as voluntary agreements with stakeholders (innovators, civil society, national/regional or local authorities) and the Commission services aim to address perceived regulatory obstacles to innovative solutions stemming from existing EU rules, when a need for clarification (instead of revision) exists. See European Commission: Better Regulation Toolbox, Tool #22, p. 170, 176 – 178 [https://ec.europa.eu/info/law/law-making-process/planning-and-proposing-law/better-regulation-why-and-how/better-regulation-guidelines-and-toolbox/better-regulation-toolbox-0_en], accessed 18/11/2022.

In this view, experimental regulation, such as regulatory sandboxes, intuitively fits with the innovation principle and is essential in ensuring that the emerging business models that do not comply with existing regulatory frameworks are not pre-maturely excluded from the market, without allowing them to prove that they can offer adequate levels of protection of users.[35] The aim is not to deregulate or lower the existing standards of safety and protection, but to develop an appropriate regulatory environment, capable of keeping pace with innovation, while preserving the necessary safeguards.

Experimental law-making is evidence-based law-making, and it should be designed with caution to avoid potential adverse effects.[36] In any case, the approach to regulating new and disruptive technologies, as proposed by many authors, should be "dynamic, cyclic and interactive",[37] should involve many stakeholders and quasi-regulators, and most importantly, it should involve continuous reflexive processes and re-evaluation of its effectiveness according to the observed impact, effects and further development of technology and its application.

Given the aim and the scope of this paper, we will not be able to dig deeper into all the possible approaches to regulating AI. Our starting point is that coping with technological innovation requires, at least to a certain extent, regulatory innovation as well.[38] The above discussion aims to show that applying traditional regulatory strategies to innovative technological ecosystems is difficult,[39] if achievable at all. We offer it as a background and an introduction to a relatively novel concept of experimental law-making through regulatory sand-

[35] See European Commission, Study supporting the interim evaluation of the innovation principle, *op. cit.* (fn. 33), p. 47. See also European Commission: Better Regulation Toolbox, Tool #69, *op. cit.* (fn. 34), p. 597 – 602.

[36] Ranchordás identifies three common adverse effects of regulatory experimentation: limited internal and external validity of experiment's results (i.e. inability to identify whether the results ensue from the experiment or other circumstances, and the inability to draw generalised conclusions), limited scientific reasoning (which impedes evidence-based law-making and rationalisation of regulation) and methodological deficiencies (lack of objective, transparent and predictable standards which violate the principles of legal certainty, non-discrimination, and proportionality). The awareness of these shortcomings is crucial for designing better experimental legal regimes. See Ranchordás, S.: *Experimental Regulations and Regulatory Sandboxes – Law Without Order?*, Law and Method 2021 - Special Issue: Experimental Legislation in Times of Crisis (edited by Ranchordás, S.; van Klink, B.), p. 3.

[37] Leenes, R. *et al.*: *op. cit.* (fn. 4), p. 39-40.

[38] On the concept of regulatory innovation see e.g. Black, J.: What is regulatory innovation?, in: Black, J.; Lodge, M.; Thatcher, M.: *Regulatory innovation. A comparative analysis*, Cheltenham – Northampton, 2005, p. 12.

[39] Brummer, C.; Yadav, Y.: *op. cit.* (fn. 2), p. 244.

boxes. They are liable to open up an alternative avenue for risk management of disruptive technologies, such as AI, through a dynamic learning process that benefits businesses, consumers, and regulators.[40]

3. REGULATORY SANDBOXES: INNOVATIVE LEGAL REGIMES FOR INNOVATIVE TECHNOLOGIES

3.1. THE CONCEPT AND FEATURES OF REGULATORY SANDBOXES

We start from a definition of regulatory sandboxes offered by Ranchordás, who defines them as "experimental legal regimes which wave, modify national regulatory requirements (or implementation) or provide bespoke guidance on a temporary basis and for a limited number of actors in order to support businesses in their innovation endeavors".[41] Whereas experimental law-making in the EU is mostly associated with multi-level governance frameworks, regulatory sandboxes can be "much more and sometimes much less than that": they are innovation friendly, flexible and adaptable regulatory instruments.[42] Other authors refer to regulatory sandboxes as "an attempt by authorities to build supervisory capacity through engagement and state-sponsored innovation and experimentation",[43] and an opportunity for the firms to "test their products with real customers in an environment that is not subject to the full panoply of rules", creating a "collaborative relationship between regulator and regulated firm", and lifting "regulatory burdens from sandbox participants by affording flexibility in satisfying the regulatory goals of the sandbox".[44] Regulatory sandbox is praised as a forward-looking form of regulatory engagement, and a "genuinely new addition to the regulatory arsenal", as opposed to merely *ad hoc* policy responses to digital innovation.[45] The European Commission relies on a broad definition of regulatory sandboxes as "schemes that enable firms to test innovations in a controlled real-world environment, under a specific plan developed and monitored by a competent authority".[46]

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[40] Yordanova, K.: *The Shifting Sands of Regulatory Sandboxes for AI*, CITIP Blog, [https://www.law.kuleuven.be/citip/blog/the-shifting-sands-of-regulatory-sandboxes-for-ai/], accessed 18/11/2022.

[41] Ranchordás, S.: *op. cit.* (fn. 36), p. 1 – 2.

[42] *Ibid.*, p. 1.

[43] Brummer, C.; Yadav, Y.: *op. cit.* (fn. 2).

[44] Allen, H. J.: *Regulatory Sandboxes*, The George Washington Law Review 87(3) 2019, pp. 579-645, p. 592.

[45] Brummer, C.; Yadav, Y.: *op. cit.* (fn. 2).

[46] European Commission: Better Regulation Toolbox, Tool #69, *op. cit.* (fn. 34), p. 597.

The above descriptions point to several important features of regulatory sandboxes: their experimental nature, genuine innovation, temporary character, (limited) regulatory relief, controlled entry/access, close engagement, and interaction between regulators and innovators which allows mutual learning, supervision, flexibility, and adaptation. The idea is to allow the developers to test and build new ideas and inventions in a "simplified, interactive regulatory environment", "within the controlling parameters of the regulatory sandbox", but "without restrictive or complex rules that elevate regulatory risk and stifle innovation".[47] A regulatory sandbox provides a ground for experimenting with innovative technologies/products/services in an environment that will (hopefully) be able to contain or limit the consequences of a failure.

An obvious association with a sandbox in children's playground might be misleading: there is a lot more structure, control, and supervision here, and strict adherence to the rules of the game is required. Nevertheless, the process is flexible enough to let the innovators experiment and try out their innovations in real-world conditions, in a relaxed regulatory environment, whereas regulators get a direct insight into the development of innovations, and their design, and can better understand how emerging technologies, products, and services operate in the real world.[48]

A sandbox is not a novel concept in the world of computer science, where it denotes "an isolated environment meant for testing and/or preventing malicious programs from damaging a computer system or critical system resources".[49] Its testing function and risk mitigation are key features that bring this concept into the realm of regulation, where it becomes "a process and a tool for regulation", comparable to a laboratory where innovations are tested against the existing regulatory framework, through a process involving participating business entities and a regulator.[50]

Together with innovation hubs,[51] which represent another (well-established, and perhaps more familiar) concept of institutionalized supervisory outreach

[47] Brummer, C.; Yadav, Y.: *op. cit.* (fn. 2), p. 291- 292.

[48] *Loc. cit.*

[49] Yordanova mentions the example of a web browser, see Yordanova, K.: *op. cit.* (fn. 40). See also Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 45-46.

[50] Yordanova, K.: *op. cit.* (fn. 40).

[51] There is no uniform definition of innovation hubs, but they typically encompass one-stop shops involving multi-stakeholder cooperation and serve as a "…central contact point to streamline queries and provide support, advice, and guidance to either regulated or unregulated firms, helping them navigate the regulatory, supervisory, policy, or legal environment. Support can be direct or indirect, via guidance to the market, and it does not generally include testing of products or services." See World Bank: Global Experiences from Regulatory Sandboxes,

for new and emerging technologies, regulatory sandboxes are known as "innovation facilitators".[52] Regulatory sandboxes, however, go a step further than innovation hubs: whereas innovation hubs usually provide a specific scheme or platform for firms to engage in a dialogue, and seek clarifications or non-binding guidance from the supervisory authority; regulatory sandboxes enable a direct testing environment for innovative products, services or business models, in real-world conditions, subject to the application of specific safeguards and regulatory lenience.[53] Although there is no uniform template for regulatory sandboxes and they may significantly differ in their nature and entry requirements, sometimes including also other features of experimental law-making, one shared characteristic of regulatory sandboxes is that the sandbox participants are restricted concerning the nature and scale of activities to be carried out during testing in the sandbox environment.[54]

The rise of regulatory sandboxes is associated with the development and application of new and emerging technologies, which have had a disruptive impact and have dramatically changed business models, processes, and products.[55] It started with the proliferation of FinTech regulatory sandboxes at the national level.[56] Before we take a look into their practical functioning and impact, it is important to concentrate on the common features and conceptual foundations that are applicable to regulatory sandboxes in general, regardless of the specific field in which they might operate.

Even though regulatory sandboxes may vary according to their forms, stated objectives, and practical implementation,[57] it is possible to identify several common features. Zetzsche et al. group these features around the sandboxes'

Fintech note no. 8, p. 2, [https://documents1.worldbank.org/curated/en/912001605241080935/pdf/Global-Experiences-from-Regulatory-Sandboxes.pdf], accessed 18/11/2022.

[52] Parenti, R.: Regulatory Sandboxes and Innovation Hubs for FinTech. Impact on innovation, financial stability and supervisory convergence, Luxembourg, 2020, p. 18. See more in Zubović, A.; Derenčinović Ruk, M.: Digitalna transformacija vrijednosnih papira i aktivnosti regulatora tržišta kapitala, in: Barbić, J. (ed.): *Nove tehnologije i pravo društava*, Zagreb, 2022, pp. 95 – 137, p. 113.

[53] Parenti, R.: *op. cit.* (fn. 52), p. 19 – 20. It is highlighted that these models are not mutually exclusive, and can be combined to effectively achieve desired objectives of regulation.

[54] Ahern, D.: *Regulators Nurturing FinTech Innovation: Global Evolution of the Regulatory Sandbox as Opportunity Based Regulation*, EBI Working Paper Series 2020 no. 60, p. 7.

[55] Parenti, R.: *op. cit.* (fn. 52), p. 17

[56] The UK's Financial Conduct Authority (FCA) is known as a "sandbox pioneer", but we notice the growth of regulatory sandboxes across jurisdictions. See Allen, H. J.: *Sandbox Boundaries*, Washington College of Law Research Paper No. 2019-18, pp. 299 – 321, p. 300; Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 45-46; Zubović, A.; Derenčinović Ruk, M.: *op. cit.* (fn. 52), p. 108.

[57] Allen, H. J.: *op. cit.* (fn. 56), p. 302.

objectives and conditions, with the latter encompassing the entry test, the scope of coverage, mandatory provisions, and reasons for removing the privilege.[58]

The objectives for introducing a regulatory sandbox may vary according to the context and regulator's mandate, but usually indicate promoting or supporting innovation, fostering effective and efficient service provision systems, market development, enhancing competition and economic growth, understanding how emerging technologies and business models interact with the legal framework, promoting inclusion of consumers, etc.[59] It is warned that the promotion of innovation cannot be the only regulatory goal, especially if it is implemented at the expense of consumer protection and other interests.[60] The entry test encompasses necessary legal and economic conditions of entry, to determine whether the entrant is qualified to "play in the sandbox".[61] These conditions may include an assessment of the innovation potential,[62] prospective risks, and benefits for markets and consumers,[63] the necessity for a sandbox approach,[64]

[58] Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 69 and following. Similar classifications are deployed by other authors, see e.g. Ranchordás, S.: *Experimental law-making in the EU: Regulatory sandboxes*, University of Groningen Faculty of Law Research Paper Series No. 12/2021, p. 4 - 5, available at SSRN [https://ssrn.com/abstract=3963810], accessed 18/11/2022.

[59] Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 68 - 69; Allen, H. J.: *op. cit.* (fn. 56), p. 302 – 303.

[60] Allen, H. J.: *op. cit.* (fn. 44), p. 581. Furthering this discussion in the field of FinTech regulation, Brummer and Yadav frame the so-called „innovation trilemma" and argue that regulators, when balancing three competing policy objectives—fostering innovation, maintaining market integrity, and offering rules simplicity—can, at best, fully achieve two out of three of these regulatory goals. See Brummer, C.; Yadav, Y.: *op. cit.* (fn. 2), p. 244.

[61] „Eligibility to enter a sandbox is standardized and publicized, thus requiring market participants to articulate their added value in a pre-defined format. This is cost effective for participants and resource-effective for regulators, allowing easier comparison among potential entrants to the sandbox." See Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 45 – 46, 71.

[62] A questionable characteristic, since it is debatable whether the regulator itself is capable of assessing it. See Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 69. See also Zubović, A.; Derenčinović Ruk, M.: *op. cit.* (fn. 52), p. 109. "Genuine innovation" might include anything from a new spin on the existing idea, creation of a new market for existing products, or improved access of underserved customers to existing markets. See [https://www.fca.org.uk/firms/innovation/regulatory-sandbox], accessed 18/11/2022.

[63] The exact parameters for measuring the benefits to consumers may vary, but the proposal certainly should not expose consumers to undue risk. Through the sandbox, firms are provided with support to identify the proper consumer safeguards and ensure market transparency. See World Bank: *op. cit.* (fn. 51), p. X, 24 - 25. See also [https://www.fca.org.uk/firms/innovation/regulatory-sandbox], accessed 18/11/2022.

[64] Firms will have to demonstrate a genuine need for a sandbox approach, mostly because their technology, service, or activity faces unnecessary regulatory burdens and does not fit neatly into the existing regulatory framework, which makes it difficult and costly to get the innovation to the market. See [https://www.fca.org.uk/firms/innovation/regulatory-sandbox],

as well as the entrants' preparedness test (i.e. whether technology has entered a development phase, whether the entrants understand the laws and regulation governing their conduct, and whether they engage in appropriate risk management).[65] As to the scope of coverage, the existing examples across the globe in the FinTech industry show considerable variations, from sectoral limitations, or limits to the engagement of licensed entities, to defining designated customers, and/or possible time and size constraints.[66] The scope can be limited geographically (e.g. to the national market),[67] according to the specific themes or policy priorities,[68] type of sandbox (i.e. product, policy, cross-sectoral),[69] number of participants, duration of testing, access model,[70] etc. In addition, testing restrictions may apply, e.g. restrictions concerning the number and/or type of customers a firm may serve during the testing period.

The ability to conduct a live test of innovative products or services under real-world conditions, supported by the relevant market authority and applying the sandbox tools which can relax the regulatory regime and thus lower the costs of market entry is what draws the firms to try out their innovations in regulatory sandboxes. However, the regulatory sandbox is not a "regulatory-exempt space".[71] To retain the necessary flexibility, most existing regulatory sandboxes do not prescribe in advance which mandatory provisions can be waived, but there is usually a core of rules which cannot be subject to adaptation and relaxation (such as requirements concerning the prevention of

accessed 18/11/2022.

[65] FCA, e.g., highlights that the entrants should have a clear vision of the objectives of the sandbox, understand the applicable regulations, consider the risks and impact of (successful) testing, and ensure voluntary participation of the testing partners. See [https://www.fca.org.uk/firms/innovation/regulatory-sandbox], accessed 18/11/2022.

[66] Zetzsche, D. A. *et al*.: *op. cit*. (fn. 3), p. 71 – 76.

[67] See FCA [https://www.fca.org.uk/firms/innovation/regulatory-sandbox], accessed 18/11/2022.

[68] E.g., enhancing blockchain technology, innovations in insurance technology, supporting remote authentication, etc. Available data shows that the share of thematic sandboxes in 2020 was around 40 %. See World Bank: Key data from regulatory sandboxes across the Globe, [https://www.worldbank.org/en/topic/fintech/brief/key-data-from-regulatory-sandboxes-across-the-globe], accessed 18/11/2022.

[69] *Loc. cit*.

[70] For example, in 2021 the UK's FCA regulatory sandbox has moved from a cohort to an always open model, allowing firms to submit their applications and access the testing services at any point throughout the year. See [https://www.fca.org.uk/firms/innovation/regulatory-sandbox], accessed 18/11/2022.

[71] See [https://www.fca.org.uk/firms/innovation/regulatory-sandbox], accessed 18/11/2022.

money laundering, customer confidentiality, etc.).[72] Ahern observes a hierarchy or sliding scale of models of the regulatory relief in different sandbox systems: From the most strict (no relaxation of applicable rules), over the moderation of the strict approach (relaxation of applicable rules permitted only within the discretionary scope of existing rules), and customized approach for pre-determined sandboxes with pre-determined parameters including those relating to regulatory relief (block exemption license), to the most radical model (tailor-made sandbox based on the relaxation of specific rules).[73] The last, but not least common feature involves the prescribed conditions for the forced exit,[74] or the requirement to elaborate an exit strategy in advance.[75]

Having in mind these common features, many authors point out that regulatory sandboxes might help reduce the pervasive information uncertainties attached to the growth of algorithms and AI, as well as to the viability of new data, particularly at an early stage of innovation.[76] Ideally, they should keep pace with AI development, without unduly restricting its innovative potential. In the next section, we will briefly touch upon the existing examples of FinTech regulatory sandboxes to investigate whether this experimentation – innovation – dialogue triad in regulatory sandboxes is capable of increasing competitiveness, especially for innovative SMEs.

3.2. DRAWING FROM THE EXPERIENCE OF FINTECH REGULATORY SANDBOXES

Having taken a look at the distinctive features of regulatory sandboxes, we now turn to the example of regulatory sandboxes in the FinTech industry to establish their impact on SMEs. The term FinTech denotes a diffuse set of

[72] Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 75 – 76. For example, the MAS FinTech Regulatory sandbox guidelines enumerate the list of "to maintain" and "possible to relax" requirements in an exemplary manner, to be determined in accordance with the specifics of each case. See [https://www.mas.gov.sg/-/media/MAS-Media-Library/development/Regulatory-Sandbox/Sandbox/FinTech-Regulatory-Sandbox-Guidelines-Jan-2022.pdf?la=en&hash=0136A576014D8B13D-16264CDFDA2C66791F6E8CA], accessed 20/11/2022.

[73] Ahern, D: *op. cit.* (fn. 54), p. 17 – 20.

[74] E.g., if the risks outweigh benefit, if the participant does not comply with rules and obligations, or if the purpose of the sandbox is not achieved. See Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 77.

[75] See Ahern, D.: *Regulatory Lag, Regulatory Friction and Regulatory Transition as FinTech Disenablers: Calibrating an EU Response to the Regulatory Sandbox Phenomenon*, EBI Working Paper Series 2021 no. 102, p. 15; Zubović, A.; Derenčinović Ruk, M.: *op. cit.* (fn. 52), p. 108.

[76] Brummer, C.; Yadav, Y.: *op. cit.* (fn. 2), p. 291 – 292.

technology-enabled financial services with a profound and sometimes disruptive impact on financial markets, institutions, and the financial sector in general,[77] including, but not limited to, digital banking or payment services, platform-based financing, robo-advisers, blockchain and distributed ledger technologies (DLT), smart contracts, application programming interfaces (APIs), etc. FinTech regulatory sandboxes are applicable either in the traditionally regulated financial sector or across sectors.[78] Their growing popularity across the globe is evident: in 2017, there were 16 regulatory sandboxes in operation,[79] whereas in 2020, 73 FinTech-related regulatory sandboxes were recorded.[80] About one-fifth of all regulatory sandboxes was created in the first half of 2020, suggesting a rapid growth in the use of sandboxes to test FinTech innovation and regulation.[81]

The main *ratio* behind existing FinTech sandboxes seems to be in the increase of supervisory knowledge and capacity to understand FinTech activities and their business models, risks and incentives.[82] By analogy, the same logic can be extended to the creation of AI regulatory sandboxes.

In addition to their proliferation in the last decade, the functioning of FinTech regulatory sandboxes has also diversified. The Monetary Authority of Singapore (MAS), for example, has started differentiating several sandbox regimes according to risk and necessity: there are (traditional) Sandbox, Sandbox Express, and Sandbox Plus options in place.[83] This is a perfect example of a mutual learning experience in the sandbox, which results in the regulator's better

[77] See Parenti, R.: *op. cit.* (fn. 52), p. 14 and following; Allen, H. J.: *op. cit.* (fn. 44), p. 585.

[78] Parenti, R.: *op. cit.* (fn. 52), p. 14.

[79] Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 64.

[80] See World Bank: *op. cit.* (fn. 68).

[81] See World Bank: *op. cit.* (fn. 68).

[82] Parenti, R.: *op. cit.* (fn. 52), p. 8.

[83] FinTech Regulatory Sandbox framework was implemented in Singapore in 2016, enhanced with Sandbox Express in 2019 and Sandbox Plus in 2022. Whereas Sandbox option is aimed for more complex business models where customisation is required to balance the risks and benefits of the experiment, Sandbox Express provides firms with a faster option to test certain innovative financial products and services in the market, where the risks are low and well-understood by the market. It allows eligible applicants to begin market testing within 21 days of applying to MAS. See MAS Sandbox Express Guidelines (updated January 2022), [https://www.mas.gov.sg/-/media/MAS-Media-Library/development/Regulatory-Sandbox/Sandbox-Express/Sandbox-Express-Guidelines-1-Jan-2022.pdf?la=en&hash=08F99C6216499DFCED58489B5C0B3C8A8139CC57], accessed 20/11/2022. Express Plus, on the other hand, provides a one-stop assistance designed to support early adopters and first movers of technology innovation concerning eligibility criteria and streamlining application with financial grants. See [https://www.mas.gov.sg/development/fintech/regulatory-sandbox], accessed 20/11/2022.

understanding of innovators and their needs, and the corresponding ability to adapt to the sandbox environment.

Various regulatory sandbox tools can be applied, depending on the needs and nature of specific business tests conducted, sometimes combining the functions of innovation hubs with regulatory sandboxes. For example, the UK's Financial Conduct Authority (FCA) applies an arsenal of tools, from restricted authorization, signposting, informal steer, individual guidance, waivers or modification to rules, and 'no enforcement action' letters.[84] Similar tools are applied in other jurisdictions, with so-called "innovation waivers", or waivers from existing rules during the sandbox testing, as the most commonly used tool.[85] The same tools and the lessons learned from their application should be catered to the needs of AI regulatory sandboxes.[86] The Norwegian Data Protection Authority's Sandbox for Responsible AI, for example, offers free guidance for companies selected to participate in the sandbox, in exchange for full openness about the assessments that are made.[87] The sandbox is not intended to grant exemptions from regulations, but the Data Protection Authority will not initiate corrective measures during the test – the focus is on helping the participants comply with the existing regulations.[88] In the context of AI sandboxes, the tools will depend on the sector and market for which the

[84] Restricted authorisation includes support and tailored authorisation process for non-authorised entities, but it is restricted to testing innovative product or service as agreed. Signposting is not tailored to a particular firm, but it is nevertheless helpful since it includes identifying existing rules and offering guidance that might be relevant to the firm and the proposed business model. Informal steer is a tool to help firms understand the potential regulatory implications of their innovative product or business model at an early stage of development, but without guarantees – it is followed at firm's own risk. Individual guidance might be available to explain how the authority should interpret prescribed requirements in the context of a specific test, whereas waivers or modifications to rules include waiving or modifying overly difficult rules for the purpose of the test, but cannot include waivers from national or international law. The 'no enforcement action' letters are applied where the FCA cannot issue individual guidance or waivers, they are limited for the duration of the test and to FCA's own disciplinary actions, without affecting the liability to consumers. See [https://www.fca.org.uk/firms/innovation/regulatory-sandbox], accessed 18/11/2022.

[85] See e.g., [https://www.natlawreview.com/article/hardly-child-s-play-north-carolina-joins-growing-number-states-fintech-regulatory], accessed 18/11/2022.

[86] Ranchordás refers to temporary derogations, bespoke guidance, regulatory comfort and confirmations as typical sandbox tools. See Ranchordás, S.: *op. cit.* (fn. 58), p. 4.

[87] See [https://www.datatilsynet.no/en/regulations-and-tools/sandbox-for-artificial-intelligence/; https://www.datatilsynet.no/en/regulations-and-tools/sandbox-for-artificial-intelligence/framework-for-the-regulatory-sandbox/], accessed 18/11/2022.

[88] See [https://www.datatilsynet.no/en/regulations-and-tools/sandbox-for-artificial-intelligence/framework-for-the-regulatory-sandbox/], accessed 18/11/2022.

sandbox is created (i.e. whether it is a regulated market), the powers vested in the supervising body implementing the sandbox, the objectives of the sandbox, etc. The mentioned Norwegian Data Protection Authority's Sandbox for Responsible AI enumerates the 'activities' offered in the sandbox, which boil down to signposting, informal steer, individual guidance, and mutual learning and involve an interdisciplinary team of experts depending on the needs of each participant (lawyers, technologists, social scientists, communication consultants, etc.).[89] The bottom line is that there is no "one-size-fits-all" solution, and that the chosen collection of sandbox tools should accommodate the specific objectives pursued.

There are still no clear signals as to the impact of FinTech sandboxes on the competitiveness of SMEs. Analyzing the viability of its sandbox model following the first year of its application, the UK FCA found clear evidence that the sandbox has been most popular with start-up companies and those that are not yet authorized by the FCA, whereas the share of participation of SMEs is roughly equal to that of large firms.[90] Further empirical findings support the conclusion that sandbox reduces information asymmetries and regulatory costs, thus helping sandbox participants raise more capital after entry.[91] With AI regulatory sandboxes, there might be more incentives for innovative SMEs to participate, should the EU follow through on its commitment to boost the competitiveness of SMEs.

[89] I.e. assisting in the performance of a data protection impact assessment, contributing to the identification of data protection challenges, providing feedback on relevant technical and legal solutions to data protection challenges, exploring options for the implementation of privacy by design, conducting informal inspections to highlight relevant requirements, contributing input to various assessments and considerations of the balance between necessity and potential adverse effects on user privacy, providing an arena for knowledge exchange and network-building for other sandbox participants, external experts, and other authorities, and sharing preliminary and final sandbox experiences. See [https://www.datatilsynet.no/en/regulations-and-tools/sandbox-for-artificial-intelligence/framework-for-the-regulatory-sandbox/what-happens-in-the-sandbox/], accessed 18/11/2022.

[90] Financial Conduct Authority (FCA): *Regulatory Sandbox Lessons Learned Report*, 2017, p. 9 [https://www.fca.org.uk/publication/research-and-data/regulatory-sandbox-lessons-learned-report.pdf], accessed 18/11/2022.

[91] Cornelli, G. *et al.*: Inside the regulatory sandbox: effects on fintech funding, BIS Working Papers No. 901, 2020, p. 26 [https://www.bis.org/publ/work901.pdf], accessed 20/11/2022.

4. AI REGULATORY SANDBOXES

4.1. THE EU POLICY APPROACH TO REGULATORY SANDBOXES

The growing recognition of regulatory sandboxes as innovation facilitators is apparent in policy and strategy papers of EU institutions in recent years. In its AI Strategy from 2018, the European Commission mentions regulatory sandboxes only in the passing, and describes them as "testing grounds for new business models that are not (yet) regulated".[92] The ensuing Coordinated Action Plan for AI and its Annex from the same year further elaborates the idea of establishing AI regulatory sandboxes, as part of a wider effort for supporting start-ups and innovative SMEs.[93] The accompanying reasoning was that regulatory sandboxes "can play an important role to encourage AI-based innovation for areas where the law provides regulatory authorities with a sufficient margin of maneuver".[94] The latter caveat puts obvious boundaries to sandboxing approach, and the Commission acknowledged that, depending on the circumstances, innovation can be supported with "softer approaches", i.e. other methods for policy experimentation and development, such as digital innovation hubs, innovation deals, innovation centers, and policy labs.[95] Surprisingly, the idea of regulatory sandboxes is completely absent in the White Paper on AI from 2020, which focuses primarily on digital innovation hubs as facilitators for access and use of AI by SMEs.[96] In this view, SMEs should be empowered to understand and adopt AI, but are not recognized as innovation leaders requiring the testing ground for their innovative solutions. Nevertheless, policy experimentation, especially in the context of regulatory sandboxes, is identified as a useful strategy to unleash the potential of SMEs in the digital transition.[97]

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[92] See European Commission: Artificial Intelligence for Europe, *op. cit.* (fn. 10), p. 9. This definition might not accurately convey the meaning and purpose of regulatory sandboxes. While the business model may be new and innovative, it is the fact that its impact upon entering a regulated territory may be unknown or unforeseeable in advance, or that the costs of compliance with the existing regulation is liable to impede the application of the innovative model that cause the need for a testing ground.

[93] European Commission: Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, Coordinated Plan on Artificial Intelligence, COM/2018/795 final, Brussels, 7.12.2018, p. 3; and Annex, p. 8 - 9.

[94] *Ibid.*, Annex, p. 17.

[95] *Ibid.*, Annex, p. 18.

[96] European Commission: White paper on Artificial Intelligence, *op. cit.* (fn. 9), p. 7.

[97] European Commission: Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the

In the broader EU regulatory and policy setting, it should be stressed that the Commission's Better Regulation Toolbox 2021 dedicates particular attention to regulatory sandboxes as emerging policy instruments and the most recent tools of adaptive regulation, identifying their main characteristics, benefits and challenges, as well as providing examples of existing sandboxes and a blueprint for their set-up.[98] It is highlighted that the findings from a regulatory sandbox can be used to inform *ex ante* impact assessments and consideration of various policy options, as well as *ex post* evaluation of existing legislation or fitness checks, but that other forms of experimentation may be more appropriate in a particular case.[99]

The European Parliament has already in 2019 embraced the idea of using regulatory sandboxes to introduce, in cooperation with regulators, innovative new ideas, allowing safeguards to be built into the technology from the start, thus facilitating and encouraging its market entry.[100] It also highlighted the necessity to introduce AI-specific regulatory sandboxes "to test the safe and effective use of AI technologies in a real-world environment."[101] In the context of digital financial services, the European Parliament has called on the Commission to establish a common Union framework for a pan-European sandbox for digital financial services,[102] recognizing that it would provide additional benefits for financial innovation and stability, and reduce supervisory fragmentation.

The Council has also been openly endorsing regulatory sandboxes and experimentation clauses, as part of a better regulation toolbox contributing to an innovation-friendly, future-proof, sustainable, and resilient EU regulatory framework.[103] The Council affirms that regulatory sandboxes can offer significant

Regions. An SME Strategy for a sustainable and digital Europe, COM/2020/103 final, Brussels, 10.3.2020. The draft AI Act gives effect to this by prioritising access of SMEs to AI regulatory sandboxes. This will be further elaborated under 4.2.

[98] European Commission: Better Regulation Toolbox, *op. cit.* (fn. 34), Tool #69.

[99] I.e. those under Tool #22. See: European Commission: Better Regulation Toolbox, *op. cit.* (fn. 34), Tool #22 and Tool #69.

[100] European Parliament: Resolution of 12 February 2019 on a comprehensive European industrial policy on artificial intelligence and robotics (2018/2088(INI)).

[101] *Ibid.*, para. 32.

[102] European Parliament: Resolution of 8 October 2020 with recommendations to the Commission on Digital Finance: emerging risks in crypto-assets - regulatory and supervisory challenges in the area of financial services, institutions and markets (2020/2034(INL)).

[103] Council of the European Union: Conclusions on Regulatory sandboxes and experimentation clauses as tools for an innovation-friendly, future-proof and resilient regulatory framework that masters disruptive challenges in the digital age, *op. cit.* (fn. 34). Regulatory sandboxes are defined as "concrete frameworks which, by providing a structured context for experimentation, enable where appropriate in a real-world environment the testing of innovative technologies,

opportunities particularly to innovate and grow for all businesses, especially SMEs, including micro-enterprises as well as start-ups, in industry, services, and other sectors.[104]

It is important to mention that the current financial envelope for the Digital Europe Programme for the period 2021-2027[105] does not expressly include the financing of AI regulatory sandboxes at the national or EU level.[106] This is not surprising, given that they are still not a widespread phenomenon in the EU Member States,[107] and that the common rules for their establishment are yet to be implemented with the adoption of the Draft AI Act. Instead, the Digital Europe Programme focuses on support and financing for the European Digital Innovation Hubs,[108] as bespoke legal entities for achieving the goals of the

products, services or approaches – at the moment especially in the context of digitalisation – for a limited time and in a limited part of a sector or area under regulatory supervision ensuring that appropriate safeguards are in place." Often serving as the legal basis for regulatory sandboxes, experimentation clauses are defined as "legal provisions which enable the authorities tasked with implementing and enforcing the legislation to exercise on a case-by-case basis a degree of flexibility in relation to testing innovative technologies, products, services or approaches." Compare with the stated purpose of experimentation clauses as provided under Better Regulation Tool #22 (European Commission: Better Regulation Toolbox, *op. cit.* (fn. 34)). See more on regulatory sandboxes and experimentation clauses in Štefanek, Š.: *Regulatory sandboxes and experimentation clauses: An attempt to make the (Croatian) legal system more entrepreneurial*, EU and Comparative Law Issues and Challenges (ECLIC) (6) 2022 [https://doi.org/10.25234/eclic/22416], pp. 213 – 235.

[104] Council of the European Union: *op. cit.* (fn. 102).

[105] Regulation (EU) 2021/694 of the European Parliament and of the Council of 29 April 2021 establishing the Digital Europe Programme and repealing Decision (EU) 2015/2240 (OJ L 166, 11.5.2021).

[106] This does not mean that the financing for the projects including AI regulatory sandboxes cannot be obtained either under the framework of the Digital Europe Programme, or other financing instruments of the EU.

[107] In 2020, only 7 Member States have implemented some type of sandbox (see World Bank: *op. cit.* (fn. 68)); whereas in 2021, more than half of EU Member States have set up sandboxes, mostly in areas of finance, transport and energy, with additional in the pipeline. See Science, research and innovation performance of the EU 2022. Building a sustainable future in uncertain times 2022, p. 552 [https://op.europa.eu/en/publication-detail/-/publication/52f8a759-1c42-11ed-8fa0-01aa75ed71a1/], accessed 19/11/2022. A "state-of-play" fact-finding mission was initiated during the Slovenian Presidency of the Council in July 2021, but there is no public report available on key findings. See Council Presidency: State of play on the use of regulatory sandboxes in the EU Member States, Brussels, 5 July 2021, 10338/21.

[108] European Digital Innovation Hubs are defined as legal entities selected under the prescribed procedures to fulfil the tasks of the Digital Europe Programme, by directly providing, or ensuring access to, technological expertise and experimentation facilities, such as equipment and software tools to enable the digital transformation of industry, as well as by facilitating access to finance and it is open to businesses of all forms and sizes, in particular to

Programme, which is to support and accelerate the digital transformation of the European industry, economy, and society. However, the explicit operational objectives under Specific Objective 2 – Artificial Intelligence support the establishment of testing and experimentation facilities (TEFs), as specialized large-scale reference sites open to all technology providers across Europe to test and experiments with state-of-the-art AI-based soft- and hardware solutions and products, in real-world environments and at scale.[109] In turn, the TEFs (as technological "playgrounds") can support the establishment of regulatory sandboxes (as regulatory "playgrounds"), with the goal of developing a dialogue with competent national authorities for supervised testing and experimentation under real or close to real conditions.[110] Compliance with the ethical requirements for AI systems is a prerequisite for all funding actions. The concern for the ethical aspects of AI systems has culminated in the work and recommendations of the High-Level Expert Group on AI. The Ethics Guidelines for Trustworthy AI[111] have significantly informed and influenced the work of the European Commission in preparing the text of the Draft AI Act.[112] The Guidelines set up a voluntary framework and guidance for all AI stakeholders, including but not limited to companies, organizations, researchers, public services, government agencies, institutions, civil society organizations, individuals, workers, and consumers. They can be relevant in the setting up and operation of regulatory sandboxes, and they should serve as a key reference point, particularly for those Member States which have not yet developed national AI strategies. The Guidelines set up a framework and identify seven key requirements for Trustworthy AI (1) human agency and oversight, (2) technical robustness and safety, (3) privacy and data governance, (4) transparency, (5) diversity, non-discrimination and fairness, (6) environmental and societal

SMEs, mid- caps and scale-up companies, and to public administrations across the Union. See Article 2(5) of the Regulation (EU) 2021/694 of the European Parliament and of the Council of 29 April 2021 establishing the Digital Europe Programme and repealing Decision (EU) 2015/2240 (OJ L 166, 11.5.2021).

[109] See Article 5, Regulation (EU) 2021/694 of the European Parliament and of the Council of 29 April 2021 establishing the Digital Europe Programme and repealing Decision (EU) 2015/2240 (OJ L 166, 11.5.2021).

[110] See Testing and experimentation facilities under the Digital Europe Programme [https://digital-strategy.ec.europa.eu/en/activities/testing-and-experimentation-facilities], accessed 18/11/2022.

[111] Independent High-Level Expert Group on Artificial Intelligence (HLEG): Ethics Guidelines for Trustworthy AI [https://digital-strategy.ec.europa.eu/en/library/ethics-guidelines-trustworthy-ai], accessed 18/11/2022.

[112] See European Commission: Draft AI Act, *op. cit.* (fn. 5), Explanatory Memorandum, para. 3.2.

well-being and (7) accountability.[113] These considerations should guide the national authorities in assisting the sandbox entities to develop, deploy and use AI systems in a way that adheres to the ethical principles of respect for human autonomy, prevention of harm, fairness, and explicability.[114] The advocated human-centric approach to AI, consistently emphasized throughout legislative and policy-making activities of the EU, can only be achieved if AI sandboxes adhere to these principles to maximize the benefits and minimize the risk of AI systems.

Bearing in mind the generally positive attitude of EU institutions, we now turn to analyzing the proposed provisions on AI regulatory sandboxes in the draft AI Act.

4.2. AI REGULATORY SANDBOXES UNDER THE DRAFT AI ACT

The Draft AI Act, presented by the European Commission in April 2021 aims to set up a robust, yet flexible legal framework for trustworthy AI, encompassing harmonized rules for the development, placement on the market, and use of AI systems in the Union. One of the most important features underlying the Draft AI Act is its proclaimed human-centric approach, based on respect for EU values and human rights. The rules are meant to ensure that people can embrace AI solutions and technology trusting that it is safe and that it complies with the law, including the respect for human rights.

Its stated specific objectives include ensuring that AI systems placed on the Union market and used are safe and respect existing law on fundamental rights and Union values; ensuring legal certainty to facilitate investment and innovation in AI; enhancing governance and effective enforcement of existing law on fundamental rights and safety requirements applicable to AI systems; and facilitating the development of a single market for lawful, safe and trustworthy AI applications, as well as preventing market fragmentation.[115] The AI Act

[113] HLEG: *op. cit.* (fn. 111), p. 2.

[114] *Loc. cit.*

[115] See European Commission: Draft AI Act, *op. cit.* (fn. 5), Explanatory Memorandum, para. 1.1. See more on AI Act in e.g., Veale, M.; Frederik Zuiderveen Borgesius, F.: Demystifying the Draft EU Artificial Intelligence Act, Computer Law Review International 22(4) 20221, p. 97 – 112 [https://doi.org/10.9785/cri-2021-220402]; Ebers, M.: Standardizing AI – The Case of the European Commission's Proposal for an Artificial Intelligence Act, in: DiMatteo, L. A.; Cannarsa, M.; Poncibò, C. (eds.): *The Cambridge Handbook of Artificial Intelligence: Global Perspectives on Law and Ethics*, Cambridge, 2022, p. 321 – 344; Bogucki, A. *et al.*: *The AI Act and emerging EU digital acquis*, CEPS In-Depth Analysis, Brussels, 2022 [https://www.ceps.eu/wp-content/uploads/2022/09/CEPS-In-depth-analysis-2022-02_The-AI-Act-and-emerging-

adopts a proportionate risk-based approach, differentiating between uses of AI that create an unacceptable risk, a high risk, and low or minimal risk. Whereas AI systems that create an unacceptable risk[116] are prohibited, because they contravene Union values and violate fundamental rights, high-risk AI systems[117] are permitted, subject to compliance with certain mandatory requirements and an *ex ante* conformity assessment.

AI system for the purposes of the AI Act is defined as "software that is developed with one or more of the techniques and approaches listed in Annex I and can, for a given set of human-defined objectives, generate outputs such as content, predictions, recommendations, or decisions influencing the environments they interact with".[118] Without going into further discussions about this

EU-digital-acquis.pdf], accessed 20/11/2022; Raposo, V. L.: *Ex machina: Preliminary critical assessment of the European Draft Act on artificial intelligence*, International Journal of Law and Information Technology, 30 2022, pp. 88–109 [https://doi.org/10.1093/ijlit/eaac007].

[116] Article 5 of the Draft AI Act contains an exhaustive list of specific prohibited AI practices, such as those applying manipulative or exploitative practices through subliminal techniques beyond a person's consciousness or exploit vulnerabilities of specific vulnerable groups; or AI-based social scoring for general purposes by public authorities, or the use of 'real time' remote biometric identification systems in public spaces for the purposes of law enforcement, with certain exceptions. In their Opinion on the Draft AI Act, the IMCO and LIBE committees of the European Parliament have suggested adding the predictive policing AI systems to the list. See European Parliament, Committee on the Internal Market and Consumer Protection (IMCO), Committee on Civil Liberties, Justice and Home Affairs (LIBE): Draft Report on the proposal for a Regulation of the European Parliament and of the Council on harmonised rules on Artificial Intelligence (Artificial Intelligence Act) and amending certain Union Legislative Acts, 2021/0106, 22 April 2021.

[117] Classification of an AI system as high-risk is based on its intended purpose, function and modalities for which it is used. Two main categories of high-risk AI systems are those intended to be used as a safety component of other products; and stand-alone AI systems with mainly fundamental rights implications that are explicitly listed in Annex III of the Draft AI Act (such as AI systems intended to be used for the 'real-time' and 'post' remote biometric identification of natural persons; AI systems used to determine access or assigning natural persons to educational and vocational training institutions; or a recruitment or selection of natural persons for job vacancies). The European Commission is empowered to expand this list in line with the emerging uses and applications of AI, and in accordance with the defined criteria and risk assessment methodology. High-risk AI systems have to comply with the minimum legal requirements concerning data and data governance, documentation and record keeping, transparency and provision of information to users, human oversight, robustness, accuracy and security. See Article 6 et seq., Draft AI Act.

[118] Article 3(1) Draft AI Act. The AI techniques and approaches referred to in this provision are listed in Annex I, and include (a) machine learning approaches, including supervised, unsupervised and reinforcement learning, using a wide variety of methods including deep learning; (b) logic- and knowledge-based approaches, including knowledge representation, inductive (logic) programming, knowledge bases, inference and deductive engines, (symbolic) reasoning

legislative definition, it is apparent that it could cause some doubts in practice, especially concerning a delineation between (purely) software and hardware-embedded AI systems.[119]

Being that this is the first comprehensive regulatory framework for AI, the expectations are high. We will analyze the draft provisions[120] concerning the AI regulatory sandboxes to check whether they can support the ambitious goals of the Draft AI Act.

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and expert systems; (c) statistical approaches, Bayesian estimation, search and optimization methods. Under Article 4 of the Draft AI Act, the European Commission is empowered to adopt delegated acts to amend the list of techniques and approaches listed in Annex I, in order to update that list to market and technological developments on the basis of characteristics that are similar to the techniques and approaches listed therein. This provision is likely to be expanded with additional requirements and specifications for the Commission, especially concerning general purpose AI systems, as evident from the procedure and standpoint of delegations in the Council. See Council of the European Union: Proposal for a Regulation of the European Parliament and of the Council laying down harmonised rules on artificial intelligence (Artificial Intelligence Act) and amending certain Union legislative acts - Third Presidency compromise text (Title IA, Articles 30-85 and the relevant recitals, Annexes V-IX) Brussels, 23.9.2022, 12549/22 [https://artificialintelligenceact.eu/wp-content/uploads/2022/09/AIA-CZ-3rd-Proposal-23-Sept.pdf], accessed 18/11/2022.

[119] See, e.g., the definition by the Independent High-Level Expert Group on Artificial Intelligence (HLEG) that proposes to use the term AI system to "…mean any AI-based component, software and/or hardware. Indeed, usually AI systems are embedded as components of larger systems, rather than stand-alone systems." Independent High-Level Expert Group on Artificial Intelligence (HLEG): *op. cit.* (fn. 11), p. 1. For a conceptual comparison between the interchangeable terms "AI systems" (in the Draft AI Act) and "automated decision systems" (in the proposed U.S. Algorithmic Accountability Act), and the preference for the latter, see Mökander, J. *et al.*: *The US Algorithmic Accountability Act of 2022 vs. The EU Artificial Intelligence Act: what can they learn from each other?*, Minds and Machines 2022 [https://doi.org/10.1007/s11023-022-09612-y], published online 18 August 2022. Analysing the definition of AI systems in the Draft AI Act, Schwemer *et al.* advocate for a narrower reading, in light of the overall context and provisions of the AI Act. See Schwemer, S. F.; Tomada, L.; Pasini, T.: *Legal AI Systems in the EU's proposed Artificial Intelligence Act*. Proceedings of the Second International Workshop on AI and Intelligent Assistance for Legal Professionals in the Digital Workplace (LegalAIIA 2021), held in conjunction with ICAIL 2021, June 21, 2021, Sao Paulo, Brazil, available at SSRN [https://ssrn.com/abstract=3871099], accessed 18/11/2022.

[120] We will rely primarily on the text of the relevant provisions, as proposed by the European Commission. Since the legislative process is well under way, in addition to the text of the Draft AI Act proposed by the European Commission, we will also refer to the currently available positions of the Council and the European Parliament committees on specific aspects of the draft proposal, where relevant and appropriate. For the sake of clarity, any reference to 'Draft AI Act' or 'AI Act' in this paper means the version of the text as proposed by the European Commission.

Title V ('Measures in support of innovation') of the Draft AI Act, in the version proposed by the European Commission, contains three provisions (Articles 53 – 55). Although one might be (mis)lead by the title to expect an arsenal of measures, these provisions are primarily concentrated on regulatory sandboxes. The proclaimed objective of this Title is to create a "legal framework that is innovation-friendly, future-proof and resilient to disruption."[121] The addressees are national competent authorities from one or more Member States, as well as the European Data Protection Supervisor.[122] To ensure uniform implementation across the Union, the Draft AI Act provides minimum common rules for regulatory sandboxes (Article 53).[123] The Draft AI Act further offers additional safeguards in terms of data protection (Article 54), as well as measures to reduce the regulatory burden on SMEs and start-ups (Article 55).

Under the Draft AI Act, AI regulatory sandboxes establish a controlled environment that facilitates the development, testing, and validation of innovative AI systems for a limited time before their placement on the market or put into service, based on a specific testing plan agreed with the competent authorities. The competent authorities provide direct supervision and guidance to sandbox entities, to ensure compliance with the requirements of the AI Act and, where relevant, other Union and Member States' legislation supervised within the sandbox.[124]

The content of Article 53 of the Draft AI Act is limited to the basic requirements for AI sandboxes, concerning:

- Purpose and objectives: As can be discerned from the definition of AI regulatory sandboxes under Article 53(1) of the Draft AI Act, their purpose is to facilitate innovation while ensuring regulatory compliance. Recital 72 offers further guidance by citing three objectives: fostering innovation,

[121] European Commission: Draft AI Act, *op. cit.* (fn. 5), Explanatory Memorandum, para 5.2.5.

[122] The Council proposes to circumscribe the authority of the European Data Protection Supervisor to establish only those AI regulatory sandboxes which are connected with the AI systems provided by the EU institutions, bodies and agencies. See Council of the European Union: *op. cit.* (fn. 118), p. 93.

[123] See Recital (72) and Article 53 Draft AI Act.

[124] Article 53(1) Draft AI Act. Strict regulatory oversight in the sandbox environment is necessary to ensure a safe space for experimentation, and to promote responsible innovation and integration of appropriate safeguards and risk mitigation measures, see Recital (71) of the Draft AI Act. Yordanova points out that the definition of AI sandbox is significantly broadened, encompassing "development, testing and validation and therefore combining the traditional function of a regulatory sandbox with those of other tools such as testing and pilots." See Yordanova, K.: *The EU AI Act – Balancing human rights and innovation through regulatory sandboxes and standardization*, TechREG Chronicle, March 2022, p. 7.

enhancing legal certainty for innovators and competent authorities alike, and accelerating access to the markets, with a special focus on removing barriers for small and medium enterprises (SMEs) and start-ups.[125]

- Data protection: The Draft AI Act recognizes the obvious connection of AI use with data protection and privacy concerns, which necessitates co-operation between the relevant authorities involved in the supervision of the sandboxes. It is therefore required to involve national data protection authorities or other competent national authorities in the operation of the AI regulatory sandbox, if and to the extent that the innovative AI systems involve the processing of personal data or otherwise fall under the supervisory remit of other national authorities or competent authorities providing or supporting access to data.[126]
- Powers of competent authorities: It is highlighted that AI regulatory sandboxes do not affect the supervisory and corrective powers of the competent authorities. [127]
- Risk mitigation: Immediate mitigation of any significant risks to health and safety and fundamental rights identified during the development and testing of such systems is required. In case of failure to take mitigation measures, the development and testing process shall be suspended until such mitigation takes place.[128]
- Liability: Experimentation in the sandbox does not exonerate the participants from liability under applicable Union or national legislation for any harm inflicted on third parties as a result of the experimentation taking place in the sandbox.[129]
- The EU dimension: The new European Artificial Intelligence Board[130] and the European Commission provide a reference point for all national compe-

[125] Recital (72) Draft AI Act. The changes to Recital (72) under the Third Presidency compromise text in the Council specifically highlight the "contribution to evidence-based regulatory learning" as a benefit of the sandbox exercise, and place focus on issues that raise legal uncertainty for providers and perspective innovators to innovate. See Council of the European Union: *op. cit.* (fn. 118). The Council proposes to insert the sandbox objectives into the text of Article 53 as well.

[126] Article 53(2) Draft AI Act.

[127] Article 53(3) Draft AI Act.

[128] Article 53(3) Draft AI Act.

[129] Article 53(4) Draft AI Act.

[130] The tasks of the European Artificial Intelligence Board are to provide advice and assistance to the Commission and contribute to the effective cooperation with the national supervisory authorities; to coordinate and contribute to guidance and analysis by the Commission

> tent authorities. National competent authorities will be required to submit annual reports to the Board and the Commission on the results from the implementation of a sandbox, including good practices, lessons learned, and recommendations. This ensures coordination, cooperation, and mutual learning from best practices.[131]

Specific modalities and the conditions of the operation of the AI regulatory sandboxes, including the eligibility criteria and the procedure for the application, selection, participation, and exiting from the sandbox, and the rights and obligations of the participants shall be set out in an implementing act, to be subsequently adopted by the European Commission.[132]

An important addition to the version proposed by the European Commission suggested by the Council concerned the clarification of the relationship between the AI sandboxes set up to ensure compliance with the AI Act, and other national AI regulatory sandboxes that already exist, or will be established in Member States to ensure compliance with legislation other than the AI Act. AI regulatory sandboxes set up under the AI Act should be without prejudice to existing legislation allowing for the establishment of those other sandboxes.[133] Potentially, 'other' regulatory sandboxes could switch to the AI regulatory sandbox operated and supervised under the framework of the AI Act, provided that such agreement between national competent authorities and sandbox participants exists. Such explanations are missing in the text proposed by the European Commission, but they are extremely valuable in view of the fact that many Member States have already introduced, or are in the process of adopting their legal frameworks for AI sandboxes and/or other digital testing grounds.[134] This means that, given the optional character of AI sandboxes under the AI Act, diverging experimental legal regimes will continue to exist

and the national supervisory authorities and other competent authorities on emerging issues covered by the AI Act; and to assist the national supervisory authorities and the Commission in ensuring the consistent application of the AI Act. See Articles 56 – 58 Draft AI Act.

[131] Article 53(5) Draft AI Act.

[132] The blueprint is already provided in the broader context of a Better Regulation Toolbox, where regulatory sandboxes are viewed as an emerging method and policy instrument for *ex ante* policy assessments, or *ex post* fitness checks. See European Commission: Better Regulation Toolbox, *op. cit.* (fn. 34), Tool #69.

[133] See Council of the European Union: *op. cit.* (fn. 118), p. 36 – 37.

[134] See, e.g. in Germany, Bundesministerium fur Wirtschaft und Energie, Neue Raume fur Innovation zu proben, Konzept fur ein Reallabore-Gesetz [https://www.bmwk.de/Redaktion/DE/Publikationen/Digitale-Welt/konzept-fur-ein-reallabore-gesetz.pdf?__blob=publicationFile&v=6], accessed 18/11/2022. See also Federal Ministry for Economic Affairs and Climate Action: [https://www.bmwk.de/Redaktion/EN/Downloads/I/info-reallabore.pdf?__blob=publicationFile&v=4], accessed 18/11/2022.

even after the adoption of the Draft AI Act, and it is necessary to address their potential intersections.

Article 54 of the Draft AI Act prescribes strict conditions for further processing of personal data, which are lawfully collected for other purposes, in the AI regulatory sandbox. The conditions for further processing attach to the purpose of the processing,[135] effective monitoring and mitigation mechanisms,[136] as well as data storage, usage, transmission, and deletion.[137] There are additional requirements concerning the obligatory content of the technical documentation referred to in Annex IV of the Draft AI Act,[138] and transparency of the AI project developed in the sandbox.[139] These obligations are without prejudice to Union or Member States legislation excluding processing for other purposes than those explicitly mentioned in that legislation.[140] The additional

[135] When processing is necessary for the development and testing of certain innovative AI systems aimed at safeguarding substantial public interest (Article 54(1)(a) (i) – (iii) Draft AI Act), and where such data is necessary for complying with one or more requirements on data governance for high-risk AI systems under Title III, Chapter II of the Draft AI Act, if those requirements cannot be effectively fulfilled by processing anonymised, synthetic or other non-personal data (Article 54(1) (b) Draft AI Act). There is no guidance as to the required standard for constituting a 'substantial' public interest.

[136] There are effective monitoring mechanisms to identify if any high risks to the fundamental rights of the data subjects may arise during the sandbox experimentation as well as response mechanism to promptly mitigate those risks and, where necessary, stop the processing (Article 54 (1) (c) Draft AI Act).

[137] Any personal data to be processed in the context of the sandbox are in a functionally separate, isolated and protected data processing environment under the control of the participants and only authorised persons have access to that data (Article 54 (1) (d) Draft AI Act). Any personal data processed shall not be transmitted, transferred or otherwise accessed by other parties (Article 54 (1) (e) Draft AI Act). Any processing of personal data in the context of the sandbox shall not lead to measures or decisions affecting the data subjects (Article 54 (1) (f) Draft AI Act). Any personal data processed in the context of the sandbox shall be deleted once the participation in the sandbox has terminated or the personal data has reached the end of its retention period (Article 54 (1) (g) Draft AI Act). The logs of the processing of personal data in the context of the sandbox are kept for the duration of the participation in the sandbox and 1 year after its termination, solely for the purpose of and only as long as necessary for fulfilling accountability and documentation obligations under this Article or other application Union or Member States legislation (Article 54 (1) (h) Draft AI Act).

[138] A complete and detailed description of the process and rationale behind the training, testing and validation of the AI system shall be kept together with the testing results as part of the technical documentation (Article 54 (1) (i) Draft AI Act).

[139] A short summary of the AI project developed in the sandbox, its objectives and expected results has to be published on the website of the competent authorities (Article 54 (1) (j) Draft AI Act).

[140] Article 54 (2) Draft AI Act.

legal basis and permission to process personal data specified in the context of AI innovation, apart from that regulated under the GDPR, might prove problematic in practice.[141]

The Draft AI Act pays particular attention to the position of small-scale providers[142] and users in the context of regulatory sandboxes, and other activities aimed at supporting them to comply with the AI Act. This entails specific obligations of Member States to provide small-scale providers and start-ups with priority access to the AI regulatory sandboxes to the extent that they fulfill the eligibility conditions,[143] and to undertake specific awareness raising activities about the application of the AI Act tailored to the needs of the small-scale providers and users.[144] Where appropriate, Member States shall establish a dedicated channel for communication with small-scale providers and user and other innovators to provide guidance and respond to queries about the implementation of the AI Act.[145] When setting the fees for conformity assessment under Article 43 of the Draft AI Act (applicable for high-risk AI systems), the specific interests and needs of the small-scale providers shall be taken into account, with appropriate reduction in those fees according to their size and market size. [146]

The Draft AI Act acknowledges and attempts to mitigate its negative impact in terms of compliance costs on competitiveness of SMEs, especially those supplying high-risk AI systems.[147] It is not surprising that the support for regulatory sandboxes during stakeholder consultations primarily came from businesses and business associations, which have recognized their potential

[141] See Bomhard, D.; Merkle, M.: *Regulation of Artificial Intelligence*, Journal of European Consumer and Market Law, 10(6) 2021, pp. 257-261, p. 259; Smuha, N. *et al*.: *How the EU can achieve legally trustworthy AI: A response to the European Commission's proposal for an Artificial Intelligence Act*, available at SSRN: [https://ssrn.com/abstract=3899991] or [http://dx.doi.org/10.2139/ssrn.3899991], accessed 18/11/2022, p. 42.

[142] See Article 3 (1) (3) Draft AI Act: 'Small-scale provider' means a provider that is a micro or small enterprise within the meaning of the Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (notified under document number C(2003) 1422), OJ L 124, 20.5.2003. Within the SME category, a small enterprise is an enterprise which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 10 million; whereas a microenterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million.

[143] Article 55 (1) (a) Draft AI Act.

[144] Article 55 (1) (b) Draft AI Act.

[145] Article 55 (1) (c) Draft AI Act.

[146] Article 55 (2) Draft AI Act.

[147] See Recital (73) Draft AI Act.

for the promotion of innovative business models.[148] Ensuring priority access for small-scale providers and lowering the fees for conformity assessment are examples of such measures and the embodiment of the "Think Small First"[149] principle. However, even though these measures are useful and welcome, their effect is doubtful, given that the scope of regulatory requirements for AI systems is not reduced.[150]

Some Member States are already piloting projects aimed at ensuring regulatory compliance with the future AI Act. In June 2022, the Spanish Government launched an initiative for a pilot AI sandbox, aiming to "provide companies, especially SMEs and start-ups with certainty when they start implementing the requirements and other features such as conformity assessments or post-market activities" of the future AI Act.[151] It will connect authorities with companies developing AI solutions in a joint effort to operationalize future obligations under the AI Act and to create know-how, guidance, and good practice examples for similar ventures in the years to come. The European Commission will work closely with the Spanish authorities, and all other Member States can participate or follow the development of this exercise and its outcome, which could reinforce its potential to develop into a pan-European AI sandbox and feed into the harmonized guidelines and standards to be prepared by the Commission for the implementation of the AI Act. The organizational structure of this pilot AI sandbox is typical for regulatory sandboxes: it will be based on a public call, based on transparent eligibility and selection criteria for the participating companies. Parallelly, a focus group will be established, with the task of preparing the overall framework for the sandbox, monitoring, documenting, and systematizing its progress, and based on its results, developing a set of guidelines and standards for future use. With the work on adopting the AI Act still in progress, the experiences from this and similar ventures might contribute to identifying the gaps and challenges requiring further fine-tuning.

[148] European Commission: Draft AI Act, *op. cit.* (fn. 5), Explanatory Memorandum, para, para. 3.1.

[149] See European Commission: Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Better regulation for better results - An EU agenda, COM(2015) 215 final, Strasbourg, 19.5.2015.

[150] Bomhard, D.; Merkle, M.: *op. cit.* (fn. 141), p. 259. See also European Parliamentary Research Service (EPRS): Auditing the quality of datasets used in algorithmic decision-making systems, p. 40 [https://www.europarl.europa.eu/RegData/etudes/STUD/2022/729541/EPRS_STU(2022)729541_EN.pdf], accessed 18/11/2022

[151] Bringing the AI Regulation Forward [https://digital-strategy.ec.europa.eu/en/events/launch-event-spanish-regulatory-sandbox-artificial-intelligence], accessed 18/11/2022.

4.3 BENEFITS AND CHALLENGES OF AI REGULATORY SANDBOXES

The existing contours of AI regulatory sandboxes under the Draft AI Act provide a solid background for contemplating the benefits and challenges of the proposed regulatory regime.

Once adopted, the AI Act will be the first horizontal piece of legislation regulating the use of AI. Although it aspires to provide innovative and comprehensive solutions, any new regulation puts additional, although undoubtedly necessary, regulatory pressure on innovators. It will certainly take time and substantial effort to fully comprehend and comply with its requirements, during which time the innovative AI systems will continue to evolve and emerge. This pressure can be alleviated by engaging in regulatory sandboxes. One of the most obvious benefits is that experimenting in the sandbox might help the companies adapt to the new framework, and at the same time reveal whether the new regulation itself needs to be refined and adapted in response to unforeseen effects of experimental technologies.[152]

The common approach to AI sandboxes might help overcome regulatory fragmentation and regulatory friction, and the resulting legal uncertainty. Different Member States currently have different sandbox rules or no rules at all. Since the AI sandbox regime under the Draft AI Act is optional, whether it will prevail over national options depends on its design and clearly formulated benefits for Member States and businesses alike. In addition, the AI sandboxes might provide a necessary jumpstart for those Member States that are lagging behind in supporting innovation.

Sandbox might help in protecting from the risk inherent in the operation of AI systems, especially those identified as high-risk AI systems. The testing environment allows for risk containment, advance preparation and implementation of risk mitigating strategies, thus insulating the consumers and market from large-scale adverse effects of AI technologies.

The existence of sandbox regime sends a positive signal to businesses and creates an innovation-friendly environment, which in turn increases competitiveness. Nevertheless, competitiveness is not an automatic consequence, it will depend on the sandbox conditions. When entry and testing conditions are too relaxed, bad, or even harmful innovation can sneak in. The sandbox conditions should therefore serve an important gatekeeping function.[153] So far, the AI sandbox framework under the Draft AI Act does not appear either overly permissive or too strict. The proposed provisions provide a general framework and organizational

[152] See also Brummer, C.; Yadav, Y.: *op. cit.* (fn. 2), p. 295.

[153] *Loc. cit.*

principles, whereas the particularities concerning eligibility and selection criteria, the procedure for application and participation, monitoring, exit strategies, etc. are to be adopted by the European Commission. The solutions adopted in the implementing act will have a decisive impact on the success of this legal regime in the context of the AI Act and will provide ground for further assessment.

The benefits and challenges of AI sandboxes are often intertwined. A sandbox by definition creates a closed environment for safe(r) experimentation and mutual learning, but the inherent limits of the sandbox testing experience might reflect negatively on the lessons drawn from the experiment. The question is, whether the sandbox offers sufficiently informative evidence as to how the approved innovation is likely to work outside of the shielded environment, i.e. in the main market.[154] The scaling-up of the results observed in the testing environment to the wider market is a well-known challenge.[155] The national competent authorities that will operate the sandbox will have to design it keeping in mind that the outcome of the testing will have to be relevant in the wider context and sufficiently informative, which will be a difficult task. This is where the EU added value, arising under the coordination and cooperation tenets under the Draft AI Act for the Member States' authorities and EU bodies and institutions, could prove helpful. Mutual learning, exchange of best practices, and cross-border sandbox implementation and cooperation might help to overcome the scale-up challenge.

On the other hand, there is not much guidance as to how multi-jurisdictional[156] AI sandboxes should be implemented in practice.[157] Another issue that will be challenging in practice concerns the relationship between overlapping experimental regimes at European and local levels.[158] The intersection between

[154] Brummer, C.; Yadav, Y.: *op. cit.* (fn. 2), p. 295.

[155] European Commission: Better Regulation Toolbox, *op. cit.* (fn. 34), Tool #69, p. 600. See also Attrey, A.; Lesher, M.; Lomax, C.: *The role of sandbox in promoting flexibility and innovation in the digital age*, Going Digital Toolkit Policy Note, No. 2, 2020 [https://goingdigital.oecd.org/data/notes/No2_ToolkitNote_Sandboxes.pdf], accessed 18/11/2022.

[156] Under the current version of Article 53(1) of the Draft AI Act, AI regulatory sandboxes may be established by one or more Member States.

[157] Yordanova warns that without standardisation, the sandboxed activity is unfit for cross-border provision of services, which brings into question this type of sandboxes. See Yordanova, K.: *op. cit.* (fn. 124), p. 7. Evidence from Latin America and the Caribbean shows that cross-border, multi-jurisdictional sandbox is an attractive option for small markets, but the harmonization required from different jurisdictions may prove to be an insurmountable obstacle. See World Bank: *op. cit.* (fn. 51), p. 14. For an in-depth analysis of advantages and challenges of multi-jurisdictional FinTech sandboxes see Ahern, D.: *op. cit.* (fn. 75), p. 22 – 24.

[158] See European Parliamentary Research Service (EPRS): Artificial Intelligence Act and Regulatory Sandboxes, Briefing, p. 5 [https://www.europarl.europa.eu/RegData/etudes/BRIE/2022/733544/EPRS_BRI(2022)733544_EN.pdf], accessed 18/11/2022.

regulatory sandboxes and other experimental legal regimes aimed to support digital innovation is still not adequately addressed. There is a growing variety of such regimes in the Member States and the at EU level (such as living labs, test beds, innovation hubs, etc.), and the concept of AI sandboxes under the AI Act partly incorporates similar functions (i.e. testing, valid,ation and piloting). Given the competing and overlapping regimes, the obvious question is whether some of the minimum requirements for AI sandboxes might apply to them by analogy. This is especially important given experiments involving high-risk AI systems. The Council has suggested inserting an additional provision under Title V of the Draft AI Act, to recognize and regulate experimenting which takes place outside of a fully-fledged AI regulatory sandbox.[159] It requires the development of a real-world testing plan, with similar minimum requirements and safeguards as those applicable in the sandbox regime. Another addition by the Council concerns the obligation to design and implement AI sandboxes in such a way as to facilitate cross-border cooperation.[160] The AI sandboxes certainly add to the complexity of different legal regimes, and more effort should be put into ensuring minimal standardisation of sandbox rules across different Member States.

Likewise, there might be confusion between different types of sandboxes at EU level, depending on the area where they apply and the corresponding legal framework. For example, the purpose of AI sandboxes under the Draft AI Act is to facilitate innovation, while ensuring regulatory compliance. This seems to imply that, apart from suspension of the authorities' corrective powers during sandbox testing, there will be no regulatory waivers available. Thus, the AI sandbox type comes close to innovation deals, that aim to clarify regulatory barriers perceived by innovators, instead of revising or suspending them.[161] Since AI is a pervasive, general-purpose technology that may be applicable across sectors and in combination with other technologies,[162] the question is whether other types of sandboxes, such as those based on experimentation clauses (as instruments of adaptive regulation), might be allowed under the horizontal legal framework, as well.

[159] Council of the European Union: *op. cit.* (fn. 118), p. 98 – 101 (Articles 54a and 54b).

[160] See Council of the European Union: *op. cit.* (fn. 118), p. 95-96.

[161] See European Commission: Better Regulation Toolbox, *op. cit.* (fn. 34), Tool #22. See also Leimüller, who identifies sandbox type 1 as that based on explicit experimentation clause and possible waiver options, and sandbox type 2 as that including supervision comparable to Innovation Deals, i.e. without regulatory waivers. Leimüller, G.: *Regulatory Sandboxes*, Analytical paper for Business Europe, Vienna, 2020, p. 10 [https://www.businesseurope.eu/sites/buseur/files/media/other_docs/regulatory_sandboxes_-_winnovation_analytical_paper_may_2020.pdf], accessed 18/11/2022.

[162] Think of FinTech related AI applications in connection with e.g., robo-advice, APIs or DLTs.

Whereas the "sandbox concept itself is easy to copy",[163] the results are not easily replicable in different contexts and AI ecosystems. The national authorities should avoid the "copy-paste" trap and instead attempt to cultivate an in-depth understanding and knowledge exchange with the innovators, to better understand the implications of the testing experience.

Another connected challenge is the rapid pace of the development of technological solutions. Once the sandbox exercise is completed, the AI system under scrutiny and its application might have already evolved, thus making the tested model irrelevant, or in need of further examination. This can be overcome by resorting to a combination of different, even looser forms of experimentation, in and around the sandbox itself. Currently, the Draft AI Act offers no solution for this issue.

An important benefit of sandboxes in general is the regulatory lenience. It means that competent authorities might refrain from using their corrective powers against a sandbox participant during the experiment, as long as the participant adheres to the rules of play agreed upon in the sandbox. According to the version of the text proposed by the European Commission, AI sandboxes shall not affect the supervisory and corrective powers of the competent authorities.[164] The vagueness of this provision has prompted the Council to suggest changes that would provide specific safeguards for sandbox participants during the experiment: the authorities should flexibly use supervisory powers, with a view to supporting innovation. No administrative fines for infringement of applicable Union or Member State legislation shall be imposed during the testing period, provided that the participant respects the agreed sandbox plan and follows the guidance given by the authorities in good faith.[165]

Regulatory lenience does not extend to liability issues: Under the Draft AI Act, sandbox participants are not shielded from liability under applicable Union or national legislation for any harm inflicted on third parties as a result of the experimentation taking place in the sandbox.[166] Truby et al. criticize this approach as "eroding the very essence of sandbox regulation".[167] According to

[163] Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 79. On the importance of the regulator's reputation for sandbox success and appeal, see Fahy, L.: Regulator reputation and stakeholder participation: A case study of the UK's regulatory sandbox for Fintech, European Journal of Risk Regulation (13) 2022, pp. 138-157, p. 155, DOI: 10.1017/err.2021.44.

[164] Article 53 (3) Draft AI Act.

[165] See Council of the European Union: *op. cit.* (fn. 118), p. 95.

[166] Article 53(4) Draft AI Act.

[167] Truby, J. et al.: *A Sandbox Approach to Regulating High-Risk Artificial Intelligence Applications*, European Journal of Risk Regulation (13) 2022, pp. 270–294, p. 291, DOI:10.1017/err.2021.52.

them, sandbox participants run a considerable risk: they are exposed to compliance and setup costs, an added layer of regulatory scrutiny and supervision, and their classified and commercially sensitive information and trade secrets are exposed to regulators and third parties. These risks should at least be offset by a diversified approach to liability issues. We cannot agree with such proposition. A sandbox should not be seen as a way of escaping from responsibility inflicted to third parties. Quite the contrary, it should facilitate the development of safe AI systems, and motivate the developers to map out and resolve any potential liability issues in advance, before the harm is inflicted and before the product or service is placed on the market.

Sandboxes are designed with the aim of supporting innovation and increasing competitiveness. To increase competitiveness without distorting competition, a transparent, level-playing field for all potential participants should be created. This means that all rules of play should be disclosed clearly and allow participation under the same conditions, and the abstention from using corrective powers by the authorities should not be applied arbitrarily, to prevent any issues arising from the competition law perspective,[168] as well as the principle of equality.[169]

It is worth highlighting that the promotion of innovation should never be the only or predominant regulatory goal, as it is liable to lead to a regulatory race to the bottom, attracting innovation and investment at the expense of human rights and consumer protection safeguards. Furthermore, this could amplify the danger of forum shopping. Given that the AI sandbox regime under the Draft AI Act is optional and left for implementation to Member States, AI developers might be encouraged to choose those Member States with less stringent sandbox regimes.[170]

One important aspect of the sandbox environment is that it presents an opportunity for a mutual-learning experience. This is not limited to regulators and participants but should include a wide range of different stakeholders within the AI ecosystem. It would therefore be appropriate, as suggested by the Council,[171] to underline the possibility of cooperation between national competent

[168] See Ahern, D.: *op. cit.* (fn. 54), p. 9; Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 80.

[169] Ranchordás warns that the assessment of compliance of the sandbox regime with the principle of equal treatment should take into account the temporary character of the regime, whether the sandbox was established in accordance with objective criteria, whether it is proportionate to the goals pursued (i.e. the applied sandbox tools should be least disruptive for the legal order and necessary for the achievement of sandbox objectives), and whether the conditions of entry and exit are transparent. See Ranchordás, S.: *op.cit.* (fn. 58), p. 8.

[170] EPRS: *op. cit.* (fn. 158), p. 5.

[171] Council of the European Union: *op. cit.* (fn. 118), p. 36. Similar proposition is made in the Joint Report by the IMCO and LIBE Committees, see European Parliament: *op. cit.* (fn. 116).

authorities establishing AI regulatory sandbox with other relevant authorities, including those supervising the protection of fundamental rights, as well as other actors, such as national or European standardization organizations, notified bodies, testing and experimentation facilities, research and experimentation labs, innovation hubs and relevant stakeholder and civil society organizations.

5. CONCLUDING REMARKS

The potential of AI sandboxes to encourage innovation and enhance the competitiveness of SMEs is still unclear. The underlying question is whether the cost of regulatory compliance, which will certainly affect SMEs will be offset with clear benefits and opportunities arising for SMEs' business models under the Draft AI Act. As recognized in the Impact Assessment, "whether the additional costs can at the margin discourage some SMEs from entering into certain markets for high-risk AI applications will depend on the competitive environment for the specific application and its technical specificities".[172] It is too early to assess whether innovative SMEs will seize the regulatory flexibility in the sandbox as an opportunity for placing their products and services in the market. The allure of the sandbox for individual SMEs will certainly depend on the actual cost-benefit analysis within the sandbox environment, and upon exit.[173] One thing is certain, regulatory flexibility cannot substitute for market demand.[174] This is a challenge for small markets. In addition, establishing and running a sandbox is a costly exercise, both in terms of financial and institutional resources.[175] On the other hand, if applied with due care and without engaging in the race to the bottom, it can also be turned into an asset, to kickstart the innovative potential of such economies.

AI systems form complex value chains and may be applicable in a plurality of contexts, across different sectors, and for a range of different purposes. This entails further considerations, such as those concerning the identification of competent authorities for the operation of an AI sandbox, their powers and

[172] European Commission: Staff Working Document. Impact Assessment Accompanying the Proposal for a Regulation of the European Parliament and of the Council Laying Down Harmonised Rules on Artificial Intelligence (Artificial Intelligence Act) and Amending Certain Union Legislative Acts. SWD/2021/84 final, Brussels, 21.4.2021, p. 70.

[173] See Ahern, D.: *op. cit.* (fn. 75), p. 10.

[174] Zetzsche, D. A. *et al.*: *op. cit.* (fn. 3), p. 90.

[175] Bajakić, I.: *Transformation of financial regulatory governance through innovation facilitators - case study of innovation hub in Croatian capital markets*, EU and Comparative Law Issues and Challenges Series (ECLIC) (4) 2020 [https://doi.org/10.25234/eclic/1193], pp. 917–946, p. 917.

mutual relationship, as well as cooperation and coordination mechanisms to ensure the smooth functioning of the sandbox experiment. This requires capacity building for regulators, to understand the potential and the purpose of a sandbox, as well as the innovative solutions it is supposed to support. Undoubtedly, deeply experienced regulators will have sufficient expertise to facilitate innovative business models even in the absence of a regulatory sandbox.[176]

The sandbox will work only under carefully calibrated conditions. Most importantly, the sandbox procedure has to be transparent, with easily accessible and user-friendly rules and guidelines, clearly explaining the benefits of sandbox testing, i.e., how the procedure and its outcome enhance legal certainty and alleviate concerns that firms might have when placing an innovative AI system on the market. This will create a climate of mutual trust between the innovators and regulators, as well as increase the consumers' trust in the AI systems. Otherwise, the concept of an AI sandbox might not live up to its full potential.

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SHARE CAPITAL MAINTENANCE IN LARGE CROATIAN GROUPS

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ABSTRACT

Corporate governance is a fundamental mechanism for building a reliable, transparent, accountable business environment for all stakeholders. In today's growing, dynamic, unpredictable, unforgiving environment, it is more than ever crucial to ensure business continuity and going concern by applying proper strategies to achieve adequate financial stability. The conservative approach defines that own sources of financing must finance at least 50% of a company's total assets. Nevertheless, favorable financial leveraging provides higher returns to shareholders than the option of not using debt. Therefore, the management of every company should find a balance between those two strategies. Usually, the shareholders bear more significant risk, which results in demanding higher returns compared to creditors. But this is the case only for newly issued shares and increased subscribed capital, but not for internally created earned equity as retained earnings. Furthermore, internally created equity is considered the cheapest source of financing assets, and there are justified reasons for companies to focus on those sources in developing financing strategies. Although higher stock prices may materialize those returns on the market for listed companies, shareholders' expectations are more often related to the dividends distribution which directly affects the company's sources of financing structure. Thus, to meet the shareholders' expectations on the one side and achieve share capital sustainability objectives on the other, advanced analytical and accounting knowledge and skills are necessary.

The research subject is share capital structure and financial stability as a condition for sustainability and going concerned 77 large Croatian groups in which the parent company is a public limited company from 2011 to 2020. Therefore, as an imperative and precondition of capital maintenance, we analyzed large Croatian groups that have total capital (capital & reserves) at least at the subscribed capital level. Our

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results indicate that many observations have subscribed capital greater than total share capital. We also concluded that a more significant percentage uses financial leverage intensively, i.e., more than 50% of assets are financed by debt rather than by equity. Furthermore, from the cases with positive financial results (net profit), almost 75% of observations distributed more than 50% of their net profit yearly. Finally, research confirms that changes in total capital primarily result from net profit and changes in retained earnings. Accounting adjustments and subsequent measurements were not significant parameters for capital change. The results are obtained using regular descriptive statistics, nonparametric tests, and panel data analysis models.

KEYWORDS: *share capital maintenance, dividends distribution, financial stability, going concern, financial ratios*

1. INTRODUCTION

The word capital has many meanings. From an economic, finance, and accounting point of view, capital, is defined as "wealth or property that is owned by a business or a person and can be invested or used to start a business"[1]. Capital represents "the total amount of money and property that an individual or company owns"[2] or "assets remaining after deduction of liabilities; the net worth of a business"[3], or "excess of assets over liabilities"[4]. The bottom line is that the capital represents residual assets after covering all company's liabilities, i.e., part of assets belonging to the company's owners – net assets. The Conceptual Framework for Financial Reporting recognizes financial and physical concepts of capital. Under the financial concept of capital, "such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity"[5]. We get to the two terms, mostly equally defined – capital and equity. From the accounting point of view, those terms are synonyms. For example, in the Oxford dictionary, equity is defined as "the value of a property after all charges and debts have been paid"[6], i.e. as net assets. The Cambridge dictionary defines equity as "the value of a property for the owner after it has been sold and any loan paid back"[7]. Finally, Collins

[1] [https://www.oxfordlearnersdictionaries.com/definition/english/capital_1], accessed on 08/11/2022.

[2] [https://dictionary.cambridge.org/dictionary/english/capital], accessed on 08/11/2022.

[3] [https://www.collinsdictionary.com/dictionary/english/capital], accessed on 08/11/2022.

[4] [https://www.merriam-webster.com/dictionary/capital], accessed on 08/11/2022.

[5] [https://www.ifrs.org/], accessed on 14/11/2022., 8.1

[6] [https://www.oxfordlearnersdictionaries.com/definition/english/capital_1], accessed on 08/11/2022.

[7] [https://dictionary.cambridge.org/dictionary/english/capital], accessed on 08/11/2022.

dictionary defines equity as "assets minus liabilities; net worth; capital"[8]. "The difference between the liabilities and the assets is the net worth, equity, or ownership capital."[9] "Although the meaning of all those definitions is equal, there are specific differences between them. While the word capital focuses on the value or amount of assets owned by the company, the word equity is more focused on the company's value measured by the net, i.e., residual assets. "Equity means ownership"[10].

It is important to emphasize that investors in the corporate finance field observe capital from a different perspective. Brealey, Myers, Allen, and Edmans (2022) relate capital with an investment decision, often referred to as capital expenditures (CAPEX), where capital refers to the company's sources of long-term financing. The choice between debt and equity authors calls capital structure. Both debt and equity have to be closely examined because the specific mixture of the two is the firm's capital structure."[11] A company's capital structure (or financial structure) "refers to the specific mixture of long-term debt and equity the firm uses to finance its operations"[12]. The process of planning and managing a company's long-term investments is known as capital budgeting[13]. "'Optimal capital structure' involves a trade-off between the benefits of higher leverage, which include the tax-deductibility of interest and the lower cost of debt relative to equity, and the costs of higher leverage, which include higher risk for all capital providers and the potential costs of financial distress."[14] Capital formation is "a method for formalizing the division of risk-bearing, control, and income among the various contributors of funds"[15]. Finally, finan-

[8] [https://www.collinsdictionary.com/dictionary/english/capital], accessed on 08/11/2022.

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cial[16] and managerial accounting field authors also use the term 'capital' in the context of overall investments into companies' assets. In that context, Horngren, Sundem, Burgstahler, and Schatzberg (2022) emphasize that investments can be defined in several ways, for example, as stockholders' equity, as stockholders' equity and long-term liabilities, or as stockholders' equity, long-term liabilities and current liabilities[17]. Miller-Nobles and Mattison (2021) state that companies are making capital investments to acquire capital assets where the capital assets are defined as the long-term operating assets of the company[18].

The subject of this paper is the capital maintenance of large Croatian groups in which the parent company is a public liability company. From a legal point of view, Directive (EU) 2017/1132 states that "in order to ensure minimum equivalent protection for both shareholders and creditors of public limited liability companies, the coordination of national provisions relating to the formation of such companies and the maintenance, increase or reduction of their capital is particularly important"[19]. IFRS defines *capital* as "the net assets or equity of the entity"[20]. Furthermore, *capital* is maintained "if it has as much capital at the end of the period as it had at the beginning of the period"[21]. The first line of *defense* in the capital maintenance concept determines that the capital value must be at least as is the value of the subscribed capital. For the public limited companies, Chapter IV *Capital maintenance and alteration* of the Directive defines that "a minimum capital shall be subscribed the amount of which shall be not less than EUR 25,000"[22]. Thus, considering that the research subject is groups, it is expected that the nominal amount of subscribed capital shall be higher than EUR 25,000. The doctrine of capital maintenance "emphasizes a fundamental duty of the companies to keep the capital intact for the safety of the creditors giving the mandate to the courts to supervise whether the capital

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[17] Horngren, C. T., Sundem, G. L., Burgstahler, D., Schatzberg, J.: *Introduction to Management Accounting*, 17/e, Harlow, Essex, United Kingdom: Pearson Education Limited, 2022, p. 416

[18] Miller-Nobles, T., Mattison, B.: Horngren's Financial & Managerial Accounting: The Managerial Chapters, 7/e, Harlow, Essex, United Kingdom: Pearson Education Limited, 2022, p. 594

[19] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law

[20] [https://www.ifrs.org/], accessed on 14/11/2022., 8.1

[21] [https://www.ifrs.org/], accessed on 14/11/2022., 8.6

[22] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law, Article 45§1

is dissipated lawfully or not"[23]. Deloitte (2019) emphasizes that "the rules on capital maintenance exist in order to protect the interests of creditors"[24], and they refer to those rules as 'creditors' buffer. Furthermore, "a limited company should be expressly prohibited from reducing its capital and from purchasing its shares save as provided in the national legislation and the procedure for the reduction of capital must be designed to protect both creditors and shareholders."[25]

Nevertheless, profitable operations result in a capital increase for the company, creating *earned capital*. The IFRS Foundation emphasizes that "any amount over and above that is required to maintain the capital at the beginning of the period is profit"[26]. Thus, the profit represents the increase of nominal money capital[27] over the period when capital is defined in terms of nominal monetary units[28]. It is important to emphasize that, next to the realized profit from the income statement, the capital can be increased due to unrealized gains such as revaluation adjustments or fair value reserves. From that context, it is essential to regulate under which circumstances and which part of capital can be distributed to the shareholders. It is essential because 'modern' accounting includes choosing between various accounting policies, which may result in a direct capital increase or decrease bypassing income statements, or including non-cashable revenues and expenditures, which significantly can influence the financial result. "In the case of physical capital maintenance, it is required to apply current cost measurement, and arising price changes are treated not as profit or loss but as capital maintenance adjustments. Thus, these capital maintenance adjustments cannot be distributed as dividends."[29] "In addition to the

[23] Islam, M. S.: *The Doctrine of Capital Maintenance and its Statutory Developments: An Analysis*, Northern University Journal of Law, (4) 2015, pp. 47-55, p. 47

[24] [https://www.iasplus.com/en-gb/publications/uk/closer-look/2019/a-closer-look-capital-maintenance-and-distributions-under-the-spotlight], accessed on 14/11/2022, p. 2

[25] Islam, M. S.: *The Doctrine of Capital Maintenance and its Statutory Developments: An Analysis*, Northern University Journal of Law, (4) 2015, pp. 47-55, p. 55

[26] [https://www.ifrs.org/], accessed on 14/11/2022., 8.6

[27] Related to the nominal money capital, it is important to recognize and perceive in times of inflation – a general increase of prices because "increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits" (IFRS Foundation, IASB, 8.7). On the other side, when capital maintenance is considered in terms of constant purchasing power units, profit is "only that part of the increase in the prices of assets that exceeds the increase in the general level of prices" (IFRS Foundation, IASB, 8.7).

[28] [https://www.ifrs.org/], accessed on 14/11/2022., 8.4

[29] Paksiova, R., Oriskoova, D.: *Capital maintenance evolution using outputs from accounting system*, Scientific Annals of Economics and Business, 67(3) 2020, pp. 311-331, https://doi.org/10.47743/saeb-2020-0017, p. 313

nominal maintenance of (equity) capital, the principle of real capital maintenance requires that equity capital is also maintained not only nominally, but in real terms by covering inflation."[30] Related to this, Garcia (2020) concludes that "the modern view of capital maintenance in IFRS is based on comprehensive income, which corresponds to the increase in net assets. Since the scope of comprehensive income is broader than that of net income in the dynamic view, the concept of capital maintenance is less conservative"[31]. The capital maintenance rules aim to "protect creditors and other company stakeholders by preventing directors from paying dividends or return capital to members other than in limited circumstances"[32].

Under certain circumstances, the company may distribute earned capital (profit), which consequently leads to a decrease in capital. Thus, considering the minimum amount of the subscribed capital for the public limited companies in the European Union, Directive (EU) 2017/1132 deals with and defines:

- rules on distribution,
- rules on companies' acquisitions of their shares,
- rules for the increase and reduction of capital.

Islam (2015) emphasizes that the doctrine of capital maintenance supports the legal rules in four areas: (1) payment of dividends or other distributions to shareholders; (2) reduction of a company's share capital and/or reserves; (3) prohibition on the provision by a company of financial assistance for the purchase of its own shares; and (4) a company's redemption or purchase of its own shares[33]. "Capital maintenance can be understood in several ways. In a modern setting, capital maintenance refers to the need to prevent corporate capital reduction by excess dividend distribution or other aggressive equity transactions. In the pre-IFRS world, the main focus of capital maintenance was to distinguish between capital, the original investment of shareholders, and income, i.e., the profits earned from business operations."[34] Finally, "due

[30] Gleißner, W., Günther, T., Walkshäusl, C.: *Financial sustainability: Measurement and empirical evidence*, Zeitschrift Für Betriebswirtschaft, 92(3) 2022, pp. 467-516, https://doi.org/10.1007/s11573-022-01081-0, p. 475

[31] Garcia, C.: *From Financial to "Sustainable" Capital Maintenance*, InterEU Law East, 7(2) 2020, pp. 229-243, p. 238

[32] [https://www.iasplus.com/en-gb/publications/uk/closer-look/2019/a-closer-look-capital-maintenance-and-distributions-under-the-spotlight], accessed on 14/11/2022, p. 2

[33] Islam, M. S.: *The Doctrine of Capital Maintenance and its Statutory Developments: An Analysis*, Northern University Journal of Law, (4) 2015, pp. 47-55, p. 47

[34] Garcia, C.: *From Financial to "Sustainable" Capital Maintenance*, InterEU Law East, 7(2) 2020, pp. 229-243, p. 231

to restoration of non-current assets and creation of funds for their financing as the basis for capital maintenance is a key factor for sustainable development of the enterprise."[35]

Firstly, we will investigate if large Croatian groups follow the conservative rule by which the majority of assets shall be financed by equity rather than debt. Considering that it is impossible to maintain any entity's capital if its value is below the level of subscribed capital, we determined the second research objective. Thus, the objective is to determine if large Croatian groups in which the parent company is a public limited company have total capital (capital & reserves) at least at the subscribed capital level. Nevertheless, from the accounting point of view, the company's net worth (net assets) can be increased only by retaining earned capital for future growth and development of the company's business operations. Moreover, considering the IFRS Foundation's definition of financial capital maintenance, the concept is not narrowly related to the subscribed capital but to the amount of the capital, i.e., net assets. Thus, retaining earnings increase net assets at the end of the period and stands for a higher capital maintenance threshold for the upcoming period. "Lack of accounting transparency induced by compensation structures is evidence of the failure of sufficient profitability and uncontrolled risk, which damage sustainability."[36] In that context, the objective is to investigate if large Croatian groups have maintained their capital over the years. Additionally, the objective is to investigate if groups that increased the total capital between two periods refine net assets due to retained earnings or due to the accounting assumptions like adjustments, subsequent measurement, or revaluation. Related to this, the research aims to find the main determinants due to which changes in the total capital of large Croatian groups occur. Furthermore, the objective is to investigate if a large Croatian group's larger part of net profit retains to increase its capital or distribute to its shareholder. Finally, the research aims to find the main determinants due to which changes in the total capital of large Croatian groups occur.

We divided the paper as follows. The first and second chapters include an introduction and a comprehensive literature review of conducted studies regarding capital maintenance policies. In the following chapter, we explained the sampling approach and used methodology. Finally, the core part of the paper includes research results and findings, which we elaborate on in the conclusion.

[35] Paksiova, R., Oriskoova, D.: *Capital maintenance evolution using outputs from accounting system*, Scientific Annals of Economics and Business, 67(3) 2020, pp. 311-331, https://doi.org/10.47743/saeb-2020-0017, p. 313

[36] Lee, M.; Hwang I. T.: *The Effect of the Compensation System on Earnings Management and Sustainability: Evidence from Korea Banks*, Sustainability (Basel, Switzerland), 11(11) 2019, pp. 3165, p. 3170

2. LITERATURE REVIEW

Only a few studies narrowly relate to capital maintenance. A certain number of authors investigated capital maintenance more broadly than previously defined. For example, Boucekkinen, Martineznn, and Saglamnnn (2010) introduced a model for capital maintenance as a labor service[37]. Albonico, Kalyvitis, and Pappa (2014) relate capital maintenance with capital depreciation[38]. The authors designed a business-cycle model in which expenditures on capital maintenance endogenously determine the depreciation rate. Those expenditures are an integral part of the capital accumulation process, primarily related to capital expenditures (CAPEX). Kalyvitis and Vella (2014) also investigated capital maintenance from a much broader perspective[39]. Their paper focuses on operation and maintenance (O&M) spending by state and local governments in the USA and its productive impacts on public capital maintenance.

On the other hand, Bogan (2012) investigated changes in the efficiency of microfinance institutions (MFIs) related to the changes in capital structure[40]. The author defines MFIs as providers of financial services "to low-income households in developing countries around the world"[41] organized as nongovernmental organizations (NGOs), credit unions, nonbank financial intermediaries, or commercial banks. The author questions "the best mix of debt, equity, and grant funding that will ensure solvency and self-sufficiency"[42] of lending institutions. The research covers MFIs with total assets over 3.1 million USD, at least level 3 diamond disclosure rating on the MIX Market, and audited financial statements in English, French, or Spanish located in Africa, East Asia, Eastern Europe, Latin America, the Middle East, and South Asia for the years 2003 and 2006. The author uses the modified formula of operating self-sufficiency from the MIX Market database provided by the World Bank[43] and

[37] Boucekkine, R., Martinez, B., Saglam, C.: *Capital Maintenance as a Key Development Tool: Capital Maintenance*, Scottish Journal of Political Economy, 57 (5) 2010, pp. 547-567

[38] Albonico, A., Kalyvitis, S., Pappa, E.: *Capital maintenance and depreciation over the business cycle*, Journal of Economic Dynamics & Control, 39, 2014, pp. 273-286, https://doi.org/10.1016/j.jedc.2013.12.008

[39] Kalyvitis, S., Vella, E.: *Productivity effects of public capital maintenance: Evidence from U.S. States*, Economic Inquiry, 53(1) 2014, pp 72-90, https://doi.org/10.1111/ecin.12136

[40] Bogan, V. L.: *Capital Structure and Sustainability: An Empirical Study of Microfinance Institutions*, The Review of Economics and Statistics, 94(4) 2012, pp. 1045-1058

[41] Bogan, V. L.: *Capital Structure and Sustainability: An Empirical Study of Microfinance Institutions*, The Review of Economics and Statistics, 94(4) 2012, pp. 1045-1058, p. 1045

[42] Bogan, V. L.: *Capital Structure and Sustainability: An Empirical Study of Microfinance Institutions*, The Review of Economics and Statistics, 94(4) 2012, pp. 1045-1058, p. 1045

[43] DataBank, MIX Market, The World Bank, web

emphasizes that operational sustainability is having operating self-sufficiency of 100% or more while financial sustainability is having operating self-sufficiency of 110% or more[44]. The indicators represent the dependent variable in the model. As independent variables, the author uses capital structure variables as a debt-to-assets ratio, grants as a percentage of assets, shareholder capital as a percentage of assets, deposits relative to assets, and for MFIs specific variables, MFI characteristics (type of entity), MFI maturity level, country-level macroeconomic indicators (foreign direct investment, GDP, and inflation)[45]. The author uses OLS regression and probit models to analyze the data. Bogan (2012) concluded that various factors like maturity stage, the size of assets, and capital structure are associated with the performance of MFIs. In addition, the author found that debt relative to assets negatively relates to operational self-sufficiency[46].

Bodhanwala S. and Bodhanwala R. (2018) investigated whether corporate sustainability impacts profitability performance. Authors define *sustainability* as a "multi-dimensional concept covering within its reigns environmental, social, economic and governance aspects of business"[47]. As a measure of sustainability, authors used revenue growth (year-on-year change in revenue) and environment, social, and governance (ESG) score as a dummy variable where one (1) is assigned to the *high ESG compliant* with EWRS scores more than 50 in all six years. Thus, they analyzed 58 Indian companies[48] from 2010 to 2015 (290 observations). The sustainability proxies represented independent variables in the model. The authors prepared four models where the dependent variable was profitability indicator – return on invested capital (ROIC), return on equity (ROE), return on assets (ROA), or earnings per share (EPS). To ensure the homogeneity of the two groups and models, the authors included control variables such as size (total assets growth) and risk (ratio of total debt to equity). Their findings "provide evidence for Indian firms that they should align their strategies and economic goals with environmental protection, social cause, and good governance. The findings of this study reveal that a better focus on the sustainability efforts by Indian firms in taking policy decisions should have a positive and significant impact on their profitability in the long

[44] Bogan, V. L.: *Capital Structure and Sustainability: An Empirical Study of Microfinance Institutions*, The Review of Economics and Statistics, 94(4) 2012, pp. 1045-1058, p. 1048

[45] Bogan, V. L.: *Capital Structure and Sustainability: An Empirical Study of Microfinance Institutions*, The Review of Economics and Statistics, 94(4) 2012, pp. 1045-1058, p. 1052

[46] Bogan, V. L.: *Capital Structure and Sustainability: An Empirical Study of Microfinance Institutions*, The Review of Economics and Statistics, 94(4) 2012, pp. 1045-1058, p. 1056

[47] Bodhanwala S. and Bodhanwala R., 2018, p. 1739

[48] Thomson Reuters Asset 4 ESG database

run."[49]. Bodhanwala S. and Bodhanwala R. (2018) concluded that high-rated ESG companies have significantly lower leverage than low-rated ESG companies[50]. The authors explained the results as that "high-rated ESG firms enjoy larger access to equity capital markets; which limits the need for borrowed funds"[51]. Their conclusion opens the need to investigate the equity structure of those companies to obtain broad conclusions.

Garcia (2020) prepared a paper focusing on capital maintenance as the IFRS Foundation defines it. She emphasized the problem regarding capital maintenance related to the 'source' of capital increase – realized profit or unrealized gains[52]. To enhance corporate transparency and emphasize the importance of capital maintenance author suggested a new capital structure in the balance sheet. In the suggested structure, comprehensive income, sustainability reserve, other elements of net assets, and non-controlling interests would be reported separately from total shareholder's capital (subscribed capital, capital reserve, retained earnings, other reserves, and treasury stocks). The author concludes that "capital maintenance should be rediscovered as an essential tool for sustainability reporting, as well as for subsequent regulation"[53].

Paksiova and Oriskoova (2020) investigated 663 Slovak enterprises and constructed a capital maintenance evolution model for quantifying capital maintenance by applying a neural network[54]. The model consists of five input neurons, five hidden neurons, and one output neuron. According to the obtained results, the authors concluded that the most significant influence on the preservation of capital has the ratio of selected equity items which is the combined indicator of changes in the capital between two periods. The modest impact has the total assets turnover ratio (ratio between total revenues and total assets) and total assets and liabilities ratio[55].

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[49] Bodhanwala, S.; Ruzbeh B.: *Does Corporate Sustainability Impact Firm Profitability? Evidence from India*, Management Decision, 56(8) 2018, pp. 1734-1747, p. 1744

[50] Bodhanwala, S.; Ruzbeh B.: *Does Corporate Sustainability Impact Firm Profitability? Evidence from India*, Management Decision, 56(8) 2018, pp. 1734-1747

[51] Bodhanwala, S.; Ruzbeh B.: *Does Corporate Sustainability Impact Firm Profitability? Evidence from India*, Management Decision, 56(8) 2018, pp. 1734-1747, p. 1744

[52] Garcia, C.: *From Financial to "Sustainable" Capital Maintenance*, InterEU Law East, 7(2) 2020, pp. 229-243

[53] Garcia, C.: *From Financial to "Sustainable" Capital Maintenance*, InterEU Law East, 7(2) 2020, pp. 229-243, p. 242

[54] Paksiova, R., Oriskoova, D.: *Capital maintenance evolution using outputs from accounting system*, Scientific Annals of Economics and Business, 67(3) 2020, pp. 311-331, https://doi.org/10.47743/saeb-2020-0017

[55] Paksiova, R., Oriskoova, D.: *Capital maintenance evolution using outputs from accounting system*, Scientific Annals of Economics and Business, 67(3) 2020, pp. 311-331, https://doi.org/10.47743/saeb-2020-0017, p. 326

Gleißner, Günther, and Walkshäusl (2022) in their paper do not focus directly on capital maintenance but on creating a measure of overall financial sustainability[56]. Nevertheless, they include four conditions to define financial stability and emphasize that "the four conditions are also in line with traditional principles of accounting theory on capital maintenance"[57]. According to the authors, conditions for measuring financial sustainability are: "(1) a real growth of the firm that prevents its shrinkage or liquidation over time, (2) a significant probability of firm survival, (3) an adequate level of risk exposure by the firm and (4) an attractive risk–return profile for the owners"[58].

3. SAMPLE AND METHODOLOGY

To meet research objectives we obtained data for large Croatian groups from annual consolidated financial statements. Investigating groups instead of companies captures a broader range of business activities of a particular entity and consolidate transactions between related entities. Under Croatian Accounting Law, the parent company (investor) must prepare consolidated financial statements if they have control over one or more subsidiaries (investee)[59]. "An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee"[60]. Furthermore, IFRS 10 defines that the parent company has control over the subsidiary if it has all of the following: (a) power over the subsidiary, (b) exposure, or rights, to variable returns from its involvement with the subsidiary, and (c) the ability to use its power over the subsidiary's to affect the amount of the investor's returns[61]. The parent company, together with all its subsidiaries, is a group[62].

[56] Gleißner, W., Günther, T., Walkshäusl, C.: *Financial sustainability: Measurement and empirical evidence*, Zeitschrift Für Betriebswirtschaft, 92(3) 2022, pp. 467-516, https://doi.org/10.1007/s11573-022-01081-0

[57] Gleißner, W., Günther, T., Walkshäusl, C.: *Financial sustainability: Measurement and empirical evidence*, Zeitschrift Für Betriebswirtschaft, 92(3) 2022, pp. 467-516, https://doi.org/10.1007/s11573-022-01081-0, p. 507

[58] Gleißner, W., Günther, T., Walkshäusl, C.: *Financial sustainability: Measurement and empirical evidence*, Zeitschrift Für Betriebswirtschaft, 92(3) 2022, pp. 467-516, https://doi.org/10.1007/s11573-022-01081-0, p. 507

[59] Accounting Law (Official Gazette No. 78/2015, 134/2015, 120/2016, 116/2018, 42/2020, 47/2020, 114/2022), Article 23§1

[60] [https://www.ifrs.org/], accessed on 14/11/2022., IFRS 10, 6

[61] [https://www.ifrs.org/], accessed on 14/11/2022., IFRS 10, 7

[62] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, Article 2§11

Unfortunately, there is no official data on the number of groups in Croatia. However, according to data from the Croatian Chamber of Economy[63], in 2022, there were 391 large companies (0.28% of all active companies in Croatia in a given year) that generated 312 billion HRK in total revenues, making 41.96% of overall total revenues. The structure of companies by size in Croatia is in line with other European countries, i.e., sector SMEs make 99.72% of all entities, of which micro entities make 89.44%. From the Financial agency, we asked for specified items for all groups' annual consolidated financial statements from 2010 to 2021. Considering that at the moment of inquiry, all groups still did not disclose their financial statements to the Financial agency, we excluded 2021 from our analysis. By obtained data, in 2020 was a total of 178 large groups in Croatia, of which in 46% parent company was *public limited company* and in 54% were *limited liability companies* (Table 1). Large groups made 205.6 billion HRK of total revenues, had 399 billion HRK of total assets, and employed 217,897 people (by working hours).

Table 1: Structure of the sample by legal type

Year	Limited partnerships	Limited liability companies	Public limited companies	Total
2010	0	49	97	146
2011	0	51	94	145
2012	1	48	86	135
2013	0	66	104	170
2014	0	68	102	170
2015	1	75	102	178
2016	1	79	91	171
2017	1	75	93	169
2018	1	88	94	183
2019	1	89	81	171
2020	1	96	81	178
2021	0	11	13	24

Source: Author's calculation; data obtained by Financial agency (e-mail)

[63] [https://digitalnakomora.hr/home], accessed on 08/11/2022.

Nevertheless, for the sake of data homogeneity, we made certain assumptions for the inclusion of the group in further research: (1) the parent company is a public limited company, and (2) to be classified as a large group for at least six (6) years within the observed timeline. Thus, the final sample covered by the research includes 77 different groups (Table 2). For the majority of groups (56%), we had the data for the overall period covered by the study (2011-2020).

Table 2: Structure of groups included in the research by the number of business years covered by the research

Number of years	n	%	Number of observations
6	7	9.09	42
7	6	7.79	42
8	10	12.99	80
9	11	14.29	99
10	43	55.84	430
Total	77	100.00	693

Source: Author's calculation; data obtained by Financial agency (e-mail)

Observed by region (NUTS 2), 44% of 64 groups (2020) are located in the City of Zagreb, followed by 25% in Adriatic Croatia, 20% in Northern Croatia, and 11% in Pannonian Croatia. The domination of Zagreb increased by three p.p. during the ten years. The distribution is expected and follows the macroeconomic development of Croatian regions.

According to the Croatian Accounting Law, which is harmonized with Directive 2013/34/EU, large groups are parent and subsidiary companies that are included in the consolidation. Furthermore, on a consolidated basis, large groups exceed the thresholds of at least two of the three following criteria: balance sheet total of 150 million HRK (20 million EUR), revenues of 300 million HRK (40 million HRK), on average over 250 employees during the financial year.

Table 3: Descriptive statistics of size indicators for groups included in the research (in millions HRK, except employees)

Year	Employees number			Total revenues			Total assets		
	Mean	S.D.	Median	Mean	S.D.	Median	Mean	S.D.	Median
2011	2,277	4,838	894	2,347	5,726	808	3,194	6,874	1,154
2012	2,265	4,832	852	2,236	5,588	800	3,031	6,700	1,064
2013	2,165	4,516	866	2,063	5,276	617	2,863	6,555	1,003
2014	2,334	6,366	788	2,005	5,373	540	3,149	7,781	1,056
2015	2,200	6,214	725	2,137	6,433	606	3,099	7,867	1,072
2016	1,494	2,211	718	1,389	2,622	600	2,480	5,514	1,024
2017	2,236	6,149	731	2,048	5,401	610	3,001	6,742	1,082
2018	2,306	6,349	674	2,132	5,536	617	3,039	6,792	997
2019	1,713	2,361	796	1,762	3,514	714	2,897	6,393	1,029
2020	1,697	2,304	787	1,600	2,789	739	3,018	6,622	1,027
Total	2,067	4,924	796	1,965	4,972	693	2,971	6,780	1,042

Source: Author's calculation; data obtained by Financial agency (e-mail)

Therefore, by observing three size criteria (employees' number, total revenues, total assets), over the ten years, groups in samples (per year and per group), on average, employed over 2,000 employees, generated an average of almost 2 billion HRK of total revenues and had an average of 2.9 billion HRK of total assets (Table 3). However, considering high deviations in results (skewed distributions), which indicates that significant differences are present between observations, it is better to observe the median. Thus, over half of the observed groups employed more than 796 employees, generated more than 693 billion HRK of total revenues, and had a value of total assets of more than 1,042 billion HRK. Of all observations covered by the research, minimum total revenues had a group in 2018 of 105 million HRK, and minimum total assets had a group in 2012 of 172 million HRK. In fact, every group covered by the research had total assets over the prescribed threshold, but 117 observations (of 693) had total revenues in lower amounts.

However, the paper's objectives cover investigating the value and structure of groups' total capital (equity), recognizing the most critical determinants of its forming, and determining if Croatian groups respect the capital maintenance premise. Firstly, in the context of forming subscribed capital, it is essential to emphasize that Croatian Companies Law does not prescribe a minimum amount of subscribed capital for groups but only for capital companies as individual entities. The same is for distribution policies. As a result, groups cannot

distribute profit, but the distribution decisions of parent companies and subsidiaries reflect consolidated financial statements.

However, the subject of this paper is groups in which the parent company is a public limited company. Under the Companies Law, the minimal subscribed capital requirement for a public limited company is 200,000 HRK (c. 26,440 EUR)[64]. The provision of the Croatian Companies Act regarding the minimal amount of subscribed capital is harmonized with the European Parliament's Directive (EU) 2017/1132. Therefore, considering subscribed capital requirements, it is expected that subscribed capital for groups in which the parent company is a public limited company would be over that minimum requirement.

Table 4: Descriptive statistics for subscribed capital, total capital (capital & reserves), and coefficient of subscribed capital in total capital (capital & reserves) (in millions HRK, except coefficient)

	Subscribed capital			Total capital			Share of subscribed capital in total capital		
	Mean	S.D.	Median	Mean	S.D.	Median	Mean	S.D.	Median
2011	910.50	2,944.77	170.51	1,418.03	3,492.78	368.23	0.884	2.761	0.470
2012	939.52	2,860.63	197.57	1,371.93	3,423.67	359.83	0.868	1.730	0.597
2013	863.42	2,756.83	188.62	1,307.29	3,328.37	378.41	1.082	3.368	0.541
2014	858.05	2,710.78	179.90	1,307.47	3,372.57	362.61	0.056	2.704	0.524
2015	832.87	2,665.78	200.00	1,289.62	3,440.10	359.56	4.465	34.944	0.525
2016	850.39	2,680.95	213.00	1,261.64	3,553.71	361.21	0.695	2.249	0.524
2017	872.41	2,717.24	206.15	1,080.20	4,483.97	359.93	1.067	4.202	0.531
2018	891.25	2,733.35	233.91	1,076.29	4,559.61	359.38	1.578	8.146	0.570
2019	956.50	2,867.82	203.06	1,520.99	3,865.69	396.84	1.212	6.317	0.516
2020	986.79	2,932.41	193.12	1,562.61	3,955.38	427.49	1.142	6.130	0.467
Total	893.25	2,763.16	200.00	1,311.30	3,760.02	369.67	1.341	12.441	0.526

Source: Author's calculation; data obtained by Financial agency (e-mail)

As results show, on average, the subscribed capital of large groups in Croatia was 893 million HRK with a standard deviation of 2,763 million HRK for the analyzed period (Table 4). It can be noticed that the average value of subscribed capital has an increasing trend starting from 2015 up to the most recent year. On average, the value of total capital (capital & reserves) is significantly

[64] Companies Act (Official Gazette No. 111/1993, 34/1999, 121/1999, 52/2000, 118/2003, 107/2007, 146/2008, 137/2009, 125/2011, 152/2011, 111/2012, 68/2013, 110/2015, 40/2019, 34/2022), Article 162

higher than subscribed capital. Nevertheless, these results cannot take us to the conclusion that large Croatian groups meet the capital maintenance requirements. That conclusion would be superficial, considering the overall average total capital does not show an increasing trend. Furthermore, we are still determining which capital component is most significant for a capital increase; it could result from unrealized gains or revaluation reserves. Thus, we conduct a comprehensive regression analysis of panel data to make clear conclusions regarding capital structure and its maintenance.

Although descriptive statistics results for the subscribed capital and total capital are promising regarding capital maintenance, results of the average share of subscribed capital in total capital are somewhat concerning. Continuously from 2017, on average, the value of subscribed capital is higher than total capital, i.e., the ratio is higher than 1. In-depth analysis shows that there were 167 observations with a coefficient higher than 1, making up 24% of the total observations (of 693). Detailed analysis of the individual groups shows us that a total of 25 groups or 32% of all analyzed large groups had the value of total capital less than the value of subscribed capital in at least one analyzed year. Considering the high percentage of groups with an unfavorable ratio of subscribed and total capital, we will analyze groups separately to determine if differences exist in factors that significantly influence changes in total capital.

Respecting the research objectives elaborated in the Introduction chapter, we developed four research hypotheses tested in the paper using financial data from the designed sample of large Croatian groups:

H1: Large Croatian groups favor using lower financial leverage.
H2: Large Croatian groups maintain their capital at least at the level of the subscribed capital.
H3: Distribution policies of a parent company and subsidiaries significantly reflect the total capital of large Croatian groups.
H4: Changes in total capital are mainly the result of net profit and changes in retained earnings.

Considering that most analysts measure financial leverage using a debt-to-equity ratio (D/E), we will also use it to analyze the first research hypothesis (H1). Generally, the level of financial leverage represents the share of debt in total sources of financing assets. Thus, lower financial leverage means less debt in total sources of financing assets, i.e., such companies (groups) favor using their own sources of financing assets (capital). This financial indicator is calculated as a ratio of total debt and total capital (capital & reserves). The assumption for testing the hypothesis is (1):

$$D/E < 1 \tag{1}$$

Based on the new variable (D/E), we will test if at least 60% of observations prefer financing assets with capital compared to debt, i.e., that they are not using financial leverage intensively. If the ratio is below one for at least 60% of observations, we may conclude that large Croatian groups prefer capital next to debt. Finally, we will use the Binomial test to test the statistical significance of the results. The conservative financing rule determines that at least 50% of the assets of the entity shall be financed by capital (equity) to maintain financial stability and operate less riskily.

The second research hypothesis assumes that large Croatian groups maintain a total capital (CR) level of at least the subscribed capital (SC) level. Therefore, the given ratio is a precondition for respecting the capital maintenance concept. Thus, capital at the end of the financial year must be at least at the level from the beginning of the financial year. Thus, the given can be written as (2):

$$CR \geq SC \rightarrow \frac{SC}{CR} \leq 1 \tag{2}$$

The assumption covers the request that total capital must be at least at the level of the capital invested by the owner to preserve their investment. In addition, of course, the owner's objective is to increase the value of the entity's net assets, which assumes an increase in total capital over time. Considering all, we set the threshold of positive outcomes at a high level of 90% when we tested the second research hypothesis.

To analyze if the distribution policies of a parent company and subsidiaries significantly reflect the total capital of large Croatian groups, we calculated the assumed amount distributed to the shareholders in the form of dividends using the following equation (3):

$$div = netPR - \Delta LR - \Delta SR - \Delta OR - \Delta ROS - \Delta REL \tag{3}$$

where:

div – dividends
NetPR – net profit for the financial year
ΔLR – changes in legal reserve between two financial years, i.e., $LR_t - LR_{t-1}$
ΔSR – changes in statutory reserve between two financial years, i.e., $SR_t - SR_{t-1}$
ΔOR – changes in other reserves between two financial years, i.e., $OR_t - OR_{t-1}$
ΔROS – changes in reserve for own shares between two financial years, i.e., $ROS_t - ROS_{t-1}$
ΔREL – changes in profit or loss brought forward between two financial years, i.e., $REL_t - REL_{t-1}$.

It is important to emphasize that obtained amount represents only a rough approximation of distributed profit to shareholders (div). Our research assumption that parent companies and subsidiaries of large Croatian groups retain more net profit (rNetPR) than distribute to shareholders (div) can be written as follows (4):

$$rNetPR = NetPR - div \rightarrow rNetPR > div \rightarrow \frac{div}{rNetPR} < 1 \qquad (4)$$

Finally, to test the hypothesis that changes in total capital are mainly the result of net profit and changes in retained earnings, we applied the following function (5):

$$\Delta CR = f(\frac{SC_t}{CR_t}, \frac{\Delta LR}{LR_t}, \frac{LR}{CR_t}, \frac{OS_t}{CR_t}, \frac{\Delta SR}{SR_t}, \frac{\Delta OR}{OR_t}, \frac{\Delta RR}{RR_t}, \frac{\Delta REL}{CR_t}, \frac{\Delta MI}{MI_t}, \frac{NetPR_t}{CR_t}) \qquad (5)$$

As was earlier elaborated, our data make unbalanced panel data where n = 77 and the number of observed years per group goes from 6 to 10, i.e., $t_1 = 1, \ldots, 6 \ldots t_i = 1, \ldots, 10$. The total number of observations in the sample is 693. We gathered financial data from annual consolidated financial statements and calculated needed variables for the given observations. Considering that capital maintenance assumes a neutral or positive difference of total capital between two-time frames, it is justified to use changes between current and lagged value ($x_t - x_{t-1}$) in assessing capital maintenance policies in large Croatian groups. Therefore, the analysis used variables shown in the next table (Table 5).

Table 5: Variables used in the analysis

Abbreviation	Explanation (name)
D/E	Debt-to-equity ratio
CR	Total capital
SC	Subscribe capital
div	Distributed profit
NerPR	Net profit for the year
LR	Legal reserve
ST	Statutory reserve
OR	Other reserves
ROS	Reserves for owned shares
OS	Owned shares
REL	Profit or loss brought forward
RR	Revaluation reserves
MI	Minority (non-controlling) interest

4. RESEARCH RESULTS

As the first step of capital maintenance assessment, we analyzed if large Croatian groups follow a conservative rule that at least 50% of total assets shall be financed by their sources of financing (capital). To test the research hypothesis, we created a dummy variable and coded observations in which D/E is less than one with one (1), meaning that those observations finance its total assets with more than 50% of its own sources. Otherwise, observations were coded with zero (0). The binomial test shows that those two groups do not appear with the same probability of 0.5:0.5 (p-value 0.015). Descriptive statistics show that 45% of observations have a D/E ratio lower than one and finance more than 50% of total assets by own sources (on average 66%).

Table 6: Descriptive statistics for debt-to-equity (D/E) ratio (1)

	Count	% of n	Mean	Standard Deviation	Median
1<D/E<0	379	54.70	5.23	53.70	1.69
0<D/E<1	314	45.31	0.56	0.26	0.57
Total	693	100.00	3.11	39.76	0.91

Source: Author's calculation; data obtained by Financial agency (e-mail)

For those observations using financial leverage more intensively, the average value of the D/E ratio is 5.23, meaning that total debt is five times higher than total equity (Table 6). Obtained results show an extremely high standard deviation. Thus, to make more comprehensive conclusions, we analyzed those observations more closely and divided them into two groups: a ratio higher than one and a negative ratio. The results of all three groups are shown in the following table.

Table 7: Descriptive statistics for debt-to-equity (D/E) ratio (2)

	n	% of n	Mean	Standard Deviation	Median
1<D/E<0	314	45.31	0.56	0.26	0.57
0<D/E<1	314	45.31	7.97	58.55	1.93
Negative	65	9.38	-7.99	7.26	-6.33
Total	693	100.00	3.11	39.76	0.91

Source: Author's calculation; data obtained by Financial agency (e-mail)

Excluding observations with negative D/E in the separate group resulted in higher deviation for observations that more than 50% of their total assets were financed by debt (Table 7). Those observations intensively use financial leverage, i.e., debt is almost eight times higher than capital (equity). Space for future research is to investigate if those observations use financial leverage efficiently. Finally, over 9% of observations had a negative D/E ratio due to the negative value of total capital (capital & reserves). In the case of 9% of the total observations, debt is higher than total assets. In those cases, net assets are negative, which means financial instability and not respecting the going concern concept. Considering that the fundamental concept of capital is violated in such a situation, these 65 observations are excluded from testing the hypothesis.

Table 8: Frequencies, mean value, and Binomial test results for debt-to-equity (D/E) ratio

Year	Higher than 1 (code = 0)			Lower than 1 (code = 1)			One-Sample Binomial Test
	Mean	Count	% of n	Mean	Count	% of n	
Overall	7.97	314	50.00	0.56	314	50.00	0.000
2011	4.28	33	58.93	0.55	23	41.07	0.003
2012	6.46	32	55.17	0.52	26	44.83	0.013
2013	6.72	31	49.21	0.54	32	50.79	0.086
2014	2.58	33	51.56	0.58	31	48.44	0.039
2015	33	35	50.72	0.61	34	49.28	0.045
2016	3.99	32	47.76	0.58	35	52.24	0.121
2017	3.52	33	49.25	0.53	34	50.75	0.078
2018	5	34	50.75	0.52	33	49.25	0.047
2019	4.26	29	48.33	0.57	31	51.67	0.118
2020	7.6	22	38.60	0.6	35	61.40	0.468

Source: Author's calculation; data obtained by Financial agency (e-mail)

We tested the research hypothesis that large Croatian groups favor using lower financial leverage on an overall and yearly basis, i.e., for every observed year separately, to make more detailed conclusions. Considering that we divided the D/E into two categories (1 if D/E<1 and 0 if D/E>1), we used the Binomial test by which we tested if the defined categories occur with probabilities 0,6 (category 1) and 0,4 (category 0). Results suggest we cannot accept the assumption (p-value 0.000). Overall, an equal number of observations favor using higher and lower financial leverage (Table 8). Observing by years 2013, 2016, 2017, 2019, and 2020, we can accept the assumption, i.e., we could conclude that a more significant proportion of groups use lower financial leverage. Never-

theless, only in 2020, more than 60% of groups preferred owned sources of financing (D/E<1). On average, they are financing 64% of assets with equity. Opposed that groups that are intensively using financial leverage (D/E>1) in 2020 finance, on average, only 30% of their assets by equity.

Considering all results, we could not accept the first research hypothesis that large groups in Croatia favor using lower financial leverage. Above all, the reasons for this are marginal results observed over the years and rejecting statistical hypothesis on the overall basis—additionally, 9% or 65 observations with negative D/E ratio and negative value of total capital confirms the conclusion. When an entity has a negative total capital value, we cannot speak of financial stability and reasonable use of financial leverage. In those circumstances, we cannot say that large groups in Croatia are cautious in using debt and tend to finance their assets with capital (equity).

Capital maintenance assumes that the amount of capital at the end of the financial year is the same as at its beginning. Every profit-oriented entity would aim to increase net assets, i.e., the value of total capital (capital & reserves). Thus, operating with losses leads in the opposite direction and decreases the value of net assets. In such circumstances, it is not possible to talk about capital maintenance but about the ability of the company to survive, considering its financial stability is seriously endangered, and the going concern concept is violated. To analyze if groups had their capital level at least at the amount of subscribed capital, we used a ratio of subscribed capital and total capital (capital & reserves). This ratio indicates the proportion of invested capital by the owners in total available capital, including invested and earned parts of the capital. Preliminary results of the one-sample binomial test set at 10% reject the statistical null hypothesis (p-value 0.000) that 90% of observations maintain their capital at least at the amount of subscribed capital. As a result, it is impossible to accept the second research hypothesis. Considering that in the sample exists, more than 10% of observations with the value of subscribed capital higher than total capital, we supplemented our research objective to investigate the depth and reasons for those results.

Table 9: Descriptive statistics for D/E ratio for observations with a favorable and unfavorable ratio

	Count	% of n	Mean	Standard Deviation	Median
Unfavourable D/E ratio	167	24.10	4.04	25.20	1.09
Favourable D/E ratio	526	75.90	0.48	0.28	0.51
Total	693	100.00	1.34	12.44	0.53

Source: Author's calculation; data obtained by Financial agency (e-mail)

The majority of observations have a good value of the ratio, i.e., 76% have subscribed capital lower than total capital. More precisely, subscribed capital makes, on average, 48% (standard deviation of 28%) of total capital (Table 9). Furthermore, more than half of the total capital is earned capital for those observations. On the other side, 24% of observations had an unfavorable ratio of subscribed and total capital, i.e., in 24% of cases, subscribed capital was higher than total capital. This result indicates a negative value of other capital elements.

On average, almost a quarter of observations had subscribed capital four times higher than total capital. Still, the standard deviation of that result is exceptionally high (25.20), making the median a much better indicator. According to the median, 50% of observations had a coefficient less than 1.09, and in the case of the other 50% over that value. This result could lead us to conclude that the first 50% of observations only slightly exceed the threshold, but a more detailed analysis reveals more serious structural problems.

Table 10: Descriptive statistics for unfavorable D/E ratio by 'negative' and 'over one' observations

	Count	% of n	Mean	Standard Deviation	Median
Negative ratio	65	38.92	-1.70	3.65	-0.24
Ratio value over one	102	61.08	7.70	31.64	1.48
Total	167	100.00	4.04	25.20	1.09

Source: Author's calculation; data obtained by Financial agency (e-mail)

Out of 167 observations, 61% had a ratio of subscribed and total capital higher than one, with a very high average level of 7.70 and a standard deviation of 31.64 (Table 10). However, the median for 61% of observations was 1.48, meaning that 50% had a share of subscribed capital 48% higher than total capital, and the other 50% had a share less than 48% higher. Even worse case is that 39% of observations had a negative ratio. The result is possible when total capital is negative due to accumulated losses, which overcome positive capital elements.

Table 11: Results of Binomial test for D/E ratio

	D/E > 1			0 < D/E < 1			Binomial Test
	Mean	Count	% of n	Mean	Count	% of n	
sccr_ratio	7,70	102	16,24204	0,48	526	83,75796	0.000

Source: Author's calculation; data obtained by Financial agency (e-mail)

Again, we excluded from testing hypothesis 9% or 65 because of their negative total capital value, which represents significant noise in results (Table 11). Considering the importance of maintaining capital at least at the level of subscribed capital, we set a rigorous threshold that at least 90% of observations manage to preserve their total capital at least at the level of the subscribed capital. Therefore, using the Binomial test, we tested if category sc/cr>1 (code = 1) occurs with a probability of 0.9. Results show that we cannot accept the given hypothesis. The conclusion is even firmer if we consider those observations with a negative total capital value. Thus, large groups in Croatia do not maintain their total capital level, at least at the level of the subscribed capital.

To test if the distribution policies of the parent company and subsidiaries significantly reflect the total capital of large groups in Croatia, we excluded from the sample observation with a negative financial result for the year and a negative outcome of our equation (4). Therefore, the final sample includes 382 observations which we divided into two groups by the equation (4) result. The first group (code = 1) covers observations in which the parent company, together with subsidiaries, distributed less than 50% of net profit for the financial year, and the second group (code = 0) covers those observations in which the distribution ratio was over 50%.

Table 12: Mean value and frequencies of groups that distributed less and more than 50% of net profit (divNet)

Categories	Mean	Count	% of n
Distributed more than 50%	6,58	286	74,87
Distributed less than 50%	0,26	96	25,13
Total	4,99	382	100,00

Source: Author's calculation; data obtained by Financial agency (e-mail)

The table shows that only 25% of observations distributed less than 50% of net profit (Table 12). On average, they distributed 26% while the majority of net profit they retained in the capital, representing internally created sources of financing assets. Contrary to these results, almost 75% of observations that generated positive financial results decreased capital components (retained earnings, reserves, etc.) above the amount of the net profit for that year. In most cases, the decrease resulted from decreasing retained earnings (profit or loss brought forward). It is important to emphasize that 28% or 81 (of 286) observations had a negative value of profit or loss brought forward, and 5% or 14 (of 286) observations had a negative value of total capital. On the group level, for 20% or 57 (of 286) observations, profit or loss brought forward is

worsened (become more negative) despite the positive financial result for the observed year.

To test the research hypothesis, we used multiple regression analysis of panel data in which the dependent variable was total capital (cr), and the independent variables were a result of equation (3) (div) and net profit (NetPR). The natural logarithm of total assets was the control variable. The overall model is statistically significant and explains at least 70% of all variations. The results of the Breusch and Pagan test indicate that comparing OLS and RE, RE is an appropriate model (p-value 0.000), and the Hausman test, which compares RE and FE models, demonstrates that the FE model is suitable (p-value 0.000). Results indicate the existence of autocorrelation (p-value 0.0017) and heteroskedasticity (0.000). Thus, we used robust cluster error to obtain relevant results.

Table 13: Results of panel regression analysis – Ordinary least squares (OLS), fixed effects (FE) and random effects (RE), dependent variable: change in total capital, ΔCR)

	OLS		FE		RE	
	t	P>|t|	t	P>|t|	z	P>|t|
div	-1.67	0.099	-3.95	0.000	-3.60	0.000
NetPR	4.51	0.000	3.68	0.000	4.15	0.000
lnTA	3.90	0.000	3.46	0.001	3.68	0.000
_cons	-3.85	0.000	-3.13	0.003	-3.63	0.000
Number of observations	382		382		382	
Number of groups:			75		75	
Obs per group:						
min		1		1		
avg		5.1		5.1		
max		10		10		
F	16.76		12.66		21.73	
Prov > F	0.0000		0.0000		0.0001	
R-sq:						
within			0.2991		0.2841	
between			0.6441		0.6300	
overall	0.7881		0.7065		0.6989	

Source: Author's calculation; data obtained by Financial agency (e-mail)

The results of all three models indicate that distributed amount (div) has a statistically significant negative impact on total capital (Table 13). Therefore, the results suggest that we can accept the third research hypothesis but in a negative context. Thus, the distribution policies of the parent company and subsidiaries significantly reflect the total capital of large Croatian groups, but negatively.

Considering that our results indicate that large Croatian groups are inefficient in capital maintenance, we conducted analysis separately for efficient, inefficient, and overall observations to conclude regarding the most critical determinants in forming their total capital (capital & reserves). As previously elaborated, the dependent variable in our model is a proportion of change in total capital concerning the value of total capital from the current year (c_dcr). Additionally, we have chosen eleven relevant indicators for independent variables in forming and maintaining total capital. Next to composition elements of total capital, those indicators include return on equity (roe) as a performance indicator.

To determine if it is best to use the ordinary least square (OLS), fixed effects (FE), or random effects (RE) model, we applied appropriate tests. To decide if we should choose OLS or RE, we used Breusch and Pagan Lagrangian multiplier, and to select between FE and RE, we used the Hausman test. Thus, the Breusch and Pagan Lagrangian multiplier test for random effects for the overall model shows a p-value of 1.000, meaning that the RE model is inappropriate. The result is the same for the inefficient model (p-value 1.000) and the efficient model with a p-value of 0.4629. Furthermore, the overall model result of the Hausman test indicates that we should use the FE model instead of the RE model (p-value < 0.000, the empirical p-value was 0.000). The result is the same for the model with efficient (empirical p-value 0.0085) and inefficient observations (empirical p-value 0.000). Thus, for all three groups of observations FE model is appropriate. Wooldridge test for autocorrelation in panel data shows that there is no autocorrelation problem in the overall model (p-value 0.1471) and inefficient model (p-value 0.1661). Opposed to that, in the efficient model exists an autocorrelation problem (p-value 0.000). Modified Wald test show groupwise heteroskedasticity in all three models (p-value of 0.000). We used robust standard error to deal with heteroskedasticity in the overall and inefficient model. We used robust cluster standard error (clustered by n) to deal with heteroskedasticity and autocorrelation in the efficient model (Table 14).

Table 14: Results of panel regression analysis, dependent variable: change in total capital (ΔCR)

Independent variables	Overall		Efficient		Inefficient	
c_dcr	Coef.	P>|t|	Coef.	P>|t|	Coef.	P>|t|
c_sccr	0.076	0.000	-0.148	0,369	0.071	0,015
c_dsc	-0.039	0.532	0.039	0,036	-0.088	0,701
c_dlr	0.002	0.495	0.017	0,001	0.024	0,738
perlr	0.051	0.779	0.040	0,001	0.057	0,847
peros	0.068	0.773	-0.111	0,090	12.059	0,000
c_dsr	-0.021	0.164	0.008	0,743	-0.071	0,000
c_dor	0.001	0.818	0.000	0,839	0.164	0,245
c_drr	0.000	0.912	0.001	0,010	-0.003	0,508
per_drel	0.080	0.009	0.791	0,000	0.061	0,141
c_dmi	0.000	0.852	0.000	0,509	-0.018	0,087
roe	1.064	0.000	0.784	0,000	1.079	0,000
_cons	0.930	0.000	0.993	0,000	0.086	0,741
Number of observations	693		526		167	
Number of groups:	77		71		33	
Obs per group:						
min	6.00		1.00		1.00	
avg	9.00		7.40		5.10	
max	10.00		10.00		10.00	
F	71268.570		174.490		140518.990	
Prov > F	0.000		0.000		0.000	
Model	FE (robust standard error)		FE (clustered standard error)		FE (robust standard error)	
R-sq:						
within	0.979		0.748		0.982	
between	0.931		0.639		0.430	
overall	0.975		0.719		0.911	
corr(u_i, Xb)	-0.070		-0.216		-0.306	

Source: Author's calculation; data obtained by Financial agency (e-mail)

The final results show that all three models are statistically significant (p-value is 0.000). Additionally, all models explain the high proportion of the variability of dependent variables. The overall R-squared for the overall model is 97.5%, and for the inefficient model, 91.1%. A slightly lower R-square of 71.9% for the efficient model could lead us to the conclusion that additional determinants influence the group's total capital. Finally, individual results show use differences between the three models. The only statistically significant variable in all three models is the return on equity (roe). Moreover, observing all three models, return on equity is the most significant variable in case of inefficient observations. Nevertheless, analysis of the inefficient model shows that statistically significant independent variables are the share of subscribed capital in total capital, the proportion of owned shares in total capital, and changes in statutory reserves. In contrast to inefficient observations, statistically significant independent variables differ in the case of efficient observations. Thus, next to return on equity (coefficient 0.784) most important positive effect on changes in total capital has a proportion of changes in profit or loss brought forward (coefficient 0.791). Results lead us to conclude that observations that maintain capital efficiently are profitable and retain their earnings, i.e., increase earned capital which adds value to the group. Next to those two variables, a significant positive effect on the total capital increase have changes in the subscribed capital, changes in legal reserve, the proportion of legal reserve, and changes in revaluation reserves. Finally, by observing overall observations, three independent variables are statistically significant for changes in the total capital of large Croatian groups. Firstly, return on equity is the most significant one (coefficient 1.064), followed by the proportion of changes in profit or loss brought forward (coefficient 0.080) and the proportion of subscribed capital in total capital (coefficient 0.076).

Our sample includes a total of 77 large Croatian groups in which the parent company is a public limited company and was classified as a large group for at least six (6) years within the observed timeline. Research results indicated that, on average, large groups are inefficient in capital maintenance. Detailed information reveals that out of the total observations, 24% had subscribed capital higher than the total capital.

To make more concrete conclusions regarding capital maintenance in large Croatian groups, we decided to conduct an analysis that comprehensively includes all years covered by the research. Thus, we observed if large Croatian groups successfully maintain their capital long-term. Unfortunately, the results are even worse. Over 40% of analyzed groups (total of 77) decreased their total capital (capital & reserves), and 58% of groups managed to maintain their capital within all analyzed years efficiently. Analysis of efficient groups, on average, includes 9.267 years; in the case of inefficient groups, the average number of observed years is 8.625.

Efficient groups increased their total capital on average by 771 million HRK with a standard deviation of 1,311 million HRK. Half of the groups raised their total capital of less than 243 million HRK, and another half for more than 243 million HRK. The group with a minimum increase raised its total capital by 10.7 million HRK, and the group with the maximum increase by 6,733 million HRK. Regarding the type of capital, subscribed capital increased on average by 143 million HRK, which may result from business combinations. The sum of changes in total capital compared to the amount of total capital from the last observed year (TotalREL_perCR) result in a negative average value and a bad indicator for the analysis. The negative value on the overall level results from a negative change in profit or loss brought forward (ΔREL). Even seven (7) groups, with an increase in total capital within all observed years, had this negative change in profit or loss brought forward. Those are the cases in which the increase in total capital results from additional capitalization by owners, i.e., an increase in the subscribed capital. In one group, the increase in total capital is a result generated in the last observed year and not an increase in subscribed capital. The high negative mean value of -3.325 mainly results from of individual group, which over the years had an increase of profit or loss brought forward (ΔREL) by 1,428 million HRK but in the last observed year reported a negative value of total capital (-9,9 million HRK). Thus, it is more indicative of analyzing the median for the share of change in profit or loss brought forward (ΔREL) over the years to total capital in the last observed year, which indicates that 50% of efficient groups increased total capital for 13.4% within all observed years. Other 50% increased total capital by more than 13.4% in an average of 9.267 years. On the other hand, earned capital in the form of retained earnings averagely increased by 461 million HRK. Additionally, efficient groups averagely generated 1,036 million HRK of net profit (NetPR) during the observed years. An interesting indicator is the proportion of changes in profit or loss brought forward (ΔREL) in total net profit (NetPR) generated in all analyzed years. Results show that efficient groups retained 77.6% of net profit. Again, considering the high standard deviation (2.080), it is better to observe the median by which 50% of groups retained less than 40% of net profit, and the other 50% retained more than 40% of net profit.

Results for inefficient groups are, as expected, negative. For those groups, total capital decreased, on average, by 1,248 million HRK (standard deviation of 4,999 million HRK). For 50% of inefficient groups, total capital decreased by less than 199 million HRK, and for the other 50%, more than 199 million HRK. Out of 32 groups with a negative change in total capital, 10 or 31% had a negative value of total capital in the last observed year. Other 22 or 69% had positive total capital, but its value decreased over the analyzed period. The decrease is a direct result of cumulated negative financial results over the years

and, as a result, a decrease in retained earnings (or an increase of loss brought forward). Despite its unfavorable results, 10 or 31% of inefficient groups decreased their subscribed capital. The results confirm comprehensive findings that the financial result is the most significant variable for change in total capital for large Croatian groups with inefficient capital maintenance.

5. CONCLUSION

From an accounting point of view, the value of entities is measured by their net assets, i.e., their total capital. Thus, to increase their value, entities must operate profitably and retain their earnings for future growth and development of business operations. The capital increase assumes its maintenance, where capital maintenance occurs when an entity has as much capital at the end of the period as it did at the beginning. Analysis of 77 large Croatian groups in which the parent company is a public limited company from 2011 to 2020 shows us that 16 groups, a total of 65 observations, had a negative value of total capital. Those 16 groups are considered financially unstable with violated going concern concept. Out of the other 61 groups (628 observations) with a positive value of total capital, 50% finance, on average, 19% of their total assets by equity, and the other half finance, on average, 66% of their assets by equity. Considering the results, we concluded that large groups in Croatia are not cautious in using debt, and they tend to use high financial leverage. Future research could focus on the analysis if they manage to make higher returns due to financing its assets by debt. The major indicator of capital maintenance shows that large Croatian groups do not maintain their capital at least at the level of the subscribed capital. Over 16% of observations (observations with a negative value of total capital excluded) had the value of subscribed capital higher than the value of total capital. These results indicate that 167 or 24% of all observations do not meet the minimum capital maintenance requirement – the capital at the end of the period is the same as the capital at the beginning. Even 54 groups had an unfavorable ratio of subscribed and total capital for at least one year, but most had it in several years. Those groups are mostly included in observations with a negative total capital value. Thus, only two groups had a negative value of total capital during the overall analyzed period. Finally, 56 out of 77 large groups (or 73%) had the value of subscribed capital higher than the value of total capital in at least one analyzed year. All together leads to the conclusion that large groups in Croatia do not maintain their capital appropriately. Additionally, the research results suggest that distributed amount for observations with net profit has a statistically significant negative impact on total capital. Thus, the distribution policies of the parent company and subsidiaries significantly reflect the total capital of large Croatian groups, but negatively. Fur-

thermore, of those profitable observations, almost 75% distribute more than half net profit for the year. Finally, research results show that net profit and changes in retained earnings (loss carried forward) are the most significant capital components for annual changes in total capital. This research confirms the need for developing precise guidelines regarding capital maintenance and profit distributions as starting points for corporate sustainability.

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6. [https://www.iasplus.com/en-gb/publications/uk/closer-look/2019/a-closer-look-capital-maintenance-and-distributions-under-the-spotlight], accessed on 14/11/2022.
7. [https://www.ifrs.org/], accessed on 14/11/2022.
8. [https://www.merriam-webster.com/dictionary/capital], accessed on 08/11/2022.
9. [https://www.oxfordlearnersdictionaries.com/definition/english/capital_1], accessed on 08/11/2022.

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TO BE OR NOT BE... DIRECTOR IN CROATIA

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ABSTRACT

According to the 2019 Directive on Digital Tools and Processes in Company Law (referred to here as 'the Digitalization Directive'), Member States are required until August 2023 to lay down a set of rules defining what kind of persons are not legally allowed to be directors of companies (e. g. those with a criminal background).

Building their paper around long-standing critics of the EU company law regime and the transposition rules thereof, the authors present legal provisions of Croatian company law where special regard is paid to the 'disqualified directors' and the recipes for how to deal with these new challenges imposed by the Digitalization Directive.

One of the positive aspects of the Digitalization Directive is that it requires Member States to clearly state the reasons why persons are not allowed to be company directors and that a list of these disqualified directors must be maintained. Company directors risk losing their rights of setting up or representing a company if they fail to meet their legal responsibilities. Although practically all Member States have at least one reason for disqualification, in practice there is wide variation in the reasons and in whether or not a list is kept.

Given the scope and aim of the Digitalization Directive, the paper seeks to find out whether and to what extent the term 'disqualified directors' would and should be introduced into Croatian law. The paper argues that the EU regime allows the introduction of the 'disqualified directors' test into Croatian law.

Alongside examining legal sources and literature, the authors pursue their research by systematically analyzing rules on 'disqualified directors' under the Digitalization Directive and Croatian Companies Act. After the introduction, the second part of the paper considers the concept of disqualified directors and provides an overview of

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other Member States. The paper gives a background picture of why the Digitalization Directive proposed certain actions, inherent problems inherent, and what major critiques have been brought forward in the meantime regarding 'disqualified directors'. The third part analyses the Croatian legal regime, aiming at revisiting it in the light of the 'transposition test'. The fourth part summarizes and concludes.

KEYWORDS: *Disqualified directors, the Digitalization Directive, Croatian Companies Act.*

1. INTRODUCTION

The Court of Justice of the European Union has repeatedly recognized that not all differences in national rules can be solved by jurisprudence, but may need to be dealt with by future legislation or conventions[1]. This legislative update with the Digitalization directive[2] seeks to improve the standards associated with company directors across the EU.

On July 31, 2019, the Digitalization Directive entered into force. The requirements introduced by the Digitalization Directive are based on the Company Law Package of the European Commission and particularly relate to the online formation of corporations but also have requested in respect of directors. In this paper, the emphasis is on the latter.

The Company Law Directive[3] was amended with three directives: the Directive on restructuring and insolvency[4], the Digitalization Directive, and the Cross-border Directive[5].

[1] Judgment of 27 September 1988, The Queen v H. M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc. C-81/87 EU:C:1988:456, para. 21 to 23, Judgment of 5 November 2002, Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC), C-208/00, EU:C:2002:632, para. 69, Judgment of 16 December 2008, Cartesio Oktató és Szolgáltató Bt , C-210/06, EU:C:2008:723, para. 108.

[2] Directive (EU) 2019/1151 of the European Parliament and of the Council of 20 June 2019 amending Directive (EU) 2017/1132 as regards the use of digital tools and processes in company law, PE/25/2019/REV/1, OJ L 186, 11.7.2019, p. 80–104 (hereinafter: The Digitalization Directive)

[3] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law, OJ L 169, 30.6.2017, p. 46–127

[4] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132, OJ L 172, 26.6.2019, p. 18–55

[5] Directive (EU) 2019/2121 of the European Parliament and of the Council of 27 November 2019 amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions OJ L 321, 12.12.2019, p. 1–44

The objective of the Digitalization Directive is namely to provide more digital solutions for companies in the internal market at the EU level by the principle of subsidiarity as set out in Article 5 of the Treaty on European Union[6] and with the principle of proportionality.[7] The Digitalization Directive covers provisions on the use of digital tools and processes in company law. Member States had to transpose the Digitalization Directive by August 1st, 2021, with a longer deadline for some provisions[8].

Member States should bring into force by at the latest August 1st, 2023 provisions of the Digitalization Directive concerning disqualified directors. According to Digitalization, Directive Member States are required until the indicated date to lay down a set of rules defining what kind of persons are not legally allowed to be directors of companies. According to the available source[9], nine Member States have transposed the Digitalization Directive by August 1st, 2021 (partially or completely). There are eight Member States which have not yet informed the European Commission about measures taken for the transposition of the Digitalization Directive.

Member States must have rules on the disqualification of directors, i. e. on the reasons why persons are not eligible to be directors. Member States must have such rules for at least "persons who take part in the administration, supervision or control of the company" and those that "are authorized to represent the company in dealings with third parties and legal proceedings"[10]. The Digitalization Directive requires Member States to establish a system for sharing information on 'disqualified directors' (i. e. persons who are determined to be ineligible to be a company director due to criminal or other activity).

Most Member States do not have a specific concept of "disqualified directors" in company law, but the transposition of the Digitalization Directive provides an opportunity to introduce the concept of "disqualified directors" into company law in countries where this does not exist and to extend the reasons for disqualification. It should also require that a current list (if any exist) of disqualified persons (together with the reason for their disqualification) be maintained, and that this list be accessible to the public.

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6 Consolidated version of the Treaty on European Union OJ C 326, 26.10.2012, p. 13–390 - ELI: http://data.europa.eu/eli/treaty/teu_2012/oj

7 Preamble – Recital 40. of the Digitalization Directive

8 Article 2(2) of the Digitalization Directive

9 See more on https://eur-lex.europa.eu/legal-content/EN/NIM/?uri=CELEX:32019L1151 - accessed on October 10th, 2022

10 ETUC Guidelines on the Directive on digital tools and processes in company law, Brussels, 2021 - https://www.etuc.org/sites/default/files/2021-06/Guidelines_digital%20tools%20Directive%20EN.pdf accesse on September 13th, 2022

Regarding disqualifications, the Directive on restructuring and insolvency[11] was also adopted in connection with this Digitalization Directive and Company Law Directive[12]. The objective of that Directive is to contribute to the proper functioning of the internal market and remove obstacles to the exercise of fundamental freedoms, such as the free movement of capital and freedom of establishment, which result from differences between national laws and procedures concerning preventive restructuring, insolvency, discharge of debt, and disqualifications.[13]

Croatian Companies Act implemented the Digitalization Directive in 2022[14]. The aforementioned directive was implemented by law in such a way that provisions were added to the law on the conditions to be met by directors and other authorized persons to represent the company, as well as the measures that the state is obliged to undertake in this regard.

2. THE AIM – „FAST TRACK“ OR „SLOW TRACK“ APPROACH

In its 2003 Action Plan, the European Commission stated its intention to propose a directive to increase the responsibilities of directors which would include director disqualification.[15]

In 2006, the European Parliament proposed that the European Commission should have measures to enhance the cross-border availability of information on the disqualification of directors.[16] The increase in cross-border mobility of companies did lead to the risk that those who are subject to sanctions in one Member State could simply continue their improper activity in another Member State. Therefore, it called for greater access to information on the disqualification of directors. The European Commission has endeavored to broaden

[11] Directive (EU) 2019/1023 of the European parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency)

[12] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law (codification), OJ L 169, 30.6.2017, p. 46–127

[13] Preamble recital 1 of the Directive 2019/1023

[14] Law on Amendments to the Companies Act – Official gazette no. 34/22

[15] Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward (COM (2003) 284 final) - https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex%3A52003DC0284 - accessed on September 17th, 2022

[16] European Parliament resolution on recent developments and prospects in relation to company law (2006/2051(INI)) OJ C 303E , 13.12.2006, p. 114–119 - https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52006IP0295 - accessed on September 17th, 2022

disqualification throughout the EU, and thus promote mutual recognition.[17] This has been difficult to achieve because of the diverse disqualification rules of the Member States and because of issues relating to the rights of individuals.

One problem that often presents itself in addressing the issue of disqualification is that it falls into a grey area, somewhere between company law and insolvency law.[18]

On issues of corporate governance, the EU has always focused its attention on ensuring companies are managed by directors who are fit for purpose. This is most notable in the Shareholders Rights Directive[19]. The same is notable in the Takeover Bids Directive [20]and more recently, the Commission Implementing Regulation (EU) 2018/1212[21]. Corporate Governance was also highlighted as an area of interest in the context of the implementation of the Commission Action Plan on financing sustainable growth dated 2012[22]. Special provisions on corporate governance and remuneration concerning banks and investment firms were also conceived through the Capital Requirements Directive IV, as amended by Capital Requirements Directive V,[23] and Regulation No 575/2013, as amended by Regulation No 2019/876.[24]

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[17] Green Paper on the approximation, mutual recognition and enforcement of criminal sanction in the European Union (COM (2004) 334 final), 24 - https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52004DC0334 - accessed on September 17th, 2022

[18] Karsten Engsig Sorensen, "Disqualifying Directors in the EU" in Hanne S Birkmose, Mette Neville & Karsten Engsig Sørensen (eds.) Boards of Directors in European Companies. Reshaping and Harmonising Their Organisation and Duties (Wolters Kluwer 2013) - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2358368 – accessed on September 17th, 2022

[19] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement OJ L 132, 20.5.2017, p. 1–25

[20] Directive 2004/25/EC of the European Parliament and of the Council of 21 april 2004 on takeover bids OJ L 142, 30.4.2004, p. 12–23

[21] Commission Implementing Regulation (EU) 2018/1212 of 3 September 2018 laying down minimum requirements implementing the provisions of Directive 2007/36/EC of the European Parliament and of the Council as regards shareholder identification, the transmission of information and the facilitation of the exercise of shareholders rights C/2018/5722, OJ L 223, 4.9.2018, p. 1–18

[22] Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions Action Plan: Financing Sustainable Growth COM/2018/097 final

[23] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures

[24] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding

This legislative update with the Digitalization Directive seeks to improve the standards associated with company directors across the EU. It foresees the exchange of information between Member States on disqualified directors to prevent fraudulent behavior. Any disqualification information recorded by each Member State's register may be inquired into by another Member State through a regulated electronic procedure via a system of interconnected business registers[25], under the responsibility of the EU's e-Justice portal. This system facilitates the exchange of information between registries and is especially useful when a Member State is required to verify whether an applying director is disqualified in any other Member State.

In this age of digitalization, it is easier to become an incorporated company in another Member State. So the rules on disqualification in the Digitalization Directive take into account the increased mobility in the internal market and digitalization itself. The Digitalization Directive considers that it should be possible to disqualify a person who is a director of a foreign company and to enforce a disqualification order against someone who intends to use a foreign company as a vehicle for their business.[26]

Any director can be disqualified. There is a number of reasons such as wrongful trading, fraudulent trading, or unfit conduct. Failing to adhere to duties as a director will result in an investigation and/or disqualification.

Almost every Member State has disqualification rules for directors, and only a few Member States do not have a central public register of the disqualified persons[27]. The comparative legal analysis has also shown that the Member States'

ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012, OJ L 150, 7.6.2019, p. 1–225

[25] Business Registers Interconnection System (BRIS) is based on legal obligations set out by Directive 2012/17/EU on the interconnection of business registers and the Implementing Regulation (EU) 2015/884 of 8 June 2015. The directive requires the establishment of an information system that interconnects the central, commercial and companies registers (also referred to as business registers) of all Member States, whereas the Regulation details the technical specifications for the system. About BRIS see more: Ž. Bregeš i T. Jakupak, "DIGITALIZATION OF BUSINESS REGISTER", InterEULawEast, vol.4, br. 2, str. 91-99, 2017. [Online]. https://doi.org/10.22598/iele.2017.4.2.6

[26] About (increased) mobility of companies e.g. Horak, Hana; Dumančić, Kosjenka: Cross-Border Transfer of the Company Seat : One Step Forward, Few Steps Backward // US China law review, 14 (2017), 10; 711-728 doi:10.17265/1548-6605/2017.10.005

[27] Only Greece and Italy don't have the disqualification proceeding and there are other eight Member States (Austria, Belgium, Cyprus, Denmark, Germany, Netherlands, Slovakia, Slovenia) which do not have public register - Gerard McCormack – Andrew Keay – Sarah Brown

provisions may differ according to the period, the content, and the reasons for disqualification.

However, with very few exceptions, disqualification is (or should be) one of the main sanctions for the breach of insolvency-related duties. Other reasons for disqualification can include committed fraud, tax evasion, the use of company assets for personal benefit, and failure to maintain proper company accounting records.

The disqualification aim should be effective throughout the EU, not only at the national level. The lack of harmonization in this area of company law undermined national protection because according to the rules that were in force before the Digitalization Directive, there was no obstacle for a disqualified director to manage a company in a different Member State. The lack of availability of information about the disqualified directors ensured the free movement of the directors who could cause potential business failures in other Member States. For example, a director who was disqualified under Hungarian law cannot manage a company in Hungary for five years, but he could act as a director in Croatia or any other Member State. The Digitalization Directive aims to prevent and discourage further abuses in this area of company law in such a way.

Under the Digitalization Directive[28] Member States have an opportunity to share and receive this information (more precisely they are not precluded from doing so), but they are not obliged to ensure access to such information. The Digitalization Directive ensures that Member States should come up with rules on how to disqualify certain individuals from economic activities, but it does not provide details on such criteria for disqualification. The EU should ensure the availability of information on the disqualified directors more precisely.

What does the Digitalization directive say about disqualified directors? Member States shall ensure that they have rules on the disqualification of directors[29]. Member States may require that persons applying to become directors declare whether they have been disqualified[30]. Also, Member States may refuse the appointment of a person as a director of a company where that person is currently disqualified[31]. Furthermore, Member States need to be able to communicate

– Judith Dahlgreen: Study on a new approach to business failure and insolvency. Comperative legal analysis of the Member States' relevant provisions and practices. Table 1.4. Disqualification Regimes 65-69. https://ec.europa.eu/info/sites/default/files/insolvency_study_2016_final_en.pdf Croatia doesn't have public register on disqualified directors yet

[28] Preamble – 24 of the Digitalization Directive

[29] Articles 13f and 13i of the Digitalization Directive

[30] e.g. Article 239. Croatian Companies Act

[31] e.g. Article 43.6 Croatian Court Register Act

information about the disqualification of directors in one Member State to other Member States in due time.

From a legal perspective, directors' duties and liabilities are regulated in all Member States[32]. The Digitalization Directive contains significant provisions, which seek to ban "unfit" directors from being directors of a limited liability company. This action will be taken only when it is proven that the director has acted wrongfully, fraudulently, and/or negligently. The Digitalization Directive introduced further measures to disqualify directors who have run insolvent businesses in the past or have influenced other directors. Directors can also be disqualified if they are involved in company offenses abroad.

The Digitalization Directive, among others, provides a legal framework for Member States to request information from other Member States in respect of disqualified directors. Member States may refuse the appointment of any individual as a director of a company or branch who is currently under a disqualification order imposed in another Member State.

One of the positive aspects of the Digitalization Directive is that it requires Member States to clearly state the reasons why persons are not allowed to be company directors and that a list of these disqualified directors must be maintained. Company directors risk losing their rights of setting up or representing a company if they fail to meet their legal responsibilities. Although practically all Member States have at least one reason for disqualification, in practice there is wide variation in the reasons and in whether or not a list is kept.

Currently, most EU countries do not have a codified section in company law with a clear definition of 'disqualified director' and grounds for disqualification[33]. In most countries, the grounds for disqualification are limited and scattered over different laws. Few countries[34] keep a public record of disqualified directors[35]. It is therefore necessary that Member States define broad criteria for disqualification, keep a list of current and former disqualified persons, and give the public access to this list.

[32] European Commission, Directorate-General for Justice and Consumers, Study on directors' duties and sustainable corporate governance: final report. Publications Office, 2020, https://data.europa.eu/doi/10.2838/839863 - accessed on September 13th, 2022

[33] UK as the former EU member state was an exception and has a specific law on disqualified directors

[34] e.g. Estonia, Finland, Ireland, the Netherlands

[35] ETUC Guidelines on the Directive on digital tools and processes in company law, Brussels, 2021 - https://www.etuc.org/sites/default/files/2021-06/Guidelines_digital%20tools%20Directive%20EN.pdf accessed on September 13th, 2022

In Malta, following the Digitalization Directive's provisions, changes introduced by the new act[36] include the new requirement for newly appointed directors to give their consent in writing for such an appointment and to declare whether they are aware of any circumstances that could lead to disqualification from being appointed or to hold the position of director of a company registered in any Member State[37]. In the instance that a director is disqualified or does not hold the necessary license to act as a company service provider, and provided that no exceptions under the law are applicable to such a case, Malta Business Registry[38] shall inform the company accordingly[39]. The company should then remove such a director and submit the necessary statutory form within 14 days of such removal. If the company fails to proceed according to this provision, the Registry may apply before the competent court asking for the removal of such an officer. The new act amends also the provisions relating to the disqualification of directors. The amendment introduces a new disqualification in those cases where a director would be acting and providing the services of a company service provider without the necessary authorization from the Malta Financial Services Authority[40]. The second amendment is related to the consideration which is to be taken by the Registry when a person applies for the position of director. Apart from the disqualifications under the Act, the Registry may take into account any disqualifications that already bar the respective person from being appointed to or from holding the office of director in another Member State.

In Luxembourg, there is no, strictly speaking, the definition of "disqualified director". A director ex officio or de facto, apparent or hidden, remunerated or not of a company declared insolvent can be disqualified if he/she contributed to the insolvency with a serious and characterized fault by the District Court Luxembourg dealing with commercial matters[41]. The disqualification may concern the exercise, directly or through an intermediary, of commercial activity as well as a function of administrator, manager, statutory auditor, or any function conferring the power to enter into an agreement on behalf of

[36] Act No. LX of 2021 - Companies (Amendment) Act, 2021, Thirteenth Legislature (2017 - 2022), accessed on September 13th, 2022.

[37] These requisites are provided for by Article 139(1) and (5) of the Companies Act and concern directors who apply when a company is being formed, as well as for new appointments in existing companies.

[38] see more on https://registry.mbr.mt/ROC/ - accessed on September 17th, 2022

[39] A new duty on the Registry is being introduced under article 140(7) of the Act No. LX

[40] Article 142(1)(e) of Act No. LX

[41] Article 444-1 Commercial Code - https://legilux.public.lu/eli/etat/leg/code/commerce/20160101-accessed on October 12th, 2022

the company. The disqualification will be obligatorily pronounced against the one who is condemned for simple bankruptcy or fraudulent bankruptcy. The disqualification in its duration shall not be less than one year nor more than twenty years.[42]

In Germany, there are generally very few restrictions on who can become a managing director. Only individuals may be appointed as managing directors. Managing directors are not required to be German citizens and do not need to be residents of Germany. The practice of some commercial registers ("Handelsregister") is, however, to require foreign managing directors to be capable of entering Germany at any time. The disqualification causes are regulated in statutes on the various forms of companies (GmbHG, AktG, etc.), which require some form of criminal conduct committed by the director as a precondition to disqualification. This includes bankruptcy, aggravated bankruptcy, violation of bookkeeping duties, extending unlawful benefits to creditors, and extending unlawful benefits to debtors.[43] Based on the Federal Government's draft of February 10, 2021, the German Bundestag passed the Act Implementing the Digitalization Directive (DiRUG)[44] on June 10, 2021. It also passed the Bundesrat on June 25, 2021 and entered into force on August 1, 2022. The DiRUG contains several new regulations that facilitate the cross-border exchange of information on disqualified directors. To this end, the Companies Register is entrusted with answering foreign inquiries and forwarding requests for information from German courts[45]. In addition, professional and trade bans imposed abroad shall lead to the disqualification of German Managing Directors and Board Members.[46]

In Denmark, while records are not open to public access, disqualification details are kept by the Danish Business Authority (Erhvervsstyrelsen)[47]. The pur-

[42] Article 444-1 (3) Commercial Code - https://legilux.public.lu/eli/etat/leg/code/commerce/20160101-accessed on October 12th, 2022

[43] Heribert Hirte, Tim Lanzius, Sebastian Mock: Directors' disqualification and creditor protection. In: Marcus Lutter (ed.): Legal Capital in Europe. De Gruyter Recht, Berlin, 2006. 257.

[44] Gesetz zur Umsetzung der Digitalisierungsrichtlinie, DiRUG dated 5 July 2021, German Federal Law Gazette I 2021, p. 3338, entered into force on 1 August 2022

[45] Article sec. 9c HGB-E, Handelsgesetzbuch - https://www.gesetze-im-internet.de/hgb/BJNR002190897.html - accessed on October 12th, 2022

[46] sec. 6 para. 2 sent. 3 GmbHG-E, Gesetz betreffend die Gesellschaften mit beschränkter Haftung - https://www.gesetze-im-internet.de/gmbhg/BJNR004770892.html and sec. 76 para. 3 sent. 3 AktG-E, Aktiengesetz - https://www.gesetze-im-internet.de/aktg/BJNR010890965.html - accessed on October 12th, 2022

[47] The Danish Business Authority was established on 1 January 2012. It has a broad portfolio of tasks and responsibilities, which overall should make it easier and more attractive to do business in Denmark. The Business Authority operates in many fields - from planning law and rural development to digitisation, effective supervision and monitoring of funds, companies,

pose of the register is to prevent persons who are subject to disqualification from being registered as members of the management of a company, and to ensure that any existing records in the system of the persons concerned are deregistered. The register is open for other public authorities (the police, the prosecution authority, and the bankruptcy court), when necessary for the performance of their tasks. The Danish Business Authority informs the Danish Tax Authorities about registrations in the disqualification register.

In Slovenia, when appointing a person as a director in a Slovenian company, prohibitions that exist in other Member States will not be taken into account. The Ministry of Justice and the Supreme Court will respond to Member States' inquiries about the bans in force in Slovenia, each within their respective jurisdictions[48]. The Ministry of Justice is responsible for managing criminal records and records of final decisions in courts, so it will check whether the person has been legally convicted of a crime or whether a security measure prohibiting him/her from practicing the profession was imposed on him/her. Supreme Court of the Republic of Slovenia will verify the existence of circumstances, whether the person was a member of the management body or of the control of the company, over which the bankruptcy procedure was initiated, was finally ordered to pay compensation to creditors by the provisions of the law governing the financial operations of companies, liability for damages, namely for two years after the judgment becomes final. The Slovenian competent authority has to answer immediately to the listed authorities through the business register integration system to the competent authority of the Member states.

In the UK, as a former Member State of the European Union[49], the principal statutory restrictions on acting as a director derive from the Company Directors Disqualification Act 1986 (hereinafter CDDA)[50]. The Act provides that persons who are undischarged bankrupt or subject to a bankruptcy restrictions order may not act as directors of limited companies[51]. It is an offense for persons to act in contravention of these provisions. The CDDA lays down several

money laundering, accounting, auditing, export and EU checks. It is responsible for the Central Business Register (CVR), which is the state's main register for information on all Danish companies. The Business Authority is part of the Danish Ministry of Business and Growth (Erhvervsministeriet). On erhvervsstyrelsen.dk, you can find information on all the Authority's areas of work, including the Danish Business Register CVR.dk.

[48] https://e-uprava.gov.si/drzava-in-druzba/e-demokracija/predlogi-predpisov/predlog-predpisa.html?id=14371 – accessed on September 10th, 2022

[49] The UK left the EU on 31 January 2020 after a withdrawal deal was passed by Parliament

[50] Company Directors Disqualification Act 1986-https://www.legislation.gov.uk/ukpga/1986/46/contents – accessed on October 12th, 2022

[51] Section 11 of Act

other grounds on which directors may be disqualified by law from acting as directors. A director may be disqualified from holding office as director, or from being otherwise involved in the management of limited companies. Where a person has been disqualified under the CDDA, he or she may not – without special leave of the court – act as a director of any limited company or be concerned or take part in the management of a company. Disqualification orders may be imposed on companies as well as individuals, so those companies that act as 'corporate directors' of other companies may be barred in the same way as individuals[52].

3. STATE OF PLAY IN CROATIA

State of play of transposition of the Digitalization Directive in Croatia: Companies Act has been amended and supplemented in March 2022[53]. On March 9th, 2022, the Croatian assembly voted to amend the Companies Act. The law entered into force on June 1st, 2022. Provisions on 'disqualified directors' have to wait for the rulebook by the Minister of Justice and Administration to register disqualified directors. The minister responsible for judicial affairs will adopt the rulebook on disqualified directors by July 15, 2023. The ministry responsible for judicial affairs will organize records by August 1, 2023.

Simultaneously with amendments to the Companies Act, Court Register Act was amended on the same day[54]. The mentioned acts are mutually connected by cause-and-effect principles, goals, and purpose of enactment, mainly due

[52] The courts have discretion under the CDDA to determine what constitutes 'unfitness'. They have used a number of criteria to assess this. In Re Bath Glass Ltd [1988] 4 BCC 130, it was held that, to declare a director unfit, the court must be satisfied that the defendant has been guilty of a serious failure or failures, whether deliberate or through incompetence, to perform his or her duties. Furthermore, a director would be unfit if his actions were very far from those of a 'reasonably competent director'. Other specific criteria which at various times have been deemed significant for this purpose include (i) the amount of the company's debts, and in particular the amounts owing to the Crown, (ii) the number of companies with which a director has been involved which have gone into liquidation, (iii) breaches of commercial morality, iv) gross incompetence and (v) recklessness. The court held that, if a director is to be found to be 'unfit' in such a situation, then there must be some additional ingredient, which in this case would have been that at the time the director received advance payment from a customer, the director knew – or should have known – that there was no reasonable prospect that the company would avoid insolvency. Given the efforts that the directors in this case were found to be making to find the necessary 'corporate solution' to save the business, this additional ingredient was not considered to be present

[53] Law on Amendments to the Companies Act – Official gazette no. 34/22

[54] Law on Amendments to the Court Register Act – Official gazette no. 34/22

to the implementation of the Digitalization Directive, therefore a decision was made to conduct a unified debate on these legal proposals. It is established (in the final text of both acts) that the text of the Final Proposal of Companies Act and the Final proposal of Court Register Act contain statements on the compliance of the Final Proposals with the acquis of the European Union, from which it follows that these acts are fully harmonized with the provisions of the primary and secondary sources of European Union law.

A company acts through two bodies: shareholders and a board of directors[55]. The board of directors is in charge of the management of the company's business such as the strategic and operational decisions of the company. Directors are responsible for ensuring that the company meets its statutory obligations. The role of a director is to participate in board meetings to enable the board to reach these decisions and make sure that the company's obligations are fulfilled[56].

The directors are effectively the agents of the company, appointed by the shareholders to manage the company's day-to-day affairs. The basic rule is that the directors should act together as a board but typically the board may also delegate certain of its powers to individual directors or a committee of the board.

Director disqualification, under the Companies Act,[57] is part of the statutory framework that's designed to deal with insolvency, and the financial misconduct that sometimes causes, or arises from, insolvency. The Companies Act contains several grounds for disqualification. According to Croatian Companies Act, the director can be liable for damages[58] (which he commits to the company), but he can also be liable for a misdemeanour and a criminal offense. Criminal, misdemeanour, and civil liability are not mutually exclusive. They all are ultima ratio societatis.

Any natural person who is fully capable of doing business can be a member of the board[59]. The articles of association may specify the conditions for the

[55] Barbić, Jakša. Pravo društava. Knjiga 2: Društva kapitala. Svezak 1. i 2. 7. izmijenjeno i dopunjeno izd., Zagreb: Organizator, 2020.

[56] responsibility of board members - see article 252., 273., 430. etc Companies Act

[57] Companies Act - Official gazette no. 111/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09, 111/12, 125/11, 68/13, 110/15, 40/19, 34/22

[58] High Commercial Court of Republic of Croatia decision no. Pž-399/2018-4 of May 21, 2020.:„The first-instance court correctly determined that the defendant, as the director of the plaintiff company, knew and must have known that she was issuing promissory notes for a claim that did not exist at the time of issuance and decision-making, nor was it likely to arise given the notices of termination. With this knowledge, the defendant, as the director of the company, disposed of the company's assets in such a way that she issued promissory notes to the company in which she is the director (Z d.o.o.), for claims that did not arise. "

[59] Article 239/1 Companies Act

appointment of board members. The board member cannot be a person: who has been punished for the criminal offense of abuse of trust in business operations, fraud in business operations, causing bankruptcy, favoring creditors, or violating the obligation to keep trade and business books from the Criminal Code of the Republic of Croatia, for a period of five years from the date of finality of the judgment by which she was convicted, with the fact that at that time the time spent serving the sentence is not counted, or who has been punished for a criminal offense of another state, which by its essential features corresponds to the criminal offenses from point 1; against whom a security measure has been imposed, prohibiting the performance of an occupation that is fully or partially covered by the subject of the company's business for the duration of the ban; which is prohibited in another country from performing professions that are fully or partially covered by the company's business for the duration of the ban.

The Ministry responsible for judicial affairs will organize and keep records of persons who cannot be members of the administration (by the beforementioned). The minister responsible for judicial affairs shall prescribe the content, manner of conducting, and conditions of use of the evidence by ordinance (referred to in this article).

According to these provisions on disqualified (company) directors, which are being amended, the object is to ensure the protection of all persons who communicate with companies or branches. They work to prevent possible fraudulent behavior or other types of abuse, it is important that the authorities can check whether the person who is appointed as director is prohibited from performing those duties. For this purpose, the Ministry of Justice and Administration will organize and keep records of persons who cannot be members of the board. Access to these records will be allowed to the court and public notaries.

Company directors risk losing their rights of setting up and/or representing a company if they fail to meet their legal responsibilities. As to 'disqualified directors': strict rules are required – there are a set of rules defining what kinds of persons are not legally allowed to be directors of companies, procurators, owners, and shareholders.

Croatia in the future will keep a non-public record of disqualified directors. It will define criteria for disqualification, keep a list of current and former disqualified persons, and give non-public access to this list. A clear and broad definition of reasons for disqualification is codified in law and the law asks for declaration of directors/applicants declaring that they are not listed as disqualified directors in any other country/Member State[60].

[60] In form of notary record - Article 83. of Public Notary Act - Official gazette no. 78/93, 29/94, 162/98, 16/07, 75/09, 120/16, 57/22

Croatia extended the provision on 'disqualified directors' to other persons as follows: when examining an application for the registration or change of a member of the board, executive director, member of the supervisory board, member of the board of directors, procurator and liquidator of a company, the court will check whether that person is registered in the register of persons who cannot be members of the board, which is maintained the ministry responsible for judicial affairs. In case of doubt, the court register can check through the registry linking system whether that person in another EU Member State is prohibited from performing a profession that is fully or partially covered by the company's business. If it determines that a person cannot be a member of the management board, executive director, member of supervisory or management board, procurator, or liquidator of a commercial company, the court will refuse to register his appointment. So, in Croatia, the option is to refuse the application of any individual that has been disqualified in another Member State[61].

The aim is that a company cannot knowingly permit an ineligible or disqualified person to serve as a director. A search on the Disqualified Director Register as well as criminal and reference checks must be part of the nominations process before an individual is appointed to the board.

Another key benefit of the Digitalization Directive is fostering information flow between the Member States' company registers via the BRIS which Croatia is part. In the future, the court register will obtain the data of companies registered in the EU electronically. The Digitalization Directive explicitly states that the exchange of information is free of charge for company registers in the Member States[62]. The practical relevance, among other things, is that the Commission Implementing Regulation[63] lays down technical specifications defining the methods of exchange of information between the register of the company and the register of the branch in case a branch is opened or closed or when changes occur in the data and information of the company. It also lays down detailed arrangements and technical details need to be laid down to ensure the effective, efficient, and prompt exchange of information on disqualified directors established by the Digitalization Directive.

[61] Article 43. 6. of Court Register Act – Official gazette no. 1/95, 57/96, 1/98, 30/99, 45/99, 54/05, 40/07, 91/10, 90/11, 148/13, 93/14, 110/15, 40/19, 34/22

[62] Article 13f of the Digitalization Directive

[63] Commission Implementing Regulation (EU) 2021/1042 of 18 June 2021 laying down rules for the application of Directive (EU) 2017/1132 of the European Parliament and of the Council as regards technical specifications and procedures for the system of interconnection of registers and repealing Commission Implementing Regulation (EU) 2020/2244, OJ L 225, 25.6.2021, p. 7–51.

We should keep in mind that the Digitalization Directive should be applied in compliance with EU data protection law and the protection of privacy and personal data: as to which data on disqualified directors should be publicly available[64].

Given that a company foundation has to be completed within five working days, it will be difficult for Croatian Court Register to reach out to other Member States' public authorities to conduct a check on the applicant's qualification to set up a company. In other words, public authorities are under time pressure. It is therefore of utmost importance that such a system is made available for other Member States – at best it should be issued centrally with „at the push of a button".

Croatia is waiting for the disqualified directors register. The disqualified directors register should include details of directors disqualified by the courts, the insolvency service and the other authorities. It should contain: their name, address, date of birth, nationality, last registered address, personal identification number (OIB), when the disqualification began and ends, how many disqualifications they've had, why they were disqualified, names of companies relevant to their disqualification, whether they have the court's permission to continue to act as a director.

Another piece of new regulation regarding liability and fraud prevention in the field of Company law: the Committee of Experts (Council of Europe) for the evaluation of measures against money laundering and financing of terrorism (hereinafter: Moneyval) adopted the Report on the 5th evaluation round of the Republic of Croatia[65], which was adopted at the 62nd plenary session held in December 2021. On May 12, 2022, the Government of the Republic of Croatia adopted the Conclusion on the acceptance of the Action Plan for strengthening the effectiveness of the Croatian system of preventing money laundering and terrorist financing[66] which contains measures and activities whose goal is to further strengthen the Croatian system of preventing money laundering and terrorist financing, and which will also fulfill the recommended measures from the cited Report. In order to prevent the misuse of legal entities for illegal purposes and with the aim of transparency of data on legal entities, the Gov-

[64] Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) OJ L 119, 4.5.2016, p. 1

[65] Anti-money laundering and counter-terrorist financing measures Croatia, Fifth Round Mutual Evaluation Report, December 2021 – see on https://rm.coe.int/moneyval-2021-24-mer-hr-en/1680a56562 - accessed on Oct 17th, 2022

[66] Official Gazette, no. 56/22, hereinafter: Action Plan

ernment will introduce (until January 1st, 2022) mechanisms that, among other things, will ensure the verification of all data provided at the stage of establishing a legal entity and prevent persons legally convicted of the criminal offenses of money laundering and terrorist financing from acting as shareholders, participants or directors, introducing a requirement to check the criminal background of those persons, including the verification of targeted financial sanctions of the United Nations. Moneyval Report in Croatia introduces mechanisms that will ensure: (i) verification of all data provided in the phase of establishing a legal entity; (ii) preventing criminals (money laundering, predicate offenses, terrorist financing) from acting as shareholders, shareholders, beneficial owners or directors, by introducing a requirement for a criminal background check on that person, including a United Nations targeted financial sanctions check; (iii) introducing a permanent monitoring mechanism to ensure timely disclosure and registration of changes in basic information; (iv) establishment of a monitoring mechanism to ensure accuracy and timely updating of information; (v) effective, proportionate and dissuasive sanctions for non-compliance with prescribed requirements. It is necessary to assign clear responsibility to competent authorities, provide the resources necessary for regular supervision, and keep statistics on the application of sanctions. The report determines that in terms of technical compliance, the legal framework has been significantly amended, but a number of technical shortcomings are noted some of which present challenges to effectiveness. There is a new Draft of Amendments to the Companies' Act regarding disqualification due to Report[67].

4. CONCLUSION

It should be noted that director's disqualifications are still relatively rare in Croatia, but also EU. The Digitalization Directive was designed to speed up the disqualification process and increase the volume of directors' disqualifications.

What are the restrictions placed upon people when disqualified as directors? If disqualified, a director may not act as a director, or manager in the disqualification period. If he /she does so, that should be (is) an offence.

Member States should take this opportunity by the Digitalization Directive to revise their systems of disqualified directors: a clear and broad definition of reasons for disqualification should be codified in law; reasons for disqualification should go beyond insolvency-related behavior to include financial fraud,

[67] See https://esavjetovanja.gov.hr/Econ/MainScreen?EntityId=21517 – accessed on September 5th, 2022.

employee-related misconduct, state aid fraud, and other criminal conduct; a list of persons disqualified and the reasons for disqualification should be maintained and made available to the public and through the BRIS; Member States should include the requirement of applicants declaring that they are not listed as disqualified directors in any other country as well as the obligation to refuse an individual's application due to disqualification in another Member State into the transposition of the Digitalization directive into national law.

Member States should be able to prevent fraudulent and/or other abusive behavior by refusing the appointment of a person as a director of a company, considering not only the former conduct of that person in their own territory, but, where so provided under national law, also information provided by other Member States. Member States should, therefore, be allowed to request information from other Member States. The reply could either consist of information on a disqualification in force or other information which is relevant for disqualification in the Member State that received the request. Such requests for information should be possible by means of the system of interconnection of registers. In that regard, Member States should be free to choose how to best collect this information, such as by gathering the relevant information from any registers or other places where it is stored in accordance with their national law or by creating dedicated registers or dedicated sections in business registers. Where further information, such as on the period and grounds of disqualification, is needed, Member States should be allowed to provide it through all available systems of exchange of information, in accordance with national law.

It would appear that this latest Directive will continue to strengthen the trend for qualified, balanced boards. It was necessary to raise the bar as regards the competency of directors serving on listed or regulated entities in EU.

From the perspective of a commercial court register judge, while all of the above seems well thought out, it remains to be seen how the law will apply to existing technology and allow judges to view the registers of disqualified directors when making decisions. It is likely that the adoption of the rulebook alone will not be enough, but greater cooperation will be required from state bodies within Croatia, and subsequently from the Member States.

From the perspective of a commercial trial court judge business judgment rule should also be considered because according to beforementioned rule members of the management board and the supervisory board, i.e. the board of directors, are given the opportunity to be released from responsibility for the business decisions they make if, when making them, on the basis of adequate information, they reasonably assumed that they were acting for the benefit of the company and did not act contrary to the obligation of the manner management of the company's affairs. The business judgment rule excludes ju-

dicial control of management members if they adhere to the assumptions of fair judgment in their work. The business judgment rule makes it possible to negate the responsibility of members of the management board, the supervisory board, or the board of directors in cases where they acted with due care.

A part of the wonder at being a commercial court judge is that decision-making is endless, and every decision is important.

To summarize: companies, not only in Croatia, should strengthen its executive (senior) leadership by engaging experienced and credible individuals, with significant experiences. Ensure risk culture is at the heart of the organisation. These principles are based on sound principles of Corporate Governance, and could easily be applied across the boards of multiple companies, with a strong board of directors at the helm, creating a balanced team composed of credible individuals.

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HOW DOES THE LAW PROTECT THE CROWD? ABOUT CROWD INVESTOR PROTECTION MECHANISMS INTRODUCED BY THE EU REGULATION 2020/1503

Jakub Brejdak *

ABSTRACT

Crowdfunding services provide an unconstrained pool of investors who all receive investment proposals at the same time, and they mainly entail the raising of capital from individual people, including those who are not high-net-worth individuals. Crowdfunding allows a company to raise capital without conducting a formal public offering procedure. Equity crowdfunding, as a relatively new form of raising capital for business ventures, raises many doubts in the field of corporate governance. The fundamental advantage of crowdfunding from an entrepreneur's perspective is that the founder of the company does not have to cede as many rights to crowd investors as he or she would if the investor were a venture capital or private equity fund. As a result, a crowd investor is a passive investor by definition. To unify rules among Member States and create mechanisms of protection for this completely new type of investor, the Regulation (EU) 2020/1503 was enacted.

This paper aims to analyze the main investor protection mechanisms included in Regulation 2020/1503 and compare them with MIFID II provisions, which constitute the main protection mechanisms for traditional retail investors. This analysis enables an answer to whether crowd investors are offered a higher level of protection than traditional retail investors. The author of this paper claims that protection mechanisms introduced by Regulation 2020/1503 regarding non-sophisticated investors are an example of increasing paternalism in the financial markets. However, the characteristic of the equity crowdfunding market justifies a higher-level paternalism and intervention in order to protect non-sophisticated investors.

KEYWORDS: *crowdfunding, crowd investors, investor's protection*

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1. INTRODUCTION

Crowdfunding is becoming a more and more common form of raising capital for business ventures in Europe. Collecting capital from a mass group of anonymous investors (often not professional) creates new opportunities for companies at the early stage of development that has struggled with gaining the interest of business angels and venture capital funds.[1] Crowdfunding services provide an unconstrained pool of investors who all receive investment proposals at the same time, and they mainly entail the raising of capital from individual people, including those who are not high-net-worth individuals.

The literature often highlights that crowdfunding is a cheaper and more accessible source of capital for companies than traditional ones.[2] Nevertheless, as the majority of crowd investors are unprofessional, they face a larger degree of risk than institutional investors. Inexperienced individuals who are distributing capital in crowdfunding are making decisions based not on the same factors as institutional investors.[3] Their investment decisions are often based not on the expected capital return but, for instance, on the need to show support and endorsement to the mission or value a particular project represents.[4] Moreover, as research shows, crowd investors are often consumers of products and services provided by the company in which they invest.[5] Given the above, crowd investors elude the standard types of investors, creating an entirely new group of financial market participants.

This paper aims to analyze the main investor protection mechanisms included in Regulation 2020/1503 and compare them with MIFID II provisions, which constitute the main protection mechanisms for traditional retail investors. This analysis enables an answer to whether crowd investors are offered a higher level of protection than traditional retail investors. The author of the paper claim that protection mechanisms introduced by Regulation 2020/1503 regarding non-sophisticated investors are an example of increasing paternalism in the

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financial markets. However, the characteristic of the equity crowdfunding market justifies a higher-level paternalism and intervention in order to protect non-sophisticated investors.

2. INVESTOR PROTECTION

In the 1980s of the last century, there was a belief among legal doctrine related to the law & economics approach that most financial market laws are superfluous since sophisticated entrepreneurs and sophisticated investors enter financial contracts.[6] Investors typically perceive a risk of expropriation and penalize companies that did not contractually obligate themselves to treat investors fairly and provide information about themselves.[7] Entrepreneurs were incentivized to commit themselves through agreements with investors to minimize expropriation since they incurred these expenses when they issued shares.[8] However, numerous corporate governance misconducts on financial markets in recent decades and the financial crisis in 2008 showed that assumptions about deals made between rational issuers and rational investors were wrong.[9] Investors' limitations in comparing investments and evaluating long-term performance, all serve to increase information asymmetries.[10] Retail investors also have little power to oversee intermediaries and negotiate for safeguards.[11] Between retail investors and financial intermediaries can occur agency conflict.[12] Primarily, those issues are visible in the context of non-sophisticated investors who are unable to protect their rights through contracts. This type of investor is becoming more and more present in the financial markets, among others, in relation to the development of crowdfunding.

Currently, the prevailing view of legal researchers is that protecting investors promotes the growth of financial markets.[13] The protection can be focused

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on eliminating information asymmetries and preserving at the same time individual autonomy and favoring minimal intervention.[14] An example of this approach is the disclosure regime that requires the publication of relevant information in order to enable investors to evaluate their options and choose the best investments based on reported prospective risks and rewards.[15] The main advantage of this approach is that it promotes investor autonomy. The underlying presumption is that individuals will make wise judgments if provided with accurate information.[16] Nevertheless, in recent years increasing popularity is reaching a more paternalistic approach to investor protection which is more related to intervention for the person's "own good" and less oriented on reducing information asymmetries.[17] Paternalism is to assist those whose "judgment is so impaired due to immaturity, ignorance, incompetence, or the like that they do not know or appreciate that they are about to harm their interests".[18] Behavioral finance research shows that investment decisions are impaired by many systematic biases and cognitive errors.[19] The most common cognitive errors include overconfidence and over-optimism.[20] Investors may have too positive expectations for the market's future and their performance. Although they are aware that there is a chance for negative results, they think that only other individuals face these risks and not them specifically. On the crowdfunding market significant is also herding behavior described often as "wisdom of the crowd".[21] When crowd investors see other investors acting in a certain way, they may respond instinctively and do the same. Market breakdowns and speculative bubbles may be exacerbated by strong herding effects.[22]

Returns, and Financial Globalization, Journal of Financial and Quantitative Analysis, 45(1), 2010, p. 135-168.

[14] Moloney, N.: *How to Protect Investors : Lessons from the EC and the UK*, Cambridge 2010, p. 46.

[15] Ripken, S.: *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, Baylor Law Review, 58, 2006, p. 149-156.

[16] Ibidem.

[17] Ogus, A.: Regulatory Paternalism: When Is It Justified, in: Hopt K. et. al. (ed.): *Corporate Governance in Context* Oxford, 2005, p. 303.

[18] Garren, D.: *Paternalism, part II*. Philosophical Books, 48(1), 2007, p.55.

[19] Pompian, M.: *Behavioral Finance and Wealth Management How to Build Investment Strategies That Account for Investor Biases,* Hoboken, 2012.

[20] Ripken, S.: The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation, Corporate Law: Securities Law, 2006, p. 149-156.

[21] Hossain, M.: et al.: *Wisdom of the Crowd and Stock Price Crash Risk: Evidence from Social Media*. Review of Quantitative Finance and Accounting, 58(2), 2022, p. 709–742.

[22] Juurikkala, O.: *The Behavioral Paradox: Why Investor Irrationality Calls for Lighter and Simpler Financial Regulation*, Fordham Journal of Corporate & Finance Law, 33, 2012, p. 40.

Paternalism is not only an act of kindness and benevolence of society toward vulnerable individuals, but it also protects whole markets and societies as aggregated errors and wrong decisions can have much wider consequences.[23] It is claimed that a paternalistic approach is justified when the benefits to investors from using an appropriate legal tool to reduce harmful externalities must be weighed against the expense of that intervention.[24]

Given the above, the EU Regulation 2020/1503 has an important goal to achieve with investor protection mechanisms. As crowdfunding enables numerous non-sophisticated investors to enter the financial markets for the first time, the regulation has to provide a suitable level of protection, balancing between investors' lack of financial knowledge and a risk appetite that is inherently associated with financial markets.

In the EU, the main framework for investor protection was introduced by MiFID II, which was implemented in the aftermath of the financial crisis in 2008.[25] MiFID II aimed to increase the protection of retail investors, enlarge it for more financial products and improve transparency in the market.[26] As a matter of principle, the scope of MiFID II encompasses the whole financial market. Nevertheless, the early years of crowdfunding practice in Europe proved that the equity crowdfunding practice escapes traditional financial market conventions and non-sophisticated crowd investors do not always behave the same way as retail investors do.[27] Moreover, several Member States introduced specific regulations on crowdfunding.[28] As a result, crowdfunding platforms were subject to a variety of national regimes, which broke up MiFID's harmonization and made it difficult to create a pan-European market for crowdfunding services.[29] That is why Regulation 2020/1503 set out specific rules for protecting investors in the crowdfunding market. Many rules implemented by Regulation 2020/1503 are directly related to MiFID II, but some of them indicate significant differences.

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[23] Ripken, S.: *Paternalism and Securities Regulation*, Stanford Journal of Law, Business & Finance, 21(1), 2015, p. 55-56.

[24] Moloney, N.: *How to Protect Investors : Lessons from the EC and the UK*, Cambridge 2010, p. 301.

[25] Della Negra, F. *MiFID II and Private Law: Enforcing EU Conduct of Business Rules*. London, 2019.

[26] Busch, D., Ferrarini G., *Regulation of the EU Financial Markets : MiFID II and MiFIR*., Oxford, 2017.

[27] Ibidem.

[28] Cicchiello, A., *Harmonizing the Crowdfunding Regulation in Europe: Need, Challenges, and Risks*. Journal of Small Business and Entrepreneurship, 32(6), 2020, p. 588.

[29] Ibidem, p. 84.

3. EQUITY CROWDFUNDING – MARKET MECHANICS

Regulation 2020/1503 in art. 3 oblige crowdfunding platforms to act honestly, fairly, and professionally and operate "as neutral intermediaries between clients". Those three fundamental standards protect transactional certainty and ensure investors are on the market. Further general standards are included in art. 19 which states that all information published by crowdfunding platforms should be fair, clear, and not misleading. The standards mentioned above are based on the idea that financial markets are transparent, which presupposes that market participants should have access to the data they need to make informed decisions. Crowdfunding service providers play a crucial role in shaping the effectiveness of the crowdfunding market as infrastructure providers for the functioning of this market. Contrary to investment firms regulated by MIFID II that operate on markets centered around main stock exchanges, crowdfunding platforms are creating and facilitating their market venues for transactions. Each crowdfunding service provider has its digital venue to service transactions and there is no one center market.

Regulation 2020/1503 highlights the neutrality of crowdfunding service providers but accommodating both sides of the market; buy-side (crowd investors) and sell-side (project owners) may create conflicts of interest. Regulation 2020/1503 forbids the participation of crowdfunding service providers in the offers. In addition, crowdfunding service providers should implement internal policies to ensure effective and prudent management, including the segregation of duties, business continuity, and the prevention of conflicts of interest, in a manner that promotes the integrity of the market and the interests of its clients. In art. 5 of Regulation 2020/1503 it is stated that a crowdfunding service provider shall undertake at least a minimum level of due diligence in respect of project owners that propose their projects to be funded through the crowdfunding platform of the crowdfunding service provider. But in fact, the legal requirement of due diligence is narrowed only to the project owner's check of a criminal background and non-cooperative jurisdiction establishment.

In his remarkable *efficient markets hypothesis*, Eugene Fama claimed that share prices reflect the accessibility of information on a particular market.[30] The market characterized as low efficient share valuation is based on the share price in the past. The semi-efficient market price of shares reflects all publicly available data like financial and annual reports. Strong efficient markets are those where price reflects all data that is not publicly available or confidential. In Fama's framework, used primarily to describe public markets, the equity

[30] Fama, E., *Efficient Capital Markets: A Review of Theory and Empirical Work*., The Journal of Finance, 25 (2), 1970, p. 383–417.

crowdfunding market of private companies at the early stage of financing should be considered highly inefficient. The share price offered to crowd investors is determined based on valuations carried out at the request of the companies. Then this price is offered to investors, most of whom do not have the instruments and knowledge to verify it. That is why crowdfunding service providers play a crucial role in gatekeeping the information provided to investors.[31] Regulation 2020/1503 with annexes sets rules for publishing key investment information sheets. The sheet is an information document similar to the prospectus required for the IPO. However, contrary to the prospectuses that need to be approved by financial supervision authorities, the key investor information sheet does not require approval by the authority. Therefore, the crowdfunding service provider should verify those documents' completeness, correctness, and clarity. The crowdfunding platform also has the right and obligation to halt or withdraw the offer containing any error. As a result, crowdfunding services providers are highly responsible for the efficiency of the market they are creating. Nevertheless, it has to be also highlighted that the vast majority of crowdfunding service providers are charging fees from both sides of the market, which creates a strong incentive to boost the volume of transactions on their platforms. This incentive does not need to be aligned with the role of the gatekeeper function of crowdfunding service providers described above as quality can give way to the quantity of offered projects. In the situation where a crowdfunding service provider starts to be less selective in terms of offered projects on the platform, it becomes riskier for investors. It is a conflict of interest that has not been addressed by the regulation so far.

Concerning key investment information sheets it should be also mentioned that often the question arises as to whether the abundance of information actually enables investors to make well-informed judgments.[32] Even though the Regulatory Technical Standards set out the model of a key investment information sheet to increase comparability and clarity of data presented in the document, it still remains hardly likely that an individual without a financial background will be able to analyze it correctly.[33] Without the ability to be understood by

[31] Lee, J.: Investor Protection on Crowdfunding Platforms, in: Ortolani P., Louisse M. (ed.): *The EU Crowdfunding Regulation*, Oxford 2021, p. 376.

[32] Moloney, N.: *How to Protect Investors: Lessons from the EC and the UK*, Cambridge, 2010, p. 288; Enriques L.: Gilotta S.: Disclosure & Financial Markets Regulation, in: Moloney, N. et. al., *The Oxford Handbook of Financial Regulation*, Oxford, 2015, p. 511-536.

[33] Draft technical standards under the European crowdfunding service providers for business Regulation, 2021.

investors, regulated disclosures are likely a misuse of regulatory effort.[34] That is why the paternalistic approach which focuses on creating incentives for stimulating non-sophisticated investors' decisions for their "own good" rather than just providing an abundance of information to investors might be more effective.

4. CATEGORIZATION OF INVESTORS

Financial markets law traditionally creates levels of protection for different types of investors.[35] Various types of investors differentiate themselves in terms of the size of capital under management, experience, knowledge about financial markets, and risk appetite. Based on investor categorization, financial regulations offer a suitable level of protection.

Crowd investors, similarly to traditional investors, are not a homogenous group. The divergence in experience and held assets between investors in crowdfunding can be significant. That is why Regulation 2020/1503 introduces the main distinction of crowd investors into two types: sophisticated and non-sophisticated. This regulatory solution aims to match the degree of protection of the investor in a manner adequate to his or her knowledge and experience in financial markets. This distinction is patterned after the distinction for professional and retail investors from MiFID II, but it is adapted to the characteristics of the crowdfunding market. As a result, those two distinctions coincide in many elements but are not identical.

The analysis of the sophisticated investor already shows significant alignment with the MIFID II as part of the definition refers directly to this act and the list of professional clients treated as sophisticated investors under Regulation 2020/1503. Some researchers call professional clients from Annex II sophisticated investors *per se*.[36] In addition to sophisticated investors *per se,* some *opt-out* sophisticated investors have the approval of the crowdfunding service provider to be treated as sophisticated investors. Annex II to Regulation 2020/15 sets out different criteria for the approval of natural persons and legal entities. The legal entity to be approved and treated by the crowdfunding service pro-

[34] Moloney, N.: *How to Protect Investors : Lessons from the EC and the UK*, Cambridge, 2010, p. 362.

[35] Domina, M.: *Rethinking the Classification of Investors in Collective Portfolio Management: Towards a Recognition of Semi-Professional Investors*., Journal of Business Law, 6, 2021, p. 499-518.

[36] Lee, J.: Investor Protection on Crowdfunding Platforms, in: Ortolani P.: Louisse M. (ed.): *The EU Crowdfunding Regulation*, Oxford 2021, p. 376.

vider as a sophisticated investor needs to meet at least one of the following identification criteria:1) own funds of at least EUR 100 000; 2) net turnover of at least EUR 2 000 000; 3) balance sheet of at least EUR 1 000 000. Each criterion relates to a different indicator in the accounting ledgers so that, with the currently very diverse financial structures of legal entities, the most extensive possible range of entities can be covered by those criteria. These criteria indicate that the size of the entity, and not the type of activity, determines the classification of a legal entity as a sophisticated investor.

Natural persons to be treated as sophisticated investors need to meet at least two of the following identification criteria:1) personal gross income of at least EUR 60 000 per fiscal year or a financial instrument portfolio, defined as including cash deposits and financial assets, that exceeds EUR 100 000; 2) having at least one year of work experience in the financial sector, in a professional position which requires knowledge of the transactions or services envisaged, or having held an executive position for at least 12 months in a legal person that qualifies as a sophisticated investor according to the aforementioned criteria; 3) having carried out transactions of a significant size on the capital markets at an average frequency of 10 per quarter, over the previous four quarters. The criteria for natural persons, as opposed to those established for legal persons, include not only financial resources but are also related to the activity and experience gained directly on the financial market. Certain doubts can be expressed if particular criteria are arranged properly. The threshold of gross income on the level that doubles the average salary in the EU seems to be too low, even considering the requirement of fulfilling the second criterion.[37] Especially in the Member States where salaries are relatively higher, the number of investors classified as sophisticated can be considerable. Low-placed criteria in the categorization of investors can have a significant impact on the general protection mechanisms in crowdfunding. A minimal level of protection for sophisticated investors is envisaged to facilitate only the most financially knowledgeable market participants but it's not suitable for the majority of crowd investors.

When an investor is recognized as sophisticated, the recognition is valid for two years. The crowdfunding service provider must be informed of any change that would affect a sophisticated investor's status, and the crowdfunding service provider must notify the investor that they will no longer be classified as sophisticated if the requirements are no longer met. As the vast majority of criteria based on investors' financial situation are variable, the categorization of investors is also changing.

[37] [https://www.reinisfischer.com/average-monthly-salary-european-union-2022], accessed on 14/11/2022.

According to art. 2 of Regulation 2020/1503, all entities that have not been classified as sophisticated should be treated as non-sophisticated investors. Crowdfunding service providers are obliged to guarantee a higher level of protection to all entities classified as non-sophisticated investors. To this end, crowdfunding service providers are required to conduct an investor knowledge test about the risks associated with crowdfunding. Moreover, crowdfunding platforms can accept only investments from non-sophisticated investors who have confirmed that they are familiar with the warnings related to the risk associated with a given investment. In addition to the specific disclosure obligations imposed on crowdfunding platforms towards non-sophisticated investors, Regulation 2020/1503 obliges crowdfunding service providers to set the maximum amount of capital that non-sophisticated investors can invest in a single project. This solution is to protect investors against the lack of diversification, which seems particularly important when investing in business ventures at an early stage of development.

Recital 42 Regulation 2020/1503 states that the differentiation between professional clients and retail investors provided by MIFID II should serve as a foundation for the differentiation between sophisticated and non-sophisticated investors. However, it is necessary to consider all characteristics of the crowdfunding market in the differentiation process between sophisticated and non-sophisticated investors. This recital suggests that categories of retail clients and non-sophisticated investors are similar but not synonymous. Firstly, MIFID II introduced the same criteria of categorization for natural persons and legal entities, while Regulation 2020/1503 set out various criteria for natural persons and legal entities. As a result, an investor (especially a natural person who needs to meet only one of three criteria) may be acknowledged as a sophisticated investor according to Regulation 2020/1503, but it will not be considered a professional client under MiFID II.[38]

Secondly, crowdfunding service providers are obliged to evaluate the status of sophisticated investors every two years, while investment firms do not have to evaluate the status of professional clients regularly. It suggests that legislators expect variability in the status of crowdfunding investors, who largely are individuals, not institutions. Professional clients under MiFID II have mainly institutional character. It is reasonable to expect that institutional investors are more resilient to any volatility in the market than individuals (even experienced high-net-worth individuals). Professional clients are in the vast majority of cases licensed or authorized by market bodies, so there is no need to obligate investment firms to evaluate their status regularly. Noteworthy is the fact that a

[38] Lee, J.: Investor Protection on Crowdfunding Platforms, in: Ortolani P.: Louisse M. (ed.): *The EU Crowdfunding Regulation*, Oxford, 2021, p. 377.

professional client is able to ask an investment firm to be treated with a higher level of protection applicable to retail investors. On the contrary, sophisticated crowd investors do not have the right to choose between protection levels.

The categorization of investors should be seen as a tool to lay foundations for more paternalistic mechanisms. Regulators create criteria based on income and net worth levels to safeguard investors and apply the proper level of protection in order to prevent investors from losing sizable portions of their wealth or suffering financial losses that could prove disastrous. The goal is to protect crowd investors, as well as the entire market, from making wrong decisions that can disproportionately affect investors' welfare and market stability. The idea to create different levels of protection suitable to the individual experience and net worth has been deployed in capital markets regulation for many years and does not arouse any doubts. More disputable is the fact that Regulation 2020/1503 first set up a relatively low threshold for categorization as a sophisticated investor (wider than professional clients under MiFID II) and then addresses the vast majority of protection mechanisms only to non-sophisticated investors. However, research shows that investors which are categorized as sophisticated by the legal rules, in fact often do not have the required expertise to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment.[39] This group of investors is also vulnerable to cognitive biases. Some scholars highlight the financial crisis in 2008 was fueled mainly by professional investors' errors and wrong decisions and not retail investors who just suffered because of the decisions of financial institutions.[40] The fact that Regulation 2020/1503 by soothing criteria for investor recognition is sophisticated and leaves many individuals with a lower level of protection is causing a risk of possible market breakdowns.

5. ENTRY KNOWLEDGE TEST AND SIMULATION OF THE ABILITY TO BEAR A LOSS

The main aim of testing investors' knowledge is prevention from the uninformed ineffective behavior that is common in the equity crowdfunding market.[41] In the crowdfunding markets, statistically, there are many more nonpro-

[39] Smith, F.: *Madoff Ponzi Scheme Exposes 'the Myth of the Sophisticated Investor.'*, University of Baltimore Law Review, 40(2), 2010, p. 219-223.

[40] Davidoff Solomon, S.: Hill, C.:, *Limits of Disclosure,* Seattle University Law Review, 36, 2013, p. 602.

[41] Armour, J.: *Principles of Financial Regulation*, Oxford, 2016, p. 226.

fessional investors than in any other segment of the financial markets.[42] Many investment decisions on crowdfunding platforms are based on the willingness of an investor to show support for the values or purpose of a particular venture. Traditional indicators of successful investment, ROI or annual dividends, are not the main driver for crowd investors. This whole spectrum of various motivations behind investment decision in crowdfunding cause crowdfunding service providers to be fully responsible for a diligent *know-your-customer* (KYC) process. The KYC process is not only valuable for protecting against fraud or money laundering. But in fact, it also gives a basic notion of an investor's financial situation, knowledge, experience, and or motivations. It must be highlighted that crowd investors do not need specific financial knowledge to invest but should be aware of the possible economic consequences of their decisions. According to Regulation 2020/1503, all non-sophisticated investors should be evaluated by the test before fully accessing any offer on the crowdfunding platform. In practice, investors are tested at the moment of registering on a crowdfunding platform. The test contains two parts: 1) the first one evaluates investors' prior activity on the financial markets; 2) the second one checks investors' awareness of fundamental financial markets rules and possible risks. Suppose a test shows that a particular investment opportunity is unsuitable for the investor's profile. In that case, the crowdfunding service provider is obliged to inform the investor about this and communicate the risk of losing capital. An investor who receives communication like this must confirm that they understand it and are aware of potential risks. The Regulatory Technical Standards harmonize the text and way of displaying test results and warnings for the investors to ensure that those investors are informed clearly and in a uniform manner about the risks they would incur if they decided to invest in crowdfunding services. The attempt to harmonize the entry knowledge test is important from the market stability perspective. An investor who is investing in similar projects on different platforms should receive similar results from the test. Otherwise, instead of a universal investor protection mechanism, an entry knowledge test would become a subjective tool in the hands of crowdfunding service providers without real benefits for investors.

In addition to the entry knowledge test, Regulation 2020/1503 obliges crowdfunding service providers to simulate non-sophisticated investors' ability to bear the loss, calculated as 10 % of their net worth. The simulation is based on their total income, owned assets, and financial commitments. Suppose an investor decides to invest more than 1000 euros or 5% of his or her net worth. In that case, a crowdfunding service provider must put forward a risk warn-

[42] Di Pietro, F.: *Crowdfunding for Entrepreneurs Developing Strategic Advantage through Entrepreneurial Finance*, London, 2020, p.43.

ing and receive confirmation from the investor of getting acquainted with that notification. Those mechanisms illustrate the nature of crowdfunding, which is about collecting relatively small amounts of capital from a wide range of investors. According to Regulation 2020/1503, an investment of 1000 euros should be considered significant enough to provide extra risk warnings for the investor.

It is essential to highlight that regardless of the result of a test knowledge and simulation results, crowdfunding service providers cannot prevent potential investors from taking advantage of an investment opportunity on the platform. The knowledge test has mainly an awareness-rising and educational value. However, those functions of tests and simulation should not be underestimated. By addressing, or at least emphasizing, the biases that investors experience, better investor education may reduce the expanded danger of investing errors and provide the most long-term prospects for more rational decision-making.[43] It is also claimed that investor education supports greater market participation.[44]

Similarly, to Regulation 2020/1503 also, MIFID II establishes an entry knowledge test for investors. Nevertheless, the tests introduced by MIFID II are more complex. Investment firms must conduct two types of tests: the appropriateness test and the suitability test. The distinction between the two different assessments is based on the various roles that investment firms are able to perform. Investor services including reception and transmission of orders in financial instruments; and the execution of orders in financial instruments on behalf of clients require conducting an appropriateness assessment of retail clients. The appropriateness test applies to retail clients regarding enabling the investment firm to obtain information about the client's knowledge and experience of the relevant financial instrument or the relevant service so that it can assess whether the financial instrument or service is appropriate for the client.[45] In case that investment firm is offering investment advice or portfolio management the suitability test must be applicable. The suitability test enlarges the assessment of knowledge and experience setting the main focus on investors' financial situation, objectives, and risk tolerance.[46]

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43 Cunningham, L.: *Behavioral Finance and Investor Governance*. Washington and Lee Law Review, 59(3), 2002, p. 788-792.

44 Choi, SJ.: Pritchard, A.: *Behavioral Economics and the SEC*. Stanford Law Review, 56(1), 2003, p. 72.

45 Busch, D.: *MiFID II. Stricter Conduct of Business Rules for Investment Firms*., Capital Markets Law Journal, 12(3), 2017, p. 361.

46 Ibidem, pp. 366.

As the crowdfunding platform does not provide financial advice neither portfolio management, so it is not obliged to conduct this particular assessment. The role of a crowdfunding service provider can be described as passive. Their main task is to provide the necessary infrastructure and create safe market conditions for both sophisticated and non-sophisticated investors. Therefore, the knowledge test carried out by crowdfunding platforms, both in its structure and its goals, is more similar to the appropriateness test than the suitability test. Nevertheless, Regulation 2020/1503 provides a possibility for crowdfunding service providers to obtain investment firm status. In that case, a crowdfunding platform could be able to offer a wider pool of services that may require suitability assessment.

6. COOLING-OFF PERIOD

Cooling-off periods are typical mechanisms for consumer protection law.[47] This legal institution is widely used in e-commerce but also some jurisdictions applies among others to timesharing, insurance services, and loans.[48] Although it has been applied to particular financial products over the years, the cooling-off period is not a typical investor protection mechanism, and it does not occur in MIFID II. That is why the pre-contractual reflection period is included in the art. 22 of Regulation 2020/1503 should be considered a novelty in the European investor protection standards.

Cooling-off periods in the past were not used widely in investment transactions because legislators feared potential usage for speculation on the stock market.[49] There is a risk that some financial consumers could benefit from the ability to withdraw after a few days from the investment in case the share price went down. However, in equity crowdfunding investments share price fluctuations are much more minor (if those fluctuations occur at all) in comparison with public stock markets. The company sets out the share price on the crowdfunding platform based on the company's valuations. As equity crowdfunding investments are characterized as highly illiquid and the secondary markets equity crowdfunding is much less developed than in the traditional

[47] Atwell, C.: *Cooling Off Periods in Franchise Contracts: From Consumer Protection Mechanisms to Paternalistic Remedies for Behavioral Biases*, Business and Politics, 17(4), 2015, p. 699.

[48] Rekaiti, P.: Van den Bergh, R.: *Cooling-Off Periods in the Consumer Laws of the EC Member States. A Comparative Law and Economics Approach*. Journal of Consumer Policy, 23, 2000, p. 374.

[49] Izdebski, P.*: Konsumenckie prawo odstąpienia od umów o świadczenie usług maklerskich*, Monitor Prawniczy, 3, 2020, p. 136.

public markets, the share price of crowdfunding projects is much less volatile from a short-term perspective.[50] Consequently, it should be claimed that the risk of speculation in equity crowdfunding is relatively low and should not be considered an obstacle in implementing a cooling-off period in equity crowdfunding markets.

The cooling-off period aims to protect the weaker side of the contract from manipulations and abuses from the stronger side, which distinguishes itself from a professional nature in a particular transaction. In the literature, it is often highlighted that cooling-off periods have two main functions: 1) reducing information asymmetry; 2) preventing the consumer from the consequences of decisions made under psychological pressure.[51] Those two functions can be straightforwardly observed in the example of distance selling. A consumer is receiving a product that he or she could not verify in person before making the purchase decision. That distance between the consumer and seller creates asymmetry information, which is reduced by giving the consumer a chance to resign from the transaction after receiving the product and verifying it in person. Purchasing on the Internet can also create psychological pressure as e-commerce websites use aggressive marketing tools that are often overwhelming for consumers.[52] The right to resign from the transaction for 14 days set out in the Directive 2011/83/EU on consumer rights gives consumers the ability to "cool off" and rethink the purchase.[53]

The question arises if the same two functions will be performed by cooling off period in applying this mechanism to equity crowdfunding. Undoubtedly, crowd investors are prone to incentives that significantly impact their behavior and can create psychological pressure. The most widely described in behavioral finance research on this type of financing is a phenomenon called "wisdom of the crowd".[54] Crowd investors, especially non-sophisticated ones, have strong preferences to invest in projects that have already collected the vast majority of the targeted amount of capital. Commonly, crowdfunding platforms

[50] Brejdak, J.: *Rynek wtórny finansowania społecznościowego*, Przeglad Prawa Handlowego, 3, 2022, p. 53.

[51] Rekaiti, P.: Van den Bergh, R.: *Cooling-Off Periods in the Consumer Laws of the EC Member States. A Comparative Law and Economics Approach*. Journal of Consumer Policy, 23, 2000., pp.381.

[52] Luzak, J.: *To Withdraw Or Not To Withdraw? Evaluation of the Mandatory Right of Withdrawal in Consumer Distance Selling Contracts Taking Into Account Its Behavioural Effects on Consumers*., Journal of Consumer Policy, 37(1), 2014, p. 91–111.

[53] Ibidem.

[54] Hossain, M.: et al.: *Wisdom of the Crowd and Stock Price Crash Risk: Evidence from Social Media*. Review of Quantitative Finance and Accounting, 58(2), 2022, p. 709–742.

present progress in raising funds with visual graphics highlighting how much is already collected and how close it is to reach the target or even becoming overfunded. As behavioral finance research shows, non-sophisticated investors have a strong preference for projects that have already reached the target.[55] Thereby, the non-sophisticated investor is following the "crowd". In addition, crowd investors receive regular notifications about passing time to invest in a particular project, which increases pressure on them. That is why implementing a cooling-off period for non-sophisticated crowd investors to minimize the negative consequences of investment decisions made under psychological pressure seems undoubtedly justified.

More questionable is if the cooling-off period in equity crowdfunding addresses the information asymmetry issue. In the distance selling example, consumers, through the cooling off period, were able to verify the product in person, so they were obtaining extra information about the product which they had not possessed at the moment of making the purchase decision. In the case of equity crowdfunding investment, the cooling-off period does not contribute any new information about the company or offered shares. It can be claimed that the asymmetry information issue is addressed by the requirements for the key investor information sheet and several other investor protection mechanisms discussed above like the entry-knowledge test. Those mechanisms increase crowd investors' awareness and educate them about the market before investing. The cooling-off period gives an investor a chance to change the decision about the investment without providing any new information. That shows that consumer protection mechanisms implemented in financial markets can address different issues.

7. CONCLUSIONS

Equity crowdfunding brought a new type of investor to the financial markets. Consequently, Regulation 2020/1503 introduced a new classification of investors, which differs from the categories used in MIFID II. The majority of crowd investor protection mechanisms reflect those already found in the application in traditional capital markets for retail clients with respect to the equity crowdfunding market characteristic. The novelty in investor protection is the cooling-off period, which enhances the investor protection level compared to MIFID II provisions. All implemented mechanisms of investor protection seem to be the epitome of a paternalistic approach, so the reduction of information asymmetry is not the main focus.

[55] Polzin, F.: et al.: *The Wisdom of the Crowd in Funding: Information Heterogeneity and Social Networks of Crowdfunders*. Small Business Economics, 50(2), 2018, p. 254.

The higher level of crowd investor protection and well-established consumer protection mechanisms introduced to the capital markets prove that non-sophisticated investors should be considered one of the most vulnerable groups in the financial markets. The paternalistic approach of the EU legislator seems to be justified and necessary to ensure further development of the European equity crowdfunding market. Investing is inherently risky, and the law certainly cannot guarantee positive returns, but the protection mechanisms should enable secure and stable market conditions for the most vulnerable and inexperienced investors who are dominating crowdfunding markets.

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HOW CAN SHAREHOLDERS' AGREEMENTS SHAPE CORPORATE GOVERNANCE AND DIRECTORS' LIABILITY? *

Mihaela Braut Filipović **

ABSTRACT

The interplay between contract and state corporate law in shaping corporate governance is not a novelty. In this article author questions the impact of private ordering through the shareholders' agreement (further in text: SA) on corporate governance and possibly on the director's duties and liabilities. The author argues that the SA might have far-reaching consequences for all the stakeholders and third persons as there are only a few limitations to its content, mainly referring to the mandatory rules of corporate law and general limitations of contract law. It means shareholders can impose additional rules for governance to directors, for transfer of shares, employment policy, and others. The author shall question whether SA can modify the articles of association. This article aims to reassess the balance between corporate and contract law instruments for the companies' governance. The author argues that analyzing corporate governance without considering contractual tools, such as SA, becomes incomplete and seriously undermines rethinking fundamental principles of corporate governance, such as the issue of directors' liability.

Keywords: *shareholders agreement, corporate governance, director's liability*

1. INTRODUCTION

Law and articles of association traditionally set fundamental features of the corporate governance of companies. However, recent practice shows that there

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is yet another tool, a contract, by which the shareholders try to tailor the corporate governance of the company according to their needs. These contracts between company members, or where at least one of the parties is a shareholder, regarding the matters of corporate governance are called shareholders' agreements (further in text: SA). Although SA is widely present in corporate practice, they are mostly not regulated in comparative legislation and is seriously undermined in scholarly writings. This leaves many questions open throughout different national jurisdictions. The research in this article is done by the functional method in the analysis of comparative law. Besides leading legal examples of US and German corporate law, the author shall draw references to Croatian law as an example of the legislature under the heavy influence of German corporate law. The author shall particularly discuss whether SA can modify the articles of association in order to answer which would prevail. Of particular interest is the discussion of how and to what extent SA can affect the company's management and position of directors. This article aims to contribute to the legal discussion regarding the scope of the desirable influence of contract law instruments on creating the corporate governance of companies.

2. CONTRACT LAW OR STATE CORPORATE LAW- WHICH ONE GAVE BIRTH TO MODERN COMPANIES?

From legal to economic literature, there is a long history of debate about what is a company or popularly called the "firm".[1] The legal nature of the company is important to understand and interpret the relations between the shareholders, the management, and other stakeholders of the company. The most prominent theory until today is the one that views the company as a "nexus of contracts", as introduced by Jensen and Meckling in 1976.[2] In essence, it considers that relations between the company's shareholders, management, employees, and other stakeholders are contractual in character.

However, the "nexus of contracts" theory has a long list of critics,[3] with the main argument that relations among the stakeholders of the company cannot

[1] For an overview see in Eisenberg, M. A.: *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, The Journal of Corporation Law, 24 (4) 1998-1999. See also Coase, R. H.: *The Nature of the Firm*, Economica New Series, 4 (16) 1937.

[2] See their seminal paper on the topic, Jensen, M. C.; Meckling, W. H.: *Theory of the firm: managerial behavior, agency costs and ownership structure*, Journal of Financial Economics, 3 1976.

[3] See for example Bratton, W. W.: *The "Nexus of Contracts" Corporation: A Critical Appraisal*, Cornell Law review, 74 1989. The author considers this theory as not empirically sustained, often regarded as self-explanatory with many features remain unclear.

be interpreted through the classical analysis of contractual rights and duties of interested parties solely. Legal authors tend to interpret the "nexus of contracts" theory, not as legally binding contracts concluded between the stakeholders of the company but as the "agreement out of the interests of the relevant parties"[4] or "nexus of reciprocal arrangements".[5] We consider that the most important contribution of the "nexus of contracts" theory is that it draws a clear distinction from the consideration that relations between stakeholders of the company originated from outside authority. It is, thus, widely accepted that the creation of companies is not mandated by the state legislators but that it is in the domain of parties' contractual freedom.

On the other side, corporate law is clearly made by state legislators. It consists of mandatory and default rules whose content depends on the applicable national laws and types of companies in which the business is incorporated.[6] We agree with the authors who claim that the most important contribution of corporate law is that it provides the legal personality to the companies, which allows them to enter into a business transaction as one contracting party and not as a group of individuals.[7] Corporate law draws out yet another crucial feature of the companies, and that is the asset partitioning and the so-called "entity shielding", which in essence, means that the company assets are protected from the shareholders' personal creditors, regardless of the type of the incorporation.[8] Finally, corporate law has effectively construed corporate governance architecture for various legal forms of companies.[9]

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4 See Kornhauser, L. A.: *The nexus of contracts approach to corporations: a comment on Easterbrook and Fischel*, Columbia Law Review, 89 1989, p. 1491.

5 See Eisenberg, M. A.: *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, op. cit., p. 822.

6 Proper distinction between mandatory and default rules is crucial, and the higher contrast in regulator approaches can be seen between U.S. and German corporate law. See in Hopt, K. J.: *Directors' Duties and Shareholders' Rights in the European Union: Mandatory and/or Default Rules?*, ECGI Working Paper Series in Law, Working Paper N°. 312/2016, 2016, [https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2749237.pdf].

7 See Armour, J.; Hansmann, H.; Kraakman, R.: What is Corporate Law?, in: Kraakman, R.; Armour, J.; Davies, P.; Enriques, L.; Hansmann, H.; Hertig, G.; Hopt, K.; Kanda, H.; Rock, E.: *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford, 2009, p. 6.

8 See Hansmann, H.; Kraakman, R.; Squire, R.: *Law and the Rise of the Firm*, Harvard Law Review, 119 2005, p. 1338.

9 Klausner argues that contractarian theory of corporate law serves only as a starting point in understanding the companies, but that it fails to explain the process and content of the corporate governance of the companies. See in Klausner, M.: *The contractarian theory of corporate law: generation later*, Journal of Corporation Law, 31 (3) 2006.

Although many legal effects provided by the corporate law for the companies could be achieved through contractual drafting as well, corporate law makes the entire business simpler for the shareholders and invokes a degree of security for all the third parties which are conducting business with the company.[10] Corporate law undergoes constant changes and upgrades where state legislators aim to improve the legal environment for all stakeholders of the company and entice entrepreneurship. And these amendments apply to all existing and future companies without the need of shareholders to contractually envelop those changes in their relationship and to the corporate governance of the company, which certainly is an important contribution of the corporate law.

Regardless of whether we consider the company as nexus of various contracts or as a creature of the state corporate law, we can strongly argue that there are certain contracts concluded between the stakeholders of the company. The fundamental contract concluded between the shareholders, many argue, would be the so-called "articles of association", "constitution", "charter" or "memorandum",[11] where shareholders can influence its content depending on the various legal form of the corporation. We shall further discuss the legal nature of the articles of association. In addition, shareholders are free to conclude added contracts among themselves and with the company, in which case these contracts fall under obligations law and not state corporate law.

The author considers that rather than taking a side in the debate about who gave birth to modern corporations, corporate or contract law, the focus of this article is on the interplay of contract and corporate law to provide a better understanding of how their interplay can shapes the corporate governance.

3. SHAREHOLDERS' AGREEMENTS VS. ARTICLES OF ASSOCIATION

Analysis of the legal nature and comparison between articles of association and SA can provide further insight into the interplay of contract and corporate law in creating the corporate governance of the companies. They both have contractual features, but while articles of association are fully acknowledged by corporate law, the legal position of SA remains ambiguous. Figuring out

[10] See also Armour, J., Hansmann, H., Kraakman, R.: What is Corporate Law?, *op. cit.,* p. 20. For a more detailed view of the „corporate" benefits see Mahoney, P. G.: *Contract or concession--an essay on the history of corporate*
Law. Georgia Law Review, 34 (2) 2000.

[11] See Easterbrook, F. H.; Fischel, D. R.: *The Corporate Contract*, Columbia Law Review, 89 1989.

their legal nature can provide some answers as to the relationship between contract and state corporate law, but also to the relation between articles of association and SA when the shareholders use both within the same company.

Formation of the articles of association is a condition for forming a company.[12] However, there are different views regarding the legal nature of the articles of association. Among scholars, three possible views of the legal nature of articles of association most often occur. The first qualifies them as a contract, the second as an objective norm (normative theory), and the third as a combination of the first two, the modified objective norm.[13]

However, the most discussed view in the literature is whether the articles of association can qualify as a contract. Viewing articles of association as a contract shows their Roman origins, where the company started as a pure obligation between the partners.[14] There is no doubt that future members of the company voluntarily make a decision to form a company with a freely chosen business purpose. In fact, before registration of the articles of association and the final steps of forming a company, relations of the future shareholders are mostly in the sphere of obligations law.[15] However, it is undisputed that by the conclusion of the articles of association, parties do not only determine rights and obligations among themselves, but they also form the company bodies, their role, and the entire corporate structure. Formation of the corporate structure is usually not a subject of the contractual drafting but rather the case where mandatory and default corporate law rules automatically apply.[16] Thus, it is questionable whether the formation of the corporate bodies and relations

[12] Sometimes, this founding legal instrument is called „statute" or a „partnership agreements". Naturally, there are differences among these instruments depending on the applicable national law and the type of the company. See the analysis for Croatian law in Barbić, J.: *Društveni ugovor kao pravni posao na kome se temelji društvo*, Zbornik Pravnog fakulteta u Zagrebu, 62 (1-2) 2012. For Germany see Schäfer, C.: § 705 in: Habersack, M. (ed.): *Münchener Kommentar zum Bürgerlichen Gesetzbuch: BGB*, Band 7: Schuldrecht Besonderer Teil IV, 8. Auflage, München, 2020, rn 159.

[13] See Podgorelec, P.: *Legal Nature of Articles of Association and Categorization of Their Elements*, Pravnik, 68 (9-10) 2013, p. 650. The founding father of normative theory was Otto von Gierke, whose dogmatic view was that companies are primarily creatures of legislators through normative, i.e. legislative acts. The leading argument revolved around the fact that it was not until the registration of the articles of association that the company can obtain its legal personality. For the role which Gierke had in creation of German dogmatic view on legal persons, see Raiser, T.: *Der Begriff der juristischen Person, Eine Neubesinnung*, Archiv für die civilistische Praxis, 199 (1/2) 1999, p. 120 and further.

[14] See Schäfer, C., § 705, *op. cit.*, rn. 159.

[15] See in Dieckmann, A.: *Gesamthand und juristische Person*, Tübingen, 2019, p. 262.

[16] See also Armour, J.; Hansmann, H.; Kraakman, R.: What is Corporate Law?, *op. cit.*, p. 23.

between the shareholders and other can be understood and interpreted through classical contract theory only.[17]

There are significant differences between articles of association and traditional contracts. In particular, articles of association shall apply to all current and future members of the company,[18] but for its modification and admittance of new members, not all shareholders must agree,[19] which would be the case if the articles of association were considered as a pure consensual, synallagmatic contract.[20] Further, articles of association aim to permanently regulate relations between the shareholders and the inner life of the company in a way it outlives its founders. For those reasons, in German literature, within the contractual theory, scholars debate whether the legal nature of articles of association is purely contractual (Schuldvertrag) or a specific type of organizational contract (Organisationsvertrag).[21] Due to the previously mentioned specifics, scholars' prevailing opinion is that articles of association should be viewed as an organizational contract.[22] Likewise, the extent to which the general obligations law can apply for interpreting the articles of association is questionable, as articles of association cannot be qualified as a traditional synallagmatic contract.[23] In legislations where a contractarian view of the companies is more pronounced, as is the USA, courts, and scholars are more inclined to conclude that the general rule of contract interpretation should be applied to articles of association as an organizational document of the company as well.[24] Thus, the theoretical view favors articles of association to be founded in contract law, but there are

[17] See Podgorelec, P.: *Legal Nature of Articles of Association and Categorization of Their Elements*, *op. cit*, p. 650.

[18] See Schmidt-Leithoff, C.: §2, in: Rowedder, H.; Schmidt-Leithoff, C. (eds.): *Kommentar zum Gesetz betreffend die Gesellschaften mit beschränkter Haftung*, 5. Auflage, München, 2013, rn 2, p. 160.

[19] One of the main argument for allowing that the articles of association can be modified without consent of all shareholders is that in such a way shareholders have better opportunity in value-maximizing and adopting the corporation to new needs, as the corporations are usually made with long-term goals. In that way legislators support entrepreneurship. For a discussion see Bebchuk, L. A.: *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments,* Harvard Law Review, 102 (8) 1989, p. 1830.

[20] See Podgorelec, P.: *Legal Nature of Articles of Association and Categorization of Their Elements*, *op. cit*, p. 650.

[21] See Schäfer, C., §705, *op.cit*., rn 159-163.

[22] See Schmidt-Leithoff, C., §2 *op. cit*., p. 160. The same opinion remains undisputed for Croatia as well. See also in Barbić, J.: *Društveni ugovor kao pravni posao na kome se temelji društvo*, *op. cit*, p. 500.

[23] See Schäfer, C., §705, *op.cit*., rn 159-168.

[24] Wischmeier Shaner, M.: *Interpreting Organizational "Contracts" and the Private Ordering of Public Company Governance*, William&Mary Law Review, 60 (3) 2019, p. 1006.

restrictions to interpreting it as a traditional contract and to using general obligations law for potential gap-filling, the extent of which can further depend on the applicable national law.

As to the legal nature of the SA, the most common definition of the SA is that they are a written or oral contract concluded between the parties,[25] where at least one of them is a shareholder, and the subject matter of the contract concerns the company, shares of the company or relations between the shareholders.[26] Thus, SA is mostly considered to be an atypical,[27] consensual, and synallagmatic contract, where general obligations law applies for its interpretation. When it comes to voting for SA, especially if all the shareholders sign them, German courts treat the SA as a private partnership for internal relations between the shareholders, regardless of whether they are disclosed to the company or not.[28] Nowadays, shareholders are generally allowed to conclude SA,[29] and they are widely present in corporate practice, although its relation to the state corporate law is not always clear.

The crucial question for the purpose of this article is can the SA override the articles of association in cases where they contain contradictory provisions. To provide an answer, the author shall confront SA and articles of association on two crucial grounds. First relates to the scope of application of the articles of association and the SA, regarding the parties and the content. The second relates to the rules of the modification of the articles of association – can it be altered by an outside contractual instrument, such as SA?

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[25] No formal requirement for the validity of the SA is definitely one of the major differences in comparison of articles of association and the SA. See Koppensteiner, H. G.; Gruber, M.: §47, in: Rowedder, H.; Schmidt-Leithoff, C. (eds.): *Kommentar zum Gesetz betreffend die Gesellschaften mit beschränkter Haftung*, 5. Auflage, München, 2013, Rn 28, p. 1575.

[26] See for example in Cadman, J.: *Shareholders' Agreements,* London, 2003, p. 3. See Mock, S.; Csach, K.; Bohumil, H.: Shareholders' Agreements between Corporate and Contract Law, in: Mock, S.; Csach, K.; Bohumil, H. (eds): *International Handbook on Shareholder' Agreements, Regulation, Practice and Comparative Analysis*, Berlin, 2018, p. 7.

[27] See Sarkozy, T.: *Shareholders' Agreements*, Acta Juridica Hungarica, 43 (1-2) 2002, p. 123.

[28] See the ruling of German Federal Supreme Court, BGH, 24.11.2008 - II ZR 116/08. For comparison to USA companies, Kulms argues that partnership law may be applicable to voting SA signed by all the shareholders for their internal relations. See Kulms, R. A.: *Shareholder's Freedom of Contract in Close Corporations – Shareholder Agreements in the USA and Germany.* European Business Organization Law Review, 2 2001, p. 693.

[29] Opposite to the view of modern corporate law, in the beginning of 20th century SA, especially voting agreements, were not enforceable before the German and the USA courts. The main reason behind such a view was the need to protect the public interest and preserving the minority rights by not allowing that a shareholder can restrict its right to freely vote on the general meeting of the company. See in Kulms, R. A.: *Shareholder's Freedom of Contract in Close Corporations – Shareholder Agreements in the USA and Germany*, *op. cit.*

3.1 CONFLICT OF ARTICLES OF ASSOCIATION AND SHAREHOLDERS' AGREEMENT – CAN PARTIES AND CONTENT OVERLAP?

The first question should reveal the extent to which we can consider the relationship between the articles of association and the SA regarding the applicable parties of each of these instruments. The main idea is that if these instruments apply to the same persons, then we must discuss whether their content can overlap and thus create a possible contradicting provision.

SA is typically concluded between the shareholders, but it does not have to include all the shareholders.[30] Importantly, at least one of them must be a shareholder in order to qualify the contract as the SA.[31] One of the most important legal effects of the SA is that it can impose obligations only to the shareholders, who are its contractual parties.[32] On the opposite, articles of association include all current and future shareholders and oblige all shareholders. From this alone stems the primary conclusion, and that is that the SA and articles of association do not necessarily have the same parties. The author shall further clarify the issue of possible parties to the SA.

Theory and practice confirm that it is possible that one of the contracting parties of the SA is not a shareholder.[33] It could, for example, be a spouse of the shareholder (which is an example of good practice if the share is marital property)[34] or a creditor of the company and others. The contracting party can also be a manager/shareholder or a manager who is not a shareholder.[35] Involving the managers in the SA, if nothing else, ensures that he/she is well aware of its existence and its content. For example, in family businesses, SA can be used to transfer family values and goals from family members/shareholders to managers.[36]

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[30] See in Miliauskas, P.: *Company law aspects of shareholders' agreements in listed companies*, Doctoral dissertation, Vilnius, 2014, p. 328.

[31] *Ibid*., p. 174.

[32] For such conclusion from comparative perspective see in Mock, S.; Csach, K.; Bohumil, H.: Shareholders' Agreements between Corporate and Contract Law, *op. cit*., p. 5. For Germany see Schmidt-Leithoff, C.: §3, *op. cit*., rn. 53, p. 212. The same for Croatia in Barbić, J.: *Pravo društava, Društva kapitala, Dioničko društvo*, Zagreb, 2013, p. 605.

[33] See Mock, S.; Csach, K.; Bohumil, H.: Shareholders' Agreements between Corporate and Contract Law, *op. cit*., p. 17. The same position in Croatian law as well. See Barbić, J.: *Pravo društava, Društva kapitala, Društvo s ograničenom odgovornošću*, Zagreb, 2013, p. 279.

[34] See Miliauskas, P.: *Company law aspects of shareholders' agreements in listed companies*, *op. cit*., p. 185.

[35] See Cadman, J.: *Shareholders' Agreements, op. cit*., p. 4.

[36] See Astrachan, C. B.; Astrachan, J. H.; Kotlar, J.; Michiels, A.: *Addressing the theory-practice divide in family business research: The case of shareholder agreements*, Journal of Family Business Strategy, 12 (1) 2021, p. 2. Equally, family members can create different mechanisms to directly or indirectly influence the managing of the company with the goal to ensure

Besides with third parties, it has been recorded that shareholders enter into a contract with the company itself, where they, for example, agree on the veto right for a certain company decision such as the change of director, selling off the company's property,[37] awarding remuneration to certain shareholders/managers[38] and other.[39] However, although it is possible that the company is a contracting party, parties should carefully draft the content of such a SA, as the SA could not be binding if it is contrary to mandatory corporate law, especially regarding the functioning of the company's bodies.[40]

Thus, regarding the applicable parties, we conclude that the SA and articles of association do not necessarily have the same parties. However, all shareholders may enter in the SA, or some shareholders enter the SA in which cases we can speak of total or partial overlapping of the parties. It is further necessary to determine if the content of articles of association and SA may overlap.

National laws explicitly provide the mandatory content of the articles of association, depending on the company's legal form.[41] On the opposite, SA is generally not regulated, both in EU[42] and comparative legislations.[43] The content of

that the business decisions are in accordance with the family values. In some family businesses are thus construed additional bodies, the so-called family councils where family members can, among other, bring business decisions and try to influence the managing body, which is much simpler if the manager is also made part of that body. See Lächler, C.: Familienverfassung und Family Governance, in: Rechenberg, von F. W-G.; Thies, A.; Wiechers, H. (eds.): *Handbuch Familienunternehmen und Unternehmerfamilien*, Stuttgart, 2016, p. 814. More about family council see in Braut Filipović, M.: *Specifičnosti upravljanja obiteljskim društvima*, Zbornik Pravnog fakulteta u Zagrebu, 67 (6) 2017, p. 952.

[37] See Rauterberg, G.: *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, Yale Journal on Regulation, 38 (4) 2021, p. 1130.

[38] See Miliauskas, P.: *Company law aspects of shareholders' agreements in listed companies*, *op. cit.*, p. 186.

[39] See the empirical study in Schoenfeld, J.: *Contracts Between Firms and Shareholders*, Journal of Accounting research, 58 (2) 2020.

[40] See Mock, S.; Csach, K.; Bohumil, H.: *Shareholders' Agreements between Corporate and Contract Law*, *op. cit.*, p. 7.

[41] For example, for mandatory content of limited liability company in Germany (GmbH), see Schmidt-Leithoff, C.: §3, *op. cit.*, rn 1, p. 192 and further.

[42] For the EU, SA is mentioned sporadically, the example is the obligation of the shareholders towards the company for transparency of SA in listed companies in certain cases under the Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390, 31.12.2004, p. 38–57.

[43] For example, German and Croatian legislature do not regulate SA. However, some legislation, such as USA, provide a legal framework for SA. See section 7.32 of the Revised Model

SA differs regarding their goal and subject matter. Thus, there are various classifications under which they can be sorted.[44] However, the literature emphasizes that the most common goal of SA is to obtain control in the company through concluding voting agreements.[45] The purpose behind voting agreements is usually that contracting parties control the election of the director or to improve the position of minority shareholders and their possible influence over the management of the company.[46] There are a few empirical studies regarding the content of the SA. In the research on U.S. domiciled companies which went IPO in 2021,[47] the primary content of the SA was to achieve control of certain shareholders over the election and composition of the board of directors. Yet another empirical research on the broad example of SA in U.S. domiciled companies concluded between the shareholders (usually controlling shareholders) and the company confirms that the right to elect the director is an important incentive for the conclusion of the SA.[48] From continental Europe, the example of empirical research comes from Italy on the sample of Italian listed companies, where SA was concluded primarily to obtain voting control.[49] Board representation

Business Corporation Act (RMBCA). See also Mock, S.; Csach, K.; Bohumil, H.: Shareholders' Agreements between Corporate and Contract Law, *op. cit.*, p. 7. Further, takeover law regulates the situations when shareholders act in concert, which can amount to their obligation to put a takeover bid. Shareholders can act in concert as a result from the SA as well. So we can argue that legislators on the European level tackled some consequences of SA, although to a limited extent, but for listed companies solely, with the goal to protect minority shareholders. See in Roth, M.: *Shareholders' Agreements in Listed Companies: Germany*, 2013 [https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2234348], p. 4.

[44] For an overview see in Miliauskas, P.: *Company law aspects of shareholders' agreements in listed companies*, *op. cit.*, p. 195.

[45] See Mock, S.; Csach, K.; Bohumil, H.: Shareholders' Agreements between Corporate and Contract Law, *op. cit.*, p. 32.

[46] See Čulinović Herc, E.; Hasić. T.: *Sudjelovanje dioničara u radu glavne skupštine dioničkog društva prema noveli zakona o trgovačkim društvima*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, 32 (1) 2011, p. 35.

[47] Rauterberg made a study on the example of 901 U.S. domiciled company which went IPO in the period from 2013-2018. See Rauterberg, G.: *The Separation of Voting and Control: The Role of Contract in Corporate Governance, op. cit.,* p. 1149.

[48] Schoenfeld conducts a study on the example of 13D filings from the SEC's EDGAR for the years 1996–2018. Schoenfeld argues that even 15% of examined SA's has a management representation clause. However, the highest rate of 28% has a private placement clause though, under which the company obliges itself to sell shares under pre-determined price, which is of special importance in closed corporations. See Schoenfeld, J.: *Contracts Between Firms and Shareholders*, *op. cit.*, p. 408.

[49] Baglioni conducted a research on the publicly available dana from Consob, in the time frame of ten years, finishing in 2007. See Baglioni, A.: *Shareholders' agreements and voting power: evidence from Italian listed firms,* Applied Economics, 43 (27) 2011.

was of high importance as well. In Croatia, there is no empirical research on the use of SA in practice. One of the reasons is that SA is not publicly available.[50] Other content of SA often concerns the restrictions on the transfer of shares, agreements on profit sharing in favor of certain shareholders (typical for venture and private equity funds), various call and put options, drag along rights, additional information provided to minority shareholders, and others.[51]

That does not mean that there are no restrictions for these agreements. Sometimes, the national legislation explicitly imposes certain limitations. For example, according to both German[52] and Croatian[53] company laws, it is a misdemeanor to contract any compensation or benefit in the name of the obligation from the contract on how to vote at the general meeting. Further, both German and Croatian legislators provide that if a shareholder undertakes to vote according to the company's instructions, the management or the supervisory board,[54] such a contract would be null and void. Further, shareholders could not, through the SA give voting rights to a third person who is not a shareholder.[55] Such provisions are a clear example of how national legislators can restrict possible shareholder voting agreements.

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[50] However, due to its strategic importance to Croatian economy, the most famous SA is the one concluded between the Government of Republic of Croatia and the MOL Hungarian Oil and Gas PLC over the strategic rights in the joint-stock company INA. For an overview of the privatization process and subsequent entering of the MOL in the structure of INA see in Kecskés, A.; Jelinić, Z.: Monistički i dualistički ustroj organa dioničkog društava u Mađarskoj i Hrvatskoj s posebnim naglaskom na problem korporativnog upravljanja u hrvatskoj naftnoj kompaniji INA d.d., in: Župan, M.; Vinković, M. (eds.): *Suvremeni pravni izazovi: EU-Mađarska-Hrvatska*, Pečuh-Osijek, 2012. The SA is available at [https://molincroatia.com/sites/default/files/GMA%2030-01-2009_EN.pdf], accessed on 18/10/2022.

[51] See Miliauskas, P.: *Company law aspects of shareholders' agreements in listed companies*, *op. cit.*, p. 195; Mock, S.; Csach, K.; Bohumil, H.: Shareholders' Agreements between Corporate and Contract Law, *op. cit.*, p. 32.

[52] For Germany see § 405 par. 3, no. 6 and 7 of Aktiengesetz vom 6. September 1965 (BGBl. I S. 1089), das zuletzt durch Artikel 2 des Gesetzes vom 20. Juli 2022 (BGBl. I S. 1166) geändert worden ist.

[53] For Croatia see articles 631/1/7 and 631/1/8 of the Croatian Companies Act, Official Gazette, Nos. 111/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09, 125/11, 152/11, 111/12, 68/13, 110/15, 40/19, 34/22. See also Jurić, D.; Zubović, A.: *Protupreuzimateljske mjere i položaj uprave ciljnog društva u postupku preuzimanja dioničkog društva*, Zbornik Pravnog fakulteta u Rijeci, 30 (1) 2009, p. 305.

[54] The same solution is adopted in German and Croatian company laws. See §136 par. 2 Aktiengesetz; Article 293 par. 2 of the CCA.

[55] For restrictions in German law see more Koppensteiner, H. G.; Gruber, M., §47, *op. cit.*, Rn 31, p. 1576. Author argues that the SA cannot override restriction on voting which are mandatory set in the law.

Further, shareholders can modify certain rights only via articles of association in order to be legally binding, i.e. to have a legal effect on the company. For example, in Croatian law, it is explicitly stated that restrictions on the transfer of shares should be inserted in the articles of association.[56] Such a solution protects all shareholders and preserves selected default rules of corporate law, which can be modified with the legal effect on the company, but only if made known and agreed upon by the requested majority of shareholders in the general meeting. It provides a certain degree of legal certainty to third parties as well. At the same time, it is a major disadvantage for those shareholders who entered a SA.

In other cases, we can argue that SA is subject to applicable general contract law limitations.[57] If we qualify the SA as a contract, which was previously discussed, then it should be interpreted that contractual remedies should be applied.[58] In the previous example, if a party to a voting agreement votes differently than agreed upon in the general meeting, such a vote shall be valid, but the other parties of SA can ask the party in breach for compensation of damages.[59]

To conclude, the content of SA is not regulated. Thus, shareholders are mostly free in its formation (limitations are set in mandatory corporate and contract law). Thus, there is no obstacle that the parties agree on a certain issue that is already regulated by the articles of association. In other words, it is possible that the content of the articles of association and of the SA overlaps, where the problem arises if these provisions are conflicted.[60]

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[56] For joint-stock companies see article 227 par 2 of the CCA. For limited liability company see article 412 par. 4 of the CCA. However, there is no explicit provision stating that such an agreement would be null and void if made outside of the articles of association. Author is of the opinion that if the parties would agree on the restriction of transfer of shares via SA, and not via articles of association, such an agreement would produce no legal effects towards the company. However, there is no obstacle that such an agreement binds the contractual parties, who could in case of breach, seek the compensation of damages. Further examples in Croatian law when modification of shareholder's rights should be done via articles of association to have a binding effect to the company would be introduction of special benefit for a member (Article 392 of the CCA), management and representation of the company (Articles 422 and 426 of the CCA), sharing of the profit (Article 406 par 2 of the CCA) and other.

[57] See Mock, S.; Csach, K.; Bohumil, H.: Shareholders' Agreements between Corporate and Contract Law, *op. cit.*, p. 13.

[58] Duffy, M. J.: *Shareholders Agreements and Shareholders' Remedies Contract Versus Statute*, Bond Law Review, 20 (2) 2008, p. 12.

[59] For Croatia, this standpoint is confirmed both in theory and in practice. See Barbić, J.: *Djelovanje zajednice (poola) prava glasa*, Revija Kopaoničke škole prirodnog prava, 1 2019, p. 258; Judgement of Visokog Trgovačkog suda, Pž-7466/04-4 from 18. September 2007. The same conclusion for German law see in Roth, M.: *Shareholders' Agreements in Listed Companies: Germany, op. cit.*, p. 12.

[60] Same line of thinking in Duffy, M. J.: *Shareholders Agreements and Shareholders' Remedies Contract Versus Statute*, op. cit., p. 8.

The author argues that for further discussion in resolving the conflict between articles of association and SA, the crucial issue is whether the articles of association could be modified by the subsequent SA, which shall be further elaborated.

3.2. CONFLICT OF ARTICLES OF ASSOCIATION AND SHAREHOLDERS' AGREEMENT – CAN SHAREHOLDERS' AGREEMENT MODIFY THE ARTICLES OF ASSOCIATION?

If the parties and content of SA and articles of association can overlap, this can lead to inconsistent solutions and disputes between the parties as to what is applicable. In such cases, a court should determine the parties' true will. In the author's opinion, the answer should be found in consideration of can the parties change the articles of the association through the SA.

Most corporate laws provide that any modification of the articles of association, regardless of the legal form of the company, should be done through formal procedures involving the general meeting and achieving a certain majority of shareholders' votes.[61] Also, articles of association and their amendments are publicly available (usually through Court registers). So, is it even possible to consider that the articles of association could be modified through an outside contractual instrument, such as SA?

Among the scholars, the prevailing opinion is that the breach of the SA, for example, of the voting agreement, does not affect the validity of shareholders' actions in the company's general meeting.[62] Such a conclusion stems from the understanding that only the articles of association can govern internal corporate governance, specifically, the functioning of the organs. In the same line of thinking, Sarkozy argues that articles of association and SA should be independently ruled upon and understood as having different consequences for the parties, as the SA derives from the contract law and articles of association

[61] See Enriques, L.; Hansmann, H.; Kraakman, R.: The Basic Governance Structure: The Interests of Shareholders as a Class, in: Kraakman, R.; Armour, J.; Davies, P.; Enriques, L.; Hansmann, H.; Hertig, G.; Hopt, K.; Kanda, H.; Rock, E.: *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford, 2009, p. 82. For Germany see Schmidt-Leithoff, C.: §3, *op. cit.*, rn. 1, p. 192. For Croatia see article 454 of the CCA.

[62] For continental law in Europe see for example Gomard, B.: *Shareholders' Agreements in Danish Law*, Scandinavian Studies in Law, 16 1972, p. 129. For German law see Koppensteiner, H. G.; Gruber, M., §47, *op. cit.*, Rn 32, p. 1577. The same for Croatia in Barbić, J.: *Pravo društava, Društva kapitala, Dioničko društvo*, op. cit., p. 605. For common law positions see for example in Duffy, M. J.: *Shareholders Agreements and Shareholders' Remedies Contract Versus Statute*, *op. cit.*, p. 8.

from the corporate law.[63] This argument narrows down even further the possibility of modifying the articles of association by a SA.

The only interpretation that allows considering such an option is if we qualify the articles of association as a contract. Under general contract law, modification of an existing contract should always be strictly interpreted, and usually, the unilateral consent of the parties would be required.[64] This would lead to a conclusion that articles of association could not be subsequently modified without the consent of all of the shareholders. In other words, any possible modification of the articles of the association through the SA that would apply to all the shareholders could be done only if all the shareholders are also parties to the SA.

However, as was previously discussed, there is no clear agreement among scholars as to the legal nature of the articles of association. The prevailing opinion is that it is an organizational contract, where due to its specifics, it is questionable whether general contract law can be used for its interpretation. Nevertheless, not all provisions of articles of association have the same legal effect. They can be divided into mandatory and facultative provisions,[65] where within the facultative provisions, it is possible to insert the contractual clauses which would apply to all shareholders. Such contractual clauses are, for example, the composition of the management board, arbitration clauses, and others.[66] It has been argued in German literature that such provisions could be subsequently altered by other contract law instruments, such as SA.[67] In the same line of thinking, an ancillary agreement between the company and managers, e.g. on a lower compensation in the event of resignation, can also override a conflicting provision with the articles of association.[68] However, the subsequent change, done outside the articles of association, shall have legal effect only on the contracting party of the SA. If all shareholders are also parties to the SA, then we can speak of modifying the facultative contractual provisions of the articles of the association through the SA.[69]

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[63] See Sarkozy, T.: *Shareholders' Agreements, op. cit.*, p. 131.

[64] See for example in Kötz, H.: *European Contract Law*, Oxford, 2017, p. 63.

[65] See Schmidt-Leithoff, C., §3, *op. cit.*, rn 2, p. 193 and further. See also in Barbić, J.: *Društveni ugovor kao pravni posao na kome se temelji društvo*, *op. cit*, p. 510.

[66] The same conclusion for private ordering of shareholders in USA companies. See Thompson, R. B.: *The Law's Limit on Contracts in a Corporation*, Journal of Corporation Law, 15 (3) 1990.

[67] See Schmidt-Leithoff, C., §3, *op. cit.*, rn 53, p. 212. In the same line of thinking for Croatian law see Barbić, J.: *Pravo društava, Društva kapitala, Društvo s ograničenom odgovornošću*, *op. cit.*, p. 283.

[68] See Schmidt-Leithoff, C., §3, *op. cit.,* rn 53, p. 212.

[69] Theory and courts in USA largely support unanimous agreements by the shareholders done outside of the articles of association. This freedom is not however without limitations, the

To conclude, even in the hypothetical case where all shareholders would be the parties of the SA, the court would be highly reluctant to adopt the position that the shareholders contractually, through the provisions of the SA, modified the articles of association. Formal requirements for modifying the articles of association are usually mandatory provisions. We support the finding that the only exception could be in the case when SA modified the facultative contractual provisions of the articles of association and if all shareholders agreed on its modification in the SA. Considering these difficulties, parties should consider whether the change of articles of the association through a SA is prudent, as its legal effectiveness could be questioned. In each case, there is no obstacle that the parties of SA agree to propose an amendment of articles of association in the general meeting and that, through the corporate law, change the articles of association in a way that corresponds to their will previously expressed in the SA.

Although provisions of the articles of association shall mostly prevail over the SA, it should be noted that by that it does not mean that the articles of association could prohibit conclusions of the SA.[70] They cannot be considered as a source of mandatory law for the contractual capacity of the shareholders. However, the author argues that if the parties agreed in the articles of association not to enter into any or a specific SA, a breach of such a provision could lead to contractual remedies, such as compensatory damages.

If the SA, in most cases, cannot modify the articles of association, the author shall further discuss whether the SA affects the corporate governance of the company at all.

4. CAN SHAREHOLDERS' AGREEMENTS AFFECT THE CORPORATE GOVERNANCE OF THE COMPANY?

As discussed, SA, in most cases, cannot modify the articles of association. At the same time, the presence of SA in practice rises, and the content of the SA has very few limitations. The dominant view among scholars and practitioners is that SA is mostly used in privately held companies,[71] but there is no obstacle

primary limit being the fiduciary duty of managers/directors. See Thompson, R. B.: *The Law's Limit on Contracts in a Corporation*, *op. cit.*, p. 395.

[70] See Barbić, J.: *Pravo društava, Društva kapitala, Društvo s ograničenom odgovornošću*, *op. cit.*, p. 281.

[71] For an overview of arguments why SA are more of interest to shareholders of the closely held companies vs listed companies see in Miliauskas, P.: *Company law aspects of shareholders' agreements in listed companies*, *op. cit.*, p. 157. The prevailing argument is that by using the contract, minority shareholders can obtain a better position towards the controlling shareholders, especially as in privately held companies there is no easy way out of the compa-

for shareholders to use them in public companies (companies whose shares are traded on the regulated market) as well,[72] which is confirmed in previously elaborated studies.

The crucial issue remains whether the SA can change the corporate governance of the company. To answer that, we must answer two questions: can shareholders modify default corporate rules equally by articles of association and by SA, and can shareholders modify the mandatory corporate rules by SA that they could not modify by the articles of association?

The answer to the first question should be found in applicable national corporate laws and the interplay between the articles of association and the SA, which was *in extenso* discussed in the previous chapter of this article. The conclusion was that parties could modify default corporate rules by SA as well, but it shall mostly have a binding effect only on those shareholders who are contractual parties of the SA. In other words, SA shall not be legally binding for the companies, and legal actions of the shareholders on the general meetings contrary to the SA shall be valid (the example is voting contrary to the SA). Modifications with binding effect on all shareholders are possible only if all shareholders are parties to the SA (unanimous SA).[73] Equally, corporate law can provide that some modifications in order to be legally binding must be done through the articles of association. The example put forth was the transfer of shares under Croatian law. Thus, generally speaking, shareholders can make almost all modifications of the default corporate law provisions by the SA. What is the biggest difference in comparison to the articles of association is to whom such modifications shall be binding, to all or only to certain shareholders or other stakeholders.

As to the second question, Rauterberg argues that shareholders can, in certain cases, modify even the mandatory corporate law provisions by the SA, where the example would be the separation of the voting power and control.[74] Precisely, it refers to the voting SA where even minority shareholders can agree to vote for the election of a certain director and obtain voting control which

ny as there is no regulated market for selling the shares to third parties. See e.g. Means, B.: *A contractual approach to shareholder oppression law*, Fordham Law Review, 79 (3) 2010.

[72] See Rauterberg, G.: *The Separation of Voting and Control: The Role of Contract in Corporate Governance, op. cit.,* p. 1133. See the study of Schoenfeld, J.: *Contracts Between Firms and Shareholders*, *op. cit.*

[73] For a specific regulation of unanimous SA, and its particular place in regulation of corporate governance, see Hay, R. J.; Smith, L. A.: *The Unanimous Shareholders Agreement: A New Device for Shareholders Control*, Canadian Business Law Journal, 10 (4) 1985.

[74] See Rauterberg, G.: *The Separation of Voting and Control: The Role of Contract in Corporate Governance, op. cit.*, p. 1128.

they otherwise would not have. Such a practice is especially present when venture and private equity funds invest in the company.[75] One notable example would also be the nomination of the exact person who shall act as a director in voting agreements between shareholders.[76] This could be of particular interest to family businesses that prefer to have a family member as the CEO. While that is possible to achieve in SA, shareholders could not insert in the articles of association the obligation to vote for a certain person to act as a director or directly nominate the director/management board without fulfilling additional conditions.[77]

The more questionable issue is whether shareholders can waive certain mandatory rules of the corporate law, such as the duty of loyalty towards the company by both the shareholders and the directors. In German literature, a clear standpoint is taken that shareholders could not agree in the SA to limit the duty of loyalty towards the company and other shareholders.[78] In that light, a very peculiar practice arose in the companies incorporated in selected USA countries, led by the Delaware companies, where shareholders can, from 2000, explicitly waive *ex ante* the doctrine of opportunities and its consequences for the directors and shareholders.[79] On the opposite, European legislators request informed consent from disinterested directors on a case-by-case occurrence in order to support the director in appropriate business opportunities instead of the company.[80] This is important because it firstly demonstrates that the

[75] Control rights through voting rights is crucial for investors as are venture and private equity funds. Once negotiated, the contract by which these investors obtain certain control rights can be undoubtedly qualified as SA. See the study Kaplan, S. N.; Strömberg, P.: *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, Review of Economic Studies, 70 2003.

[76] See Rauterberg, G.: *The Separation of Voting and Control: The Role of Contract in Corporate Governance, op. cit.*, p. 1146.

[77] In Croatian law, in the limited liability company shareholders can nominate the management board directly in the articles of association only if they nominate one of the founders, i.e., one of the shareholders who signed the articles of association during the constitution of the company. See article 423 par. 2 of the CCA. For the joint-stock companies, only the members of the first supervisory board (in the one-tier system) or board of directors (in the two-tier system) can be nominated in the articles of association. See article 180 of the CCA.

[78] See Koppensteiner, H. G.; Gruber, M.: §47, *op. cit.,* Rn 31, p. 1577. Roth, M.: *Shareholders' Agreements in Listed Companies: Germany, op. cit.*, p. 8.

[79] There is no universal waiver, but certain requirements must be met. See Rauterberg, G.; Talley, E.: *Contracting out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, Columbia Law Review, 117 2017, p. 1095.

[80] Such a standpoint is taken at least in UK, Germany, France and Italy. See Enriques, L.; Hertig, G.; Kanda, H.: Related-Party Transactions, in Kraakman, R.; Armour, J.; Davies, P.; Enriques, L.; Hansmann, H.; Hertig, G.; Hopt, K.; Kanda, H.; Rock, E.: *The Anatomy of Cor-*

shareholders are interested in contractually altering the mandatory corporate law and, secondly, that certain legislators started to allow shareholders to contractually modify some fundamental principles of corporate law regarding the directors' liability.[81]

In each case, the boundaries of the contractual freedom of SA exist. As previously discussed, mandatory rules of corporate law and general limitations of contract law should apply to the SA. Still, shareholders enjoy greater contractual freedom in SA than in the articles of association. Voting agreements in joint-stock companies, where corporate law strictly mandates shareholders' rights, is a primary example. Such SA could significantly impact all shareholders and stakeholders of the company. If some shareholders obtain control in the company, which they otherwise would not have, and if they are doing so outside of the articles of association, some authors argue that in modern corporate law, we witness the rise of stealth governance.[82] It reflects the notion that contract law instruments, undisclosed to parties outside of the contract, alter the company's governance. As the SA is mostly undisclosed to any third party,[83] the actual number and content of these agreements, together with the possible impact on the governance of the companies, remains unclear. Regardless of the possibly significant influence, this issue is seriously undermined in scholarly writings on the corporate governance of the companies.

Criticism of tailoring corporate governance by SA exists. One of the main reasons is that it facilitates unequal treatment of shareholders in the company and

porate Law, A Comparative and Functional Approach, Oxford, 2009, p. 167. For consideration of corporate opportunities doctrine in the wider context of the *self-dealing* transactions of directors see extensively in Braut Filipović, M.: *Položaj članova uprave dioničkog društva pri sklapanju ugovora u ime društva, ali s osobnim interesom u pravnom poslu*, Zbornik Pravnog fakulteta u Zagrebu, 62 (4) 2012.

[81] It should be noted that the study conducted by Rauterberg shows that the waiver of doctrine of opportunities occured mostly in articles of assotiation of the companies, which is a good practice as it condones that all shareholders at least had an opportunity to vote regarding such a provision of articles of association. See Rauterberg, G.: *The Separation of Voting and Control: The Role of Contract in Corporate Governance, op. cit.*, p. 1126.

[82] Fisch, J. E.: *Stealth Governance: Shareholder Agreements and Private Ordering*, Washington University Law Review, 99 2022.

[83] SA are mostly undisclosed in the practice. There is no requirement for the shareholders of closed companies to disclose such agreements, while public companies could, under certain conditions, depending on the applicable law, be obliged to publicly disclose SA or to have certain legal consequences. For example, if the parties concluded the SA they could be found that they act in concert, where under the takeover law, they would be obliged to pose takeover bid. For an overview for German law see in: Roth, M.: *Shareholders' Agreements in Listed Companies: Germany, op. cit.*

sacrifices transparency of governance of the company towards third persons.[84] The unequal position of the shareholders could stem from the separation of control and voting power as allocated by the corporate law, especially in cases when all shareholders do not conclude SA. In the extreme, decisions regarding the company could be made by shareholders *de facto* outside of the general meeting by only the selected shareholders who entered the SA. The author is of the opinion that further empirical studies should be conducted to reveal the actual position of shareholders and third parties in cases when SA exists parallel to public articles of association. If the analysis shows that there are possible concerns, it could serve as a starting point for reassessing the scope of the desirable influence of contract law instruments on the corporate governance of the companies by both scholars and state legislators.

5. CAN SHAREHOLDERS' AGREEMENTS AFFECT DIRECTORS' LIABILITY?

As previously stated, managers can be contracting parties of the SA, regardless of whether they are shareholders of the company. Some investors have an interest in including in the SA only a shareholder who participates in managing the company as well (which is often when venture and private equity funds enter the company).[85] By participating in SA, shareholders can take obligations to act in accordance with the SA. If the shareholder/manager participates in SA, author considers it should be clearly stated in the SA whether he/she presumes obligations as a shareholder or as a manager of the company.[86] Contractual freedom for shareholders contains fewer restrictions than for managers/directors of the company, so managers/directors must be careful in order to avoid any possible breach of duty of loyalty or of fiduciary duty towards the company.[87]

It is clear in both literature and practice that shareholders can, through SA, especially voting SA, directly affect the composition of the supervisory or

[84] See Fisch, J. E.: *Stealth Governance: Shareholder Agreements and Private Ordering, op. cit.*, p. 916.

[85] Chemla, G.; Ljungqvist, A.; Habib, M. A.: *An Analysis of Shareholder Agreements*, Journal of the European Economic Association, 5 (1) 2007, p. 94.

[86] Also Miliauskas, P.: *Company law aspects of shareholders' agreements in listed companies*, *op. cit.*, p. 185.

[87] A Canadian case clearly demonstrates this point. See Ringuet v. Bergeron, 1960 CanLII 67 (SCC), [1960] SCR 672. („The agreement did not tie the hands of the parties in their capacity as directors so as to contravene any of the provisions of the Quebec Companies Act." „The clause specifying unanimity in voting had no reference to director's meetings, but to shareholders' meetings.").

managing bodies of the company, depending on the legal form of the companies. If shareholders have the power to directly appoint and remove directors of the company, it could be argued that they hold the ultimate power over the management of the company.[88] So, if shareholders can, through SA contract to obtain higher control over the company, could directors use the SA to negotiate for a lower degree of liability? The author shall further discuss whether modifying the directors' liability through the SA is possible.

First, one must answer whether it is possible to modify directors' liability at all. National legislators should provide the answer. Generally speaking, it is considered that the US legislator is more flexible and that it provides fewer mandatory provisions in the corporate law than countries of the European Union.[89] On the level of the European Union, only some aspects of company law are harmonised and mostly only regarding the joint stock companies,[90] but most of these harmonisation rules, such as rules on capital, shareholders rights and minority protection, are considered mandatory.[91] Naturally, the ratio between mandatory and default rules in corporate law depends on the company's legal form. In joint-stock companies, the number of mandatory provisions is the highest,[92] while limited liability companies are known for their flexibility where dispositive norms prevail. However, the problem arises as it is not always clear which provisions of the corporate law are mandatory,[93] in which

[88] Power to appoint and remove directors could be regarded as more powerful tool than other legal constraints put on the directors, such as duty of loyalty towards the company, duty of care and other. See Enriques, L.; Hansmann, H.; Kraakman, R.: The Basic Governance Structure: The Interests of Shareholders as a Class, *op. cit.,* p. 79.

[89] See in Hopt, K. J.: *Directors' Duties and Shareholders' Rights in the European Union: Mandatory and/or Default Rules?, op. cit.*, p. 4. Just a reminder, from a contractarian view of the company, there should practically be no mandatory provisions in corporate law, which would naturally include the issue regarding the liability as well. See a discussion in Welch, E. P.; Saunders, R. S.: *Freedom and its limits in the Delaware General Corporation Law*, Delaware Journal of Corporate Law, 33 2008, p. 844.

[90] See in Petrović, S.; Jakšić, T.; Bilić, A.: IV. Pravo društava, in: Josipović, T. (ed): *Privatno pravo Europske unije - posebni dio*, Zagreb, 2022.

[91] See in Hopt, K. J.: *Directors' Duties and Shareholders' Rights in the European Union: Mandatory and/or Default Rules?, op. cit.*, p. 14.

[92] § 23 par. 5. of Aktiengesetz explicitely provides that any deviation from the provisions is possible only if that has been expressly permitted. The main reasons for this strictness are legal certainty, creditor protection and investors protection. For the argumentation in favour of retaining the mandatory character of most of provisions of joint-stock companies see Petrikowski, M.: *Satzungsstrenge Contra Gestaltungsfreiheit im Recht der „Deutschen" AG und SE*, Dissertation, Bielefeld, 2009.

[93] See Fisch, J. E.: *Stealth Governance: Shareholder Agreements and Private Ordering, op. cit.*, p. 923.

cases one must consult both theory and judicial practice in order to obtain an answer.

The liability of managers or directors towards shareholders and the company is one of the crucial issues of corporate governance,[94] regardless of the legal type of the company. For joint-stock companies and limited liability companies, German[95] and Croatian[96] legislators provide that the liability of managers and directors is a mandatory provision. Their liability cannot be altered by either articles of association or by contractual instruments.[97] In the study on directors' duties and liabilities in the countries of European Union, it has been reported that the liability framework for managers and directors is mandatory.[98] Lately, there have been some serious considerations about whether this strict approach to director's liability, where directors bear unlimited personal liability, should be more relaxed, and specifically, should the German law be amended in order to allow certain limitations of the directors' liability. The most repeated proposition is to extend the labour law principle to corporate managers and limit the amount of damages in cases in which the harm was caused by simple negligence.[99] Still, the German legislature regarding directors' personal liability remains unchanged.

On the other hand, US legislators took a different approach. It allows for certain limitations of the duty of care.[100] In particular, the most prominent example is always the Delaware Code, which from 1986 explicitly allows corporations to adopt a charter provision that limits or eliminates certain director liability

[94] Hopt, K. J.: *Unternehmenskontrolle (Corporate Governance),* Überlegungen *zu einem internationalen und interdisziplinären Thema*, Jahrbuch 2000 der Braunschweigischen Wissenschaftlichen Gesellschaft, Braunschweig, 2002, p. 172.

[95] Arden, J.: *Haftung der Geschäftsleiter und Aufsichtsratsmitglieder bei unklarer Rechtslage*, Tübingen, 2018, p. 9.

[96] See Barbić, J.: *Pravo društava, Društva kapitala, Dioničko društvo, op. cit.*, p. 832.

[97] For German law see Arden, J.: *Haftung der Geschäftsleiter und Aufsichtsratsmitglieder bei unklarer Rechtslage, op. cit.*, p. 9. For Croatian law see Barbić, J.: *Pravo društava, Društva kapitala, Dioničko društvo, op. cit.*, p. 832.

[98] Gerner-Beurle, C.; Paech, P.; Schuster, E. P.: *Study on directors' duties and liability, prepared for the European Commission for DG Market*, London, 2012, [https://ssrn.com/abstract=3886382], p. 172.

[99] See Wagner, G.: *Officers' and Directors' Liability Under German Law – A Potemkin Village, Theoretical Inquiries in Law*, 16 (1) 2015, p. 77; Mock, S.: Limitation of the Personal Liability of Directors in German Corporate Law in Jurčová, M.; Novotná, M. (ed.): *Damages as a Remedy in Private Law*, Prague, 2016.

[100] Hopt, K. J.: *Unternehmenskontrolle (Corporate Governance),* Überlegungen *zu einem internationalen und interdisziplinären Thema*, *op. cit.*, p. 173.

for monetary damages in duty-of-care claims.[101] Importantly, under the same provisions, directors cannot limit the liability stemming from their duty of loyalty towards the company and shareholders and for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law.[102] The primary reason for allowing such limitation was the prevention of the exodus of directors from company boards due to their fear of exposure to potential personal liability claims.[103] Although this provision is still in force, it gained some serious criticism, mainly that the deterrence role of duty of care can now be eliminated.[104] Thus, under many USA states, although there can be no universal elimination of directors' liability, it is possible to limit directors' duty of care. However, in order for such limitation to be effective, it must be done in the articles of association of the company.[105] Thus, parties could not insert such a limitation through the SA.

Does the mandatory framework of managers' and directors' liability equal to the conclusion that managers cannot avoid their duty to compensate for damages? Although the liability framework is mostly mandatory, there are certain options available to alleviate the negative consequences of liability for managers/directors. Before the actual breach of the duty, managers/directors can contract D&O insurance policies and indemnification clauses which can protect them from duty to compensate any possible damages triggered by their liability.[106] Also, the obligation to provide compensation does not arise towards the company where the action taken is based on a lawful resolution adopted by the general meeting. After the breach of their duties towards the company,

[101] See § 102(b)(7) of Delaware Code. This is one of the most famous provisions of the Delaware Code. See in Fisch, J. E.: *Governance by Contract: The Implications for Corporate Bylaws*, California Law Review, 106 2018, p. 379. May other USA states followed this solution.

[102] See § 102(b)(7) of Delaware Code.

[103] Besides exodus of directors, at the time of amending the Delaware code, there was a crisis in the field of directors and officers insurance. See Lee, T. C.: *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and The Erosion of the Directors' Duty of Care*, University of Pennsylvania Law Review, 136 (1) 1987-1988, p. 256. Fear of personal liability claims was founded on serious amount of case law, where the liability of directors on the basis of their duty of care was frequently put forward. See DeMott, D. A.: *Limiting Directors' Liability, Washington University Law*, Quarterly, 66 (2) 1988.

[104] See Lee, T. C.: *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and The Erosion of the Directors' Duty of Care*, *op. cit.,* 280.

[105] See Fisch, J. E.: *Stealth Governance: Shareholder Agreements and Private Ordering*, *op. cit.,* p. 957.

[106] See Gomes Ramos, M. E.: *Corporate Indemnification: Experiences in USA and Developments in Germany, Italy and Portugal*, European Company and Financial Law Review, 14 (4) 2017.

shareholders can waive or agree to a settlement of the claim to compensation of managers/directors by the company under additional conditions.[107]

Indemnification clauses of the directors are of particular interest for the purpose of this article, as they are usually concluded between the directors and the company by contract outside of the articles of association. There is no obstacle that an indemnification clause be inserted in the SA where the manager/director is also a contracting party or to assure shareholders that the directors they elect will be indemnified under certain conditions.[108] Corporate indemnification usually covers cases when the liability is invoked towards the third person but not towards the company itself.[109] The indemnification of directors is not harmonised on the EU level, and most EU member states do not have specific provisions regarding the indemnification of a director.[110] It means that the director can contract for indemnification clauses, where limitation to such clauses would be general rules on exclusion and limitation of liability of applicable national law. Thus, directors could limit their personal exposure to claims by inserting an indemnification clause in the SA with the company, and such a provision could provide a *de facto* limitation of their liability under the conditions that it does not violate applicable national general rules on limitation of liability.

Finally, can the SA contain provisions which enter into a sphere of directors' governance of the company? In particular, is the director obliged to follow the instructions of the shareholders imposed on him/her by the SA? If he is doing so, can it affect its potential liability? From the German law perspective, followed by Croatian, the answer is positive for the limited liability company (GmbH), explaining that shareholders are generally allowed to instruct managers.[111] Thus, there is no obstacle that such an instruction originates from the

[107] Same solution adopted in Germany and Croatia. For Germany see § 93 par 4 of Aktiengesetz. For Croatia see article 252 par 4 of CCA. In that it is crucial that the general meeting adopts the decision prior the act in question. Otherwise, there can be no exculpation towards the company, but only possible waiver or settlement not before three years since the arisal of the claim. See Barbić, J.: *Pravo društava, Društva kapitala, Dioničko društvo, op. cit.*, p. 846.

[108] For such a practice see Corporation Law Committee of the Association of the Bar of the City of New York: *The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions*, The Business Lawyer, 65 (4) 2010, p. 1165.

[109] See Gomes Ramos, M. E.: *Corporate Indemnification: Experiences in USA and Developments in Germany, Italy and Portugal*, *op. cit.*, p. 748.

[110] See Gerner-Beurle, C.; Paech, P.; Schuster, E. P.: *Study on directors' duties and liability, prepared for the European Commission for DG Market, op. cit.*, p. 184.

[111] For German law see § 37 of the Gesetz betreffend die Gesellschaften mit beschränkter Haftung in der im Bundesgesetzblatt Teil III, Gliederungsnummer 4123-1, veröffentlichten bereinigten Fassung, das zuletzt durch Artikel 6 des Gesetzes vom 15. Juli 2022 (BGBl. I S. 1146) geändert worden is. For Croatian law see article 427 of the CCA.

shareholders through the SA.[112] The author considers that this should be interpreted in a way that shareholders should decisions reached in the SA confirm through corporate law mechanism, i.e. on the general meeting, especially in cases where not all shareholders are parties to the SA. After all, directors' liability stems from the corporate law provisions, and it should be differentiated from any possible contractual liability arising from potential breach of private ordering between directors and shareholders, such as the SA.

The answer is more complex for joint-stock companies, where managers should be more independent to maintain the balance between the company's organs.[113] As previously discussed, the duty of loyalty towards the company is a mandatory limitation to any possible influence on directors' decision-making process. Regardless, we can freely state that SA, especially the voting SA will probably influence the management of the company, at least indirectly, thus making the SA and the will of its contracting party a very powerful tool in tailoring the corporate governance of the company.

To conclude, shareholders can obtain a significant level of control over the management of the company through the SA. By ensuring the majority voting on general meeting resolutions, they can obtain the power to appoint and remove the director of the company, what is traditionally considered to be the ultimate power over the management of the company. Whether directors are obliged to follow the instructions of the shareholders imposed on him/her by the SA remains somewhat unclear, as it depends heavily on the applicable national law and legal type of the company. Further, even for German legislation, which is considered the strictest, there have been some calls for introducing possible limitations on directors' personal liability. If we consider that the influence from US legislators already softened the director's liability through the business judgment rule regarding the duty of care, then we can question whether, in the future, it could influence directors' liability regarding the possible introduction of *ex-ante* limitation of duty of care as well (as it was introduced by Delaware law). In that case, both scholars and practitioners should launch a debate and reassess the standing of private ordering in companies, such as SA, and its influence on corporate governance and possible limitations of directors' liability.

[112] See in Kulms, R. A.: *Shareholder's Freedom of Contract in Close Corporations – Shareholder Agreements in the USA and Germany, op. cit.*, p. 697.

[113] For Croatian law see Barbić, J.: *Pravo društava, Društva kapitala, Dioničko društvo, op. cit.*, p. 833.

6. CONCLUSION

Shareholders evidently want to arrange the corporate governance of the company differently than the default rules. Such a statement is not a novelty in corporate law. However, what is surprising is that the recent practice shows that shareholders modify these rules on a contractual basis outside of the corporate law instruments. The legal instrument often used to achieve that is the SA. The SA is generally not regulated. Thus, it offers shareholders flexibility in the choice of contractual parties, formation, and content, which is not the case with articles of association. What is important, shareholders can make almost all modifications of the default corporate law provisions by the SA. The biggest difference compared to the articles of association is to whom such modifications shall be binding, to all or only certain shareholders or other stakeholders. This leads to the conclusion that shareholders can obtain a significant level of control over the corporate governance of the company through the SA. In the author's opinion, a rethinking of corporate governance should more extensively include the private ordering, such as SA, of the shareholders. Otherwise, one cannot escape the conclusion that there are two parallel spheres of governing the company, where we confront and discuss the consequences of their convergence only sporadically, leaving important legal issues and consequences unclear. One of the goals of this article is to raise awareness of the importance of SA for the corporate governance of Croatian companies as well. To fully grasp the legal position and importance of SA, there should be more future research focusing on empirical data on the existence, content, and effectiveness of SA in both comparative and Croatian practice.

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THE PURPOSE OF A COMPANY

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ABSTRACT

In Croatian law, it is commonly accepted that the directors should manage the company in the interest of the company itself. It has, however, rarely been discussed what is exactly the purpose of a company. In comparative legal systems, the question of corporate purpose is, somewhat simplified, often portrayed as a conflict between shareholder and stakeholder approaches. According to the first approach, the company should be managed primarily in the interests of its shareholders, while according to the latter it should be managed in the interests of all its stakeholders.

This paper reaches the conclusion that, in Croatian law, the shareholder approach should be given priority. Shareholders establish a company and bear the direct risk of their investment. On the other hand, the stakeholders are a diffuse notion, with diverse interests and no corporate mechanisms at their disposal. This enables the company directors to exercise wide powers and bear little responsibility.

The shareholder approach, however, does not mean that the directors have to follow the wishes of the current shareholder majority. The shareholders' interests are the objective interests of all shareholders, including those who will become shareholders in the future. The corporate purpose is, thus, to increase their long-term financial benefit.

Such interpretation does not have to be at the expense of the stakeholders. They should be protected on two different levels. One is top-down protection, where public regulations force companies to take minimum measures in the public interest. The other is bottom-up feedback from conscientious customers who demand that the company's conduct satisfies certain criteria.

KEYWORDS: *company purpose, company interests, financial interests, corporate governance, shareholders, stakeholders, workers, takeover law*

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1. INTRODUCTION

One of the key issues of company law is the company's purpose. Unlike a natural person, which is free to pursue as many goals as he pleases, for a company it is essential to be organized behind a central purpose. It determines what is in the interest of the company and, thus, steers the directors, boards, and shareholders in the same direction.

In Croatian law, the importance of a purpose is evident already from the notion of a company[1]. A company is a legally recognized association of several persons, based on a contract, and directed towards a common purpose.[2]

However, in Croatian law, it is far from clear what is the company purpose. Although the Commercial Companies Act (hereinafter: CCA)[3] mentions the company purpose,[4] it does not provide a definition. It is also relatively rare that the articles of association state the overall purpose of the company, aside from listing the company activities.[5]

All the more so, it surprises me that the question of company purpose has been rarely analyzed in Croatian scholarly writing. Professor Jakša Barbić, who wrote more extensively on that subject, states that the purpose of a commercial company is to manage its enterprise.[6] Because of its commercial nature, a commercial company is usually, but not necessarily, oriented towards achieving profit.[7] However, the corporate governance of a joint stock company should take into account a wider net of stakeholders.[8] Thus, the directors have to pay heed to the interests of the shareholders, employees, and the general interests of society.[9] This reflects a worldwide debate that is, somewhat simplified, portrayed as a conflict between shareholder and stakeholder approaches.[10]

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1 Which, in a wider sense, encompasses not only companies with limited liability, but also partnerships.

2 Barbić, J.: *Pravo društava, Knjiga prva, Opći dio*, Zagreb, 2008, p. 133; High Commercial Court (hereinafter: VTS), Pž-4702/08-4 of 25 July 2012; VTS, Pž-2930/11-5 of 31 May 2011.

3 *Zakon o trgovačkim društvima*, NN No. 111/1993, 34/1999, 121/1999, 52/2000, 118/2003, 107/2007, 146/2008, 137/2009, 111/2012, 125/2011, 68/2013, 110/2015, 40/2019, 34/2022.

4 In Articles 227 (2), 420 (3) CCA.

5 Barbić, fn. 2, p. 150.

6 Barbić, fn. 2, p. 148, 150.

7 Barbić, fn. 2, p. 148; Barbić, J.: *Pravo društava, Knjiga druga, Društva kapitala, Svezak I., Dioničko društvo*, Zagreb, 2020, pp. 13-14.

8 Ibid., p. 753.

9 Barbić, fn. 7, p. 866.

10 To give a few examples, for US law, Bebchuk, L. A.; Tallarita, R.: *The Illusory Promise of*

According to the shareholder approach, the purpose of a company coincides with the financial interest of its shareholders. When managing the company, above all the directors have to endeavor to increase the company's profits and, thus, shareholder value.[11] According to the stakeholder approach, the purpose of a company reflects much broader interests, including those of the company's employees, creditors, suppliers, clients, local communities, economy, society, and the environment. When managing the company, the directors have to take into account all of those interests and find the right balance.[12] As long as the company stays sufficiently successful to avoid insolvency, the directors are free to forgo a part of the profit in exchange for other societal benefits. Especially in recent times, the stakeholder approach became intertwined with the ideas of corporate social responsibility (hereinafter: CSR), and environmental, social, and governance (hereinafter: ESG).[13]

Those two approaches will often lead to the same results since shareholders' and stakeholders' interests largely overlap. Stakeholders have an interest that the company's financially successful. Shareholders have an interest that the company and its products having a positive impact on the wider community and the environment.[14] However, that does not mean that the debate is entirely academic. Especially in borderline situations, the interests of different groups

Stakeholder Governance, Cornell Law Review, Volume 106 2020, pp. 91-176 and critical appraisal of that paper, e.g. Mayer, C.: *Shareholderism Versus Stakeholderism – a Misconceived Contradiction*, Cornell Law Review, Volume 106 2021, pp. 1859-1880; for UK law, Armour, J.; Deakin, S.; Konzelmann S. J., *Shareholder Primacy and the Trajectory of UK Corporate Governance*, British Journal of Industrial Relations, 41 (3) 2003, pp. 531-555; for German law, Fleischer, H. in: Fleischer, H. (ed.): *Handbuch des Vorstandsrechts*, München, 2006, § 1, paras. 26-33; Spindler, G. in: Goette, W.; Habersack, M.; Kalss, S. (ed.): *Münchener Kommentar zum Aktiengesetz*, München, 2019, § 76, paras. 64-115; Grigoleit, H. C. in: Grigoleit, H. C. (ed.): *Aktiengesetz*, München, 2020, § 76, paras. 19-30; for Swiss law, Von der Crone, H. C.; Beyeler, K.; Dédeyan, D.: *Stakeholder im Aktienrecht*, Zeitschrift für schweizerisches Recht, Vol. 122 2003, pp. 409-471; Daeniker, D.; Hertig, G.: Capitalist Stakeholders: Shareholder Stewardship in Switzerland, in: Katelouzou, D.; Puchniak, D. W. (eds.), *Global Shareholder Stewardship*, 2022, pp. 111-129.

[11] Brandt, F.; Georgiou, K.: *Shareholders vs Stakeholders Capitalism*, *Comparative Corporate Governance and Financial Regulation*, Paper 10, 2016, pp. 5-6.

[12] Ibid., pp. 6-8; Dörrwächter, J.: *Nachhaltigkeit und Gesellschaftsinteresse Zu den Pflichten des Vorstands im Zusammenhang mit ESG*, NZG, 2022, p. 1085.

[13] Cornell, B.; Shapiro, A. C.: *Corporate Stakeholders, Corporate Valuation and ESG*, European Financial Management, Volume 27 2021, pp. 196-207; Pollman, E.: Corporate Social Responsibility, ESG, and Compliance, in: van Rooij, B.; Sokol, D. D. (eds.): *The Cambridge Handbook of Compliance*, Cambridge, 2021, pp. 662-672; Dörrwächter, fn. 12, pp. 1083-1093.

[14] Bebchuk; Tallarita, fn. 10, pp. 108-109; Spindler, fn. 10, § 76. para. 73.

can contrast, even form a zero-sum game.[15] E.g., sometimes the only way for a company to increase its profits is by laying off part of its employees. Also, different groups can come into conflict over the question of change of control due to a company takeover.[16] The correct interpretation of the company's purpose is necessary to determine which of those interests should be given priority.

The prevalence of each approach depends on geographical and historical factors. Broadly speaking, the shareholder approach has been traditionally more dominant in the USA[17] and the UK[18]. On the other hand, the stakeholder model is more common in mainland Europe,[19] e.g. Germany[20] and Switzerland[21].

Irrespectively, the stakeholder approach became increasingly popular in the last couple of years on a global level. In 2019, CEOs of US major companies, associated with Business Roundtable, expressed a commitment to all their stakeholders, including customers, employees, suppliers, and communities.[22] World Economic Forum, in its Davos Manifesto 2020, stated that the purpose of a company is to "engage all its stakeholders in shared and sustained value creation".[23] Similarly, OECD published several Guidelines which promote stakeholder interests.[24]

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[15] Dobos, N.: *Shareholder Rights and Zero-Sum CSR: Strategies for Reconciliation*, in: Idowu, S. O. et. al. (eds.): *Corporate Social Responsibility and Governance*, 2015, pp. 255-267.; Spindler, fn. 10, § 76, para. 75.

[16] More on that issue in Section 4.

[17] Bebchuk; Tallarita, fn. 10, p. 103; Brandt; Georgiou, fn. 11, pp. 33-55

[18] Art. 172 Companies Act 2006 which arguably promotes so-called enlightened shareholder value approach; Armour; Deakin; Konzelmann, fn. 10, p. 531.; Grier, N.: *Enlightened shareholder value: did directors deliver?*, Juridical Review, 2014, pp. 95-111.

[19] For a historical development of the notion of company interest, primarily in German and French law, see Fleischer, H.: *Unternehmensinteresse und intérêt social: Schlüsselfiguren aktienrechtlichen Denkens in Deutschland und Frankreich*, ZGR, 2018, pp. 703-734.

[20] Spindler, fn. 10, § 76, paras. 64-80; Brandt; Georgiou, fn. 11, pp. 12-32. A number of scholars are, however, closer to shareholder approach, e.g. Grigoleit, fn. 10, § 76, paras. 19-30, Fleischer, fn. 10, *§ 1, paras. 27, 28, 30*.

[21] Daeniker; Hertig, fn. 10, pp. 117-119.

[22] Statement on the purpose of a corporation, of 19 August 2019, https://s3.amazonaws.com/brt.org/Business-RoundtableStatementonthePurposeofaCorporationwithSignatures.pdf accessed on 24/10/2022.

[23] Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution, https://www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution/#:~:text=The%20purpose%20of%20a%20company,communities%20and%20society%20at%20large accessed on 24/10/2022.

[24] See OECD Guidelines for Multinational Enterprises, 2011 updated edition, https://www.oecd.org/daf/inv/mne/48004323.pdf accessed on 24/10/2022; OECD Due Diligence Guidance

The EU is also active in that direction.[25] In 2014 it enacted the Non-Financial Reporting Directive (hereinafter: NFRD), which requires corporate sustainability reporting from certain large companies.[26] The EU intensified its engagement within the framework of the European Green Deal. The EU Commission adopted a proposal for a Corporate Sustainability Due Diligence Directive (hereinafter: CSDDD),[27] which imposes extensive due diligence obligations on certain large companies, with the aim of protecting the employees, other individuals, groups, communities, or entities. The EU Commission also adopted a proposal to amend NFRD with a new Corporate Sustainability Reporting Directive (hereinafter: CSRD).[28]

Taking all of that into account, it could be argued that the pendulum of the debate swung towards stakeholder primacy. This paper will, however, steer away from such sweeping statements. Considering that, despite globalization, companies are still creatures of national law, it will analyze the shareholder and stakeholder approach from the perspective of Croatian law. Foreign legal sources and experiences will be used only inasmuch as they shed some light on the Croatian companies. Whether and to which extent the conclusions can apply to other legal systems is open to the reader's interpretation.

Company purpose will be primarily anal from the perspective of joint stock companies, (*dioničko društvo, d.d.*). In other Croatian companies, the company members (shareholders, partners) either manage the company (Art. 78, 136 CCA) or are authorized to give binding instructions to the company management (Art. 422 (2) CCA). Consequently, the shareholders have an efficient mechanism to impose their interests.

The paper primarily uses standard scholarly methods that focus on legal texts and provisions. Those methods include textual interpretation, as well as sys-

on Responsible Business Conduct, 2018, http://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf accessed on 24/10/2022.

[25] Dörrwächter, fn. 12, p. 1088.

[26] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ L 330, 15.11.2014, p. 1–9.

[27] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and Amending Directive (EU) 2019/1937; COM/2022/71 final, 23 February 2022. On 30 November 2022 the Council of the EU adopted its negotiation position (general approach) on the Proposal for CSDDD, which amended a number of its provisions (https://data.consilium.europa.eu/doc/document/ST-15024-2022-REV-1/en/pdf accessed on 18/1/2023).

[28] Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, COM/2021/189 final, 21 April 2022.

temic, functional, and historic analysis. Besides legal methods, the paper also uses basic economic, political, and societal reasoning, which contextualizes legal provisions.

First, the paper contrasts the shareholder and stakeholder approach in Croatian company law (2). Second, the paper gives a more precise definition of shareholders' interests (3.). Third, the role of the company purpose is analyzed from the perspective of the takeover law (4). Finally, the conclusion summarizes the most important findings (5.).

2. SHAREHOLDER VS STAKEHOLDER APPROACH

The company purpose in Croatian law will be analyzed through the lens of shareholder and stakeholder approaches. The viability of these approaches will be examined through several key criteria – the notion of a company (2.1.), the distribution of corporate functions and powers (2.2.), the guiding principle for managing the company (2.3.), and the optimal allocation of risk and resources (2.4.).

2.1. THE NOTION OF A COMPANY

As already mentioned, a company is considered an association of several persons, who enter into a contract, to achieve a common purpose.[29] Those persons are called company members or, in capital companies, shareholders. In other words, a company is created by and for its shareholders.

A joint stock company also falls under that definition.[30] To be more specific, a joint stock company is defined as a commercial company in which shareholders participate in the share capital, which is divided into shares (Art. 159 (1) CCA). Thus, a joint stock company is created and upheld by its shareholders.[31] The definition does not mention other persons, not even the company directors, much less different stakeholders' constituencies or the society at large. Consequently, the definition of a company favors the shareholders' approach.[32]

A different conclusion also cannot be drawn from the fact that the statutory provisions governing a joint stock company are mostly of a mandatory nature (Art. 173 (4) CCA). Such mandatory nature is, among other things, necessary

[29] See fn. 2.

[30] Barbić, fn. 7, p. 6.

[31] Barbić, fn. 7, p. 7.

[32] For German law, Fleischer, fn. 10, *§ 1, para. 30.*

to protect the capital market, i.e., new shareholders, from the potentially surprising provisions of the articles of association.[33]

Moreover, it does not particularly matter that the Croatian company law, including the law on joint stock companies, is mostly inspired by German law,[34] which is mostly stakeholder oriented.[35] Probably the main reason for such orientation is the historical concept of the "enterprise in itself" (*Unternehmen an sich*).[36] Inspired by Walter Rathenau's influential booklet "On the Nature of Shares" (*Vom Aktienwesen*),[37] the enterprise was understood as an amalgamation of the capital, work, and the public good, which has its interest, separate from the interests of its shareholders.[38] Such understanding left its mark on the German Stock Companies of 1937 (*Aktiengesetz 1937*), which stated that the management board manages the company in the interests of the business (*Betrieb*), its followers (*Gefolgschaft*), the whole nation (*Volk*) and the realm (*Reich*). Although the current Stock Companies Act from 1965 does not contain similar wording, its drafters thought that the company is managed in the interests of the enterprise (*Unternehmen*), shareholders (*Aktionäre*), employees (*Arbeitnehmer*), and the public (*Allgemeinheit*).[39]

Croatian law does not share a similar conceptual background. The notion of an enterprise was (re)introduced only in the 1990s, after the fall of the socialist legal system.[40] Although the enterprise is described, somewhat similar to German law, as a unity of work and capital,[41] it is primarily considered an asset through which the company appears in the market.[42] Considering that, unlike a company, an enterprise does not have a legal personality and it cannot have a legally recognized interest of its own.[43]

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33 Barbić, fn. 7, p. 160.

34 Barbić, fn. 7, p. 174.

35 See fn. 20.

36 Fleischer, fn. 10, *§ 1, para. 22*.

37 Rathenau, W.: *Vom Aktienwesen*, Berlin, 1922.

38 For a detailed explanation, Riechers, A.: *Das »Unternehmen an sich«, Die Entwicklung eines Begriffes in der Aktienrechtsdiskussion des 20. Jahrhunderts*, Tübingen, 1996, *pass*. Similar understanding can be found in the Swiss law, Daeniker; Hertig, fn. 10, pp. 118.

39 Spindler, fn. 10, para. 64; Fleischer, fn. 10, *§ 1, para. 20*.

40 Barbić, fn. 2, p. 217-223.

41 Ibid., p. 226.

42 Ibid., pp. 232-234; VSRH, Revr 154/08-2 of 21 May 2008; VTS, Pž 5613/2015-4 of 4 June 2018; VTS, Pž 8331/08-3 of 19 January, 2009.

43 The idea of the interest of an enterprise is often criticised also in German literature (Spindler, fn. 10, para. 68, Fleischer, fn. 10, *§ 1, para. 25*).

Moreover, the EU instruments for the protection of stakeholders do not affect the purpose of Croatian companies. First, as stated by the Court of Justice of the EU in Daily Mail, companies are creatures of national law.[44] Second, the EU instruments usually do not address the company's purpose.[45] Even the most recent proposal for a Corporate Sustainability Due Diligence Directive (hereinafter: CSDDD)[46] primarily expands the company's compliance function. The companies covered by that proposal are required to implement a due diligence procedure, which ensures that they do not violate human rights and environmental conventions listed in the Annex.

In the proposal for CSDDD, there is one vague reference to company purpose. Art. 25 states that, when fulfilling their duty to act in the best interest of the company, the directors should take into account the consequences of their decision for sustainability matters. Even that, however, falls short of equating the best interests of the company with sustainability. It could equally be understood as an expression of the directors' duty to ensure the company's compliance with human rights and environmental standards.

In its recent negotiation position (general approach), the Council of the EU deleted the proposed Art. 25. The deletion was explained by the strong concerns expressed by Member States that it represents an inappropriate interference with national provisions regarding directors' duty of care and that it potentially undermines directors' duty to act in the best interest of the company.[47]

Furthermore, the EU references to sustainability are usually not sufficient to influence the company's purpose. E.g., Shareholder Rights Directive II mentions sustainability as a goal of the company's remuneration policy.[48] However, it talks about the "sustainability of the company" which is not contrary to the shareholder approach. It is no wonder that it was transposed in Croatian law under the term of "long-term development of the company"[49] (Art. 247.a (1) (1) CCA). Thus, it seems that, at least for the time being, the company's purpose is left exclusively to national company laws.

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[44] Judgement of 27 September 1988, Daily Mail and General Trust PLC, C-81/87, ECLI:EU:C:1988:456, para. 19.

[45] Differently suggests Mak, C.: *Corporate sustainability due diligence: More than ticking the boxes?*, Maastricht Journal of European and Comparative Law, Volume 22 2022, p. 303.

[46] See fn. 27.

[47] Para. 30 of the general approach, available at: https://data.consilium.europa.eu/doc/document/ST-15024-2022-REV-1/en/pdf accessed on 18/1/2023.

[48] Art. 9a (4, 6) of Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, p. 1–25.

[49] In Croatian, „*dugoročnom razvoju društva*".

A reference to company purpose also exists in the Corporate Governance Code, issued by Zagreb Stock Exchange and Croatian Financial Services Supervisory Agency (HANFA).[50] It states that a company should be accountable not only to its shareholders but also to its stakeholders and society as a whole.[51] Further, the Code provides that, when assessing the interests of the company, the directors should take into account the interests of employees, shareholders (including minority ones), and other stakeholders.[52]

The effect of those provisions is questionable.[53] The code of corporate governance is a non-mandatory instrument that can only elaborate on the issues not settled in the statute.[54] CCA only requires that the companies whose shares are traded on a regulated market issue a statement about which code of corporate governance they apply (Art. 272.p). The choice of the code falls upon the management board. By choosing the Corporate Governance Code, the management board cannot depart from the company's purpose as set by the statute and the articles of association. Only shareholders have the mandate to set and consequently change, the purpose of a company. Consequently, the Corporate Governance Code cannot change CCA mandatory provisions relating to the authority of the shareholders' general meeting and the management board.

2.2. THE DISTRIBUTION OF CORPORATE FUNCTIONS AND POWERS

It is a truism that a company interacts with many different persons and groups. Most of them, however, are not a part of the company's organization. In CCA they are covered by the umbrella term of "third persons".[55] Somewhat simplified, company law divides persons and entities into those who participate in corporate governance (corporate actors) and third persons.

This does not mean that third persons are somehow less worthy or irrelevant. One of the main principles of company law is that third persons' claims have priority over shareholders financial interests.[56] To be specific, the shareholders can receive dividends only if the value of the company's assets is higher than the sum of the company obligations and the share capital (Art. 220 (7, 8)

[50] Corporate Governance Code, 2019, https://www.hanfa.hr/media/4097/zse_kodeks_eng.pdf accessed on 26/10/2022.

[51] Introduction, The Purpose of the Code.

[52] Section 2, The Duties of Board Members, Principle D.

[53] For a similar conclusion in German law, Dörrwächter, fn. 12, pp. 1088-1089.

[54] Barbić, fn, 7, p. 758.

[55] E.g. Art. 35 (3), 37 (4), 41 (2), 48, 66, 90-96, 175, 234, 237, 337 CCA and many others.

[56] E.g. Barbić, fn. 7, p. 669.

CCA). Similarly, in liquidation or insolvency proceedings, shareholders can participate in the distribution of company assets only after creditors have been satisfied (Art. 380 CCA, Art. Insolvency Act[57]). The statutory provisions which protect third persons are mandatory, and they cannot be circumvented by the articles of association (Art. 173 (4) CCA). Moreover, third persons are protected by other areas of law, such as the obligations law, labor law, tax law, capital markets law, etc.

However, unlike corporate actors, third persons do not have a say on internal company issues. In other words, they do not hold any corporate functions or powers. Properly understood, they are protected from company actions precisely because they are outsiders without any influence over those actions.

In a joint stock company, the main corporate actors are company organs - the management board, the supervisory board, and the shareholders' (general) meeting.[58] Briefly, the general meeting appoints and removes the members of the supervisory board (Art. 244 CCA) and the supervisory board appoints and removes the members of the management board - directors (Art. 256 (1), Art. 259 (1) CCA). Thus, either directly or indirectly, the shareholders exercise an influence over both company boards.

At least in theory, the general meeting is not higher-ranking than the management or the supervisory board.[59] Each organ acts independently, pursuing the company's purpose within the strictly set statutory confines. The independence of the boards is supposed to be ensured by the personal independence of their members. The supervisory board can remove the directors only if there is an objectively important reason (Art. 244 (2) CCA). The general meeting can remove the members of the supervisory board only by a supermajority of 75% of votes (Art. 259 (1) CCA). Nevertheless, in practice, the board members will be deferential to the shareholders' majority.[60] Their term in office does not last more than 4 or 5 years (Art. 258, Art. 244 (1) CCA) and if they want to be reappointed, they have to be sensitive to shareholders' wishes. Even before the expiry of their term in office, the general meeting can refuse to grant them a discharge (Art. 244 (2), Art 276 CCA).

[57] *Stečajni zakon*, NN No. 71/2015, 104/2017, 36/2022.

[58] Instead of the management and supervisory board, a joint stock company with one-tier (monistic) corporate structure can have only one organ, the board of directors (*upravni odbor*). Since this is a significantly less common option in Croatia, it is not separately discussed in this paper. Nevertheless, most of the conclusion for the management and supervisory board can analogously apply to the board of directors.

[59] Barbić, fn. 7, pp. 914-915.

[60] After all, this is the reason why the provisions on the group of companies have to protect the daughter company from the influence of the mother company (Art. 496 (1) CCA).

Consequently, not only are the shareholders important corporate actors, but arguably they have the strongest bargaining power. They are not appointed, and they got their position through an investment of capital. They cannot be removed,[61] which leaves them free to transfer their shares whenever they see fit. Through the general meeting, they exercise their right to be informed, to discuss, and to vote on the most important company matters, e.g., the payment of dividends, the amendment of the articles of association, the increase and decrease of the share capital, mergers and liquidation (Art. 287, Art. 275 (1), Art. 516 CCA). In certain situations, shareholders can also act outside of the general meeting. E.g., a shareholder can bring a lawsuit to avoid the resolutions of the general meetings (Art. 362 CCA). The shareholders who reach a threshold of 5% of the share capital can initiate the convening of the general meeting (278 CCA) or the appointment of special auditors (Art. 298 (2) CCA).

On the other hand, no other stakeholder's constituency exercises any real influence on corporate governance. The lenders, suppliers, clients, and consumers are connected to the company only through civil law contracts. They cannot vote on company matters, appoint or remove board members. Local communities, society at large and the environment do not even have a direct legal relationship with the company. Naturally, they can be affected by company actions, but the company law is not the proper vehicle to mitigate those risks. E.g., the state can order a company to behave in a certain way, but this is an issue of compliance with public law and not of a company purpose.

The company employees deserve special attention. They are not traditionally considered corporate actors. After all, their rights and obligations arising out of an employment contract and not company law.[62] However, it is impossible to ignore that they constitute the backbone of a company organization. They usually work for the company on a daily basis, unlike distant shareholders who gather only once a year. When third persons enter company premises, they usually see and deal with the company employees. This is why the employees represent the company within the scope of their usual tasks (Art. 43 CCA). In addition, one member of the supervisory board is a representative of the employees (Art. 164 Labour Act, LA[63]). In companies with twenty or more employees, the employees participate in the decision-making concerning their financial and social rights through the worker's councils (Art. 140 LA).

From a broader perspective, the employees are, at best, marginal corporate actors. First, they can neither appoint nor remove any other board members.

[61] Barring exceptional constellations, such as the shareholder squeeze-out (300.f-300.k CCA).

[62] Barbić, fn. 7, p. 1145.

[63] *Zakon o radu*, NN No. 93/2014, 127/2017, 98/2019.

Even in a supervisory board with a minimal number of members – three – the employee's representative is a minority. In larger supervisory boards, with e.g., 17, 19 or 21 members, the influence of the employee's representative is marginal. Workers council advises the company only on the decisions which are important for the position of the employees (Art. 150 LA). They can veto a company decision in cases of employee dismissal (Art. 151 LA). Consequently, employees have a right of co-determination only over the issues which immediately affect their status and not on the company's purpose and corporate governance.[64]

Equally important, employees are already protected by the provisions of labor law.[65] As to their claims towards the company, the employees are creditors par excellence. Their salary is not tied to the company's profit. Instead, it is an expense that is subtracted from the revenue. Thus, it reduces the company's profits. The employees also have priority claims in the insolvency proceedings (Art. 138 (1), 155 (1) (2), 156 (1) (5) Insolvency Act).

To conclude, apart from the shareholders, the only stakeholders who exert any corporate powers are the employees. It is questionable whether these powers can reflect on the company's purpose. Even if they can,[66] this does not translate to the other stakeholders who are not similarly intertwined with the company organization.

2.3. THE GUIDING PRINCIPLE FOR MANAGING A COMPANY

The company's purpose is not an end in itself. Somewhat ironically, the company's purpose has to have its purpose. And its main purpose is to provide a benchmark for the behavior of all company actors, especially the management board.[67]

The principal duty of the management board and its directors is to manage the company with the care of a prudent businessperson (Art. 252 (1) CCA). If the directors breach their duty, they can be liable for damages (Art. 252 (1) CCA).[68] The statute, however, does not specify in which direction the management board should guide the company. It is accepted that such direction is set by the

[64] Barbić, fn. 7, p. 1146.

[65] Ibid., p. 1147.

[66] As suggested by Barbić, fn. 7, p. 1167.

[67] Thus, it is most often discussed in the context of the directors' duties (Barbić, fn. 7, pp. 865-866; for German law, Spindler, fn. 10, § 76, paras. 63-80; Grigoleit, fn. 10, § 76, para. 17-34.).

[68] For a more detailed discussion Barbić, fn. 7, pp. 974-1033.

company's purpose.[69] In other words, the management board and its directors should strive to achieve the company's purpose with a care of a prudent businessperson.

The same is true for the supervisory board. The members of the supervisory board have to act in the interest of the company (Art. 272 (1) CCA). Again, the interest of the company is to achieve the company's purpose. While acting in the company's interest, the members of the supervisory board should apply the care of a prudent businessperson (Art. 272 (1) CCA). Unlike the management board, the supervisory board does not manage the company but supervises the management. The duty of care and the company purpose is, however, the same.[70]

There are no statutory provisions that impose the duty of care on shareholders or the general meeting. However, among scholars and in the case of law it is accepted that shareholders owe a duty of loyalty to the company and each other.[71] The duty of loyalty arises out of the very notion of a company as an association between the persons who intend to achieve a common purpose. By accepting the articles of association, the shareholders impliedly undertook an obligation to contribute to the common purpose.[72] Naturally, the shareholders' duties are not nearly as comprehensive as those of the directors or the members of the management board. Shareholders do not have to attend the general meetings and they are in principle free to sell their shares to the highest bidder. However, apart from a situation involving the liquidation of the company, they should at the very least refrain from voting in a way that would go against the company's interest and purpose. Properly understood, the duty of loyalty is an important instrument in maintaining a balance between different shareholder factions and preventing the abuse of either majority or minority rights.[73]

Considering such a wide application, it is perhaps necessary that the company's purpose remains relatively general and abstract. Company organs and shareholders should be left with sufficient discretion to independently interpret the company's purpose in the context of their functions. On the other hand, the company's purpose should not be so vague that it becomes practically unidentifiable. After all, it is possible that the company or its creditors will sue the director for damages and the court will have to assess the director's actions.

[69] Ibid., p. 865.

[70] Ibid., p. 1137.

[71] Ibid., p. 591; VTS, Pž-5129/05-3 of 30 September 2005 which states that shareholders owe a loyalty to a joint stock company.

[72] Barbić, fn. 7, p. 591.

[73] Ibid., p. 592.

The company's purpose has to serve as a workable criterion against which it is possible to measure the director's behavior.[74]

In that respect, the shareholder approach is much more appropriate than the stakeholder approach.[75] It is true that there can be friction between different groups of shareholders, as well as between their short- and long-term interests.[76] Nevertheless, shareholders are an easily identifiable, relatively homogenous group with comparable financial interests. Generally, all shareholders want to increase the value of the underlying enterprise and maximize the company profits. Consequently, it is possible to determine whether the directors and the other corporate actors could have reasonably believed that they contributed to that goal.

On the other hand, stakeholder interests are notoriously difficult to define. The problem begins already with the notion of the stakeholder.[77] Apart from the shareholders themselves, there is a consensus that it includes company employees.[78] It should most probably encompass the company's contractual partners, such as the banks, the suppliers, and other creditors. It usually also includes the entire upstream and downstream chains, especially the consumers who use the company's products or services.[79] It can also encompass the whole society,[80] whether on a local, national or global level, as well as the environment. In other words, a stakeholder can be everyone who is, either directly or indirectly, affected by the company's actions.

If such a wide definition is accepted, the next question is how to reconcile all those diverse interests. Proponents of the stakeholder approach usually mention two main arguments. First, the company directors have discretion in managing the company, exemplified in the business judgment rule (Art.252 (1) CCA).[81] Second, the directors should balance those interests without giving priority to any single one of them.[82] However, none of these arguments are persuasive.

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[74] E.g. Ibid., p. 1138.

[75] For German law, Fleischer, fn. 10, *§ 1, para. 28*.

[76] For more details see Section 3.

[77] For US law similarly Bebchuk; Tallarita, fn. 10, p. 116.

[78] E.g. Corporate Governance Code, 2019, Section 2, The Duties of Board Members, Principle D; Barbić, fn. 7, p. 753.

[79] Similarly, Ibid., p. 753.

[80] Corporate Governance Code, 2019, Introduction, The Purpose of the Code.

[81] For US law Mayer, fn. 10, pp. 1863-1864; For Geman law Spindler, fn. 10, § 76. paras. 103, 112.

[82] Brandt; Georgiou, fn. 11, pp. 7, 11. For US law Bebchuk; Tallarita, fn. 10, pp. 114-115; Blair, M. M.; Stout, L. A.: *A Team Production Theory of Corporate Law*, Virginia Law Review, Volume 85 1999, pass.; For German law Dörrwächter, fn. 12, pp. 1084-105; Fleischer, fn. 10, *§ 1, paras. 19, 30*.

The discretion means that the directors have a wide margin of error when managing the company. Thus, the directors are not liable for the actions which eventually harm the company, as long as, at the moment when those actions were undertaken, it was reasonable to assume that they will be beneficial.[83] The discretion, however, does not say anything about the purpose that directors are supposed to achieve when they exercise their discretion. It is true that the boundary between those two notions is in practice often blurred. The directors who disregard the company's purpose might convince the court that the matter was within their discretion to ultimately realize such purpose. However, this is not the reason against, but the reason for defining the company's purpose as precisely as possible. Otherwise, there would practically be no criteria for the directors' liability, and they could indeed get away with almost anything.[84]

Furthermore, the popular idea of balancing different interests without prioritizing any of them, is, actually, meaningless. The very notion of balancing evokes an image of equally distributed weight, such as of balanced scales. However, weighing has a precise common denominator – mass, with an exact expression in grams, and kilograms. On the other hand, the interests of different stakeholder constituencies do not have a common denominator.[85] Even the very first step is vague. Should more weight be given to stakeholders who are closer to the company? In that case, the order would approximately be shareholders, employees, contractual partners, upstream and downstream business chains, local communities, a country or a nation, and, in the end, the whole planet. Or more weight should be given to those who have a greater need for the protections? E.g., if the directors are acutely aware of the environmental problems, should they primarily try to prevent pollution?

Perhaps an exaggerated example might be helpful. The directors of an extremely profitable company decide to allocate all of the company's surplus profit toward finding a cure for a severe disease. From the perspective of wider society, one could hardly find a fault. Few would prioritize shareholders' hefty dividends over saving millions of lives. However, what would happen if, universalizing such behavior, the directors of all companies begin to play the heroes? Shareholders would soon start to fear for their financial interests, which would discourage the investment. The national economy would most likely shrink, with far-reaching consequences, including for the investment in medical research. Even if other aspects are disregarded, it is difficult to say in which scenario it is more likely that the cure would be found.

[83] Barbić, fn. 7, p. 985-991.

[84] Similarly for German law Dörrwächter, fn. 12, pp. 1091-1092.

[85] For US law Bebchuk; Tallarita, fn. 10, p. 25.

As it can be seen, the problem exists even if directors are well-meaning, exemplary experts, thinking hard about what the optimal net outcome is. Making that kind of decision is not only about calculating the risks and predicting the future but also about values and policies. Should the directors prioritize shareholders who invested their money, the employees who put in their work, or the whole community? The directors have neither the abilities nor the shareholder's political mandate to make those choices.[86]

The problem is compounded if the directors have an unconscious bias or, even worse, if the unscrupulous directors collude with certain stakeholder constituencies at the expense of others. Barring explicit evidence of collusion, it would be very difficult to prove that the directors misused their "balancing" discretion. Consequently, the shareholder approach should be preferred as it provides clearer guidance for managing the company.

2.4. OPTIMAL ALLOCATION OF RISK AND RESOURCES

The shareholder approach is often explained in the terms of the allocation of risk.[87] Shareholders are the investors who bear the risk of their investment. If the company is not successful, they do not receive dividends and its shares lose value. Therefore, the shareholders are sometimes portrayed as principals and the directors as their agents.[88]

This is countered by the observation that other stakeholders also bear risk in relation to the company.[89] The most obvious examples are the employees who "invest" their work and time. If the company becomes bankrupt, the employees who lose their jobs might be affected more than the shareholders who lose only a fraction of their diversified portfolio.[90] Other stakeholders can also be affected. A bankruptcy of a large, structurally important company can cause a chain reaction, spill over to other companies and destabilize the entire economy. As a rule – the larger a company, the larger the risk for the whole society.

Although the stakeholder approach claims to address all of these concerns, the problem is, again, its vagueness. There is no doubt that, ideally, every stake-

[86] As famously put by Friedman, M.: *The Social Responsibility of Business is to Increase its Profits*, The New York Times Magazine, September 13, 1970.

[87] For German law, Spindler, fn. 10, § 76. para. 72.

[88] Brandt; Georgiou, fn. 11, p. 6.

[89] For US law Anjier, J. C.: *Anti-Takeover Statutes, Shareholders, Stakeholders and Risk*, Louisiana Law Review, Voume 51 1991, p. 606; Spindler, fn. 10, § 76, para. 76.

[90] For US law Anjier, fn. 89, p. 606.

holder constituency should be protected from the adverse effects caused by a company. However, not all stakeholders face the same type of risk. Abstractly speaking, for each stakeholder constituency it would be better if it was protected by a tailor-made regulation that takes into account its unique position. After all, there are already many public and private law instruments designed specifically to protect various stakeholders' interests, and, if needed, it is possible to introduce new ones.

To give one example, the risk borne by the shareholders differs from the risk borne by company creditors, including its employees.[91] The shareholders' financial interests are directly tied to the success of a company. If the company is not sufficiently profitable, the price of its shares will decrease. On the other hand, the company has to pay its creditors' claims in full, no matter whether it is profitable or not. Creditors will only be affected if the company cannot meet its obligations. Thus, while the shareholders bear the risk of company profitability, creditors "only" bear the risk of company solvency.[92] Even if the company becomes bankrupt, the creditors can hope to receive a part of their claims. In other words, the creditors are much more protected than the shareholders by provisions of contract law, insolvency law, and labor law.[93] There is no need to fit an additional layer of protection into an already overloaded notion of company purpose.

Moreover, focusing on shareholders' financial interests could ensure the optimal allocation of societal resources and, thus, benefit all stakeholders. To be specific, shareholders' financial interests nudge the company to pursue the most profitable activity. The most profitable activity is the one the customers are willing to pay for. And customers are willing to pay for the products and services which they need or want the most. In other words, since the market ensures the optimal allocation of resources, following its impulses should favor not only the company shareholders but the whole of society.

This should not be understood as an expression of free market fundamentalism. The markets need to be regulated to a certain degree which should be determined through the political process. However, the company's purpose is not an appropriate vehicle for such regulation.[94] The companies have neither the duty nor the ability to make a correct assessment of the global picture.

[91] For German law, Fleischer, fn. 10, *§ 1, para. 28*.

[92] Ibid.

[93] Ibid.

[94] For US law Bebchuk; Tallarita, fn. 10, p. 69-73.

In short, it seems that it is better to protect the stakeholders by two mechanisms, none of which includes the company's purpose. First of them is a top-down mechanism in which the state introduces regulations intended to protect potentially weaker groups and the environment. Such regulation is found e.g., in the provisions of labor law, insolvency law, and even company law, since it protects third persons. The company and its directors have to abide by these regulations in the course of the company's regulatory compliance.[95]

The other is a bottom-up mechanism that originates from conscientious customers. E.g., if the customers cease to buy environmentally harmful products, the shareholders' interests might require raising the environmental standards. The latter approach is often called the enlightened shareholder approach.[96] However, the change of the production method often comes with a price tag, which is finally borne by the customers. Not every company has to choose that strategy. Instead, it may opt to retain the existing production methods, which do not go above the mandatory environmental protection. In return, the company will be able to offer cheaper products, thus catering to a different market segment. Not only that, similarly to natural persons, the companies should not be forced to realize their ethical maximum, but by offering affordable products they protect the interests of a different stakeholder constituency – less well-off people.

3. THE MEANING OF SHAREHOLDERS' INTERESTS

It remains to be seen how to properly define the shareholders' interests. That issue is best approached through four pairs of contrasted notions - financial vs non-financial shareholders' interests (3.1.), long-term vs short-term shareholders' interests (3.2.), the interests of a majority vs all shareholders (3.3.), and the interests of specific vs abstract shareholders (3.4.).

3.1. FINANCIAL VS NON-FINANCIAL SHAREHOLDERS' INTERESTS

People have many interests and shareholders are no different. These interests do not have to be necessarily financial.[97] However, when shareholders participate in a company, it has to be presumed that they want to realize their

[95] For German law Dörrwächter, fn. 12, pp. 1089-1090.

[96] For US law Bebchuk; Tallarita, fn. 10, p. 108; Mayer, fn. 10, p. 1860.; Jensen, M. C.: *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, European Financial Management, Volume 7, 2001, p. 298, for German law Fleischer, fn. 10, § 1, para. 31.

[97] Barbić, fn. 7, p. 13.

financial, and pecuniary interests. First, the joint stock company is a so-called commercial company (Art. 3 (3) CCA). A commercial company is always considered to be a "merchant", i.e., someone who acts in order to make a profit (Art. 3 (1, 6) CCA). Although commercial companies can also be established for other reasons, they are usually established for profit.[98] Second, because of the shareholders' limited liability, a company is a perfect vehicle for entrepreneurship. Therefore, in the absence of an indication to the contrary, the company's purpose covers only shareholders' financial interests.

The shareholders' financial interests should be understood broadly. They primarily consist of the shareholders' interest to receive dividends and to increase the market value of their shares. Sometimes, those two interests can conflict, e.g., when the payment of dividends would decrease the share value. If that is the case, the shareholders' overall interests depend on the net outcome, i.e., whether the decrease in the share value would cancel out the positive effects of the dividend. A regard is usually to be had to the likely effects on the long-term value of shares.[99]

The shareholders' financial interests generally coincide with the maximization of the company's profits and the value of the enterprise.[100] This should, however, not be equated with profit in the sense of the rules of accounting.[101] Shareholders have an interest in everything that increases the price of their shares. This includes the improvement of the company's future prospects, which cannot be fully expressed in the financial statements.

The articles of association can specify an additional or a different company purpose. That purpose can take into account shareholders' non-financial interests.[102] Those interests can directly benefit the stakeholders. This will often happen in the case of state-owned enterprises which perform a public service or a service of general (economic) interest. E.g., the articles of association could specify that the company's purpose is to ensure universal accessibility of a certain product or service.

98 Barbić, fn. 2, p. 148.

99 See Section, 3.2.

100 For German law, Fleischer, fn. 10, *§ 1, para. 26*.

101 For German law, Grigoleit, fn. 10, § 76, para. 26.

102 Barbić, fn. 7, pp. 13-14. For Geman law, Dörrwächter, fn. 12, p. 1090.

3.2. LONG-TERM VS SHORT-TERM SHAREHOLDERS' INTERESTS

One of the typical objections against the shareholder's approach is its alleged short-termism.[103] A usual counterargument is that the shareholders' interests should imply shareholders' long-term interests.[104] Properly understood, the temporal aspect of shareholders' interests depends on the period for which the company is established. The articles of association have to contain a provision on such a period (Art. 173 (3) (8) CCA). Although most companies are established with indefinite duration, their duration can also be limited to a certain event (e.g., the accomplishment of a project) or even with a fixed date.

If a company is established with an indefinite duration, the company purpose implies an indefinite gradual increase of shareholders' financial benefits. Although it is impossible to guarantee a such result, the directors should aspire towards that goal. Consequently, they have to forgo short-term profit if it would likely hinder long-term progress.[105]

One of the ways to ensure such long-term progress is to cultivate good relationships with stakeholders' constituencies. It is especially important to motivate employees and to create a loyal customer base. It is also useful to maintain a positive reputation and goodwill in a wider society. This can be achieved, among others, by caring about the environment and implementing sustainability policies and other ESG factors.[106] However, this is not an end in itself and the potential benefits should be carefully adjusted against the cost. The directors enjoy wide discretion, but they have to be able to provide a believable justification that a certain action had a reasonable chance to advance shareholders' financial interests.

Of course, the management board's choice of business strategy does not mean that the shareholders are not allowed to dispose of their shares, even if their primary aim is to enhance their own private short-term financial interests. A conclusion to the contrary would automatically lock shareholders in their given positions and thus directly contradict the fundamentals of both private and capital market law mechanisms.

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[103] For US law, Mitchell, L. E., *A Critical Look at Corporate Governance*, Vanderbilt Law Review, Volume 45 1992, pp. 1263-1318; Brandt; Georgiou, fn. 11, p. 58; For Geman law Fleischer, fn. 10, *§ 1, para. 27;* Dörrwächter, fn. 12, p. 1084.

[104] For Geman law, Spindler, fn. 10, §76, paras. 76-78; Dörrwächter, fn. 12, p. 184; for US law Babchuk; Tallarita, fn. 10, pp. 109-113; Brandt; Georgiou, fn. 11, p. 59.

[105] For German law, Grigoleit, fn. 10, § 76, para. 26.

[106] For German law, Dörrwächter, fn. 12, p. 1084.

3.3. MAJORITY VS ALL SHAREHOLDERS' INTERESTS

Shareholders express their will through the resolutions of the general meeting. The resolutions are usually brought by a simple majority of votes (Art. 190 CCA)[107] or, in some cases, by a supermajority of 75% of votes or the share capital.

Those resolutions, however, do not express shareholders' interests within the meaning of the company's purpose. The company's purpose was set by the statute and the articles of association at the time when the company was established. Thus, the company's purpose could be changed only by an amendment of the articles of association,[108] or even by the consent of all shareholders.[109]

Even the articles of association could not stipulate that the company is managed in the interests of only certain shareholders or the majority of shareholders. Such a provision would go against the mandatory principle of the equal position of shareholders (Art. 211 CCA),[110] and would, thus, be null and void.

The practical consequence is that the management board manages the company independently, at its responsibility (Art. 240 (1) CCA). In managing the company, it is not bound by the resolutions of the general meeting.[111] It should try to create value for all shareholders and not just accommodate the wishes of the shareholders' majority.[112] Equally, when voting in the general meeting, the shareholders should vote in the interest of the company, i.e., all shareholders.

[107] More votes for a resolution than against it Barbić, fn. 7, pp. 1371-1372.

[108] Barbić, fn. 2, p. 150, 152. The amendment of the articles of association requires a supermajority of three quarters of share capital and that the resolution is registered in the court register (Art. 301 (2), 303 (3) CCA).

[109] Better reasons speak for the opinion that the company purpose can be changed only with a consent of all shareholders. E.g. if the company purpose changes from profit to entirely non-profit, it alters the fundamental shareholders' expectations. This differs from some other structural changes decided by a supermajority, such as the resolution to liquidate the company or to merge it with another company. In those situations, the financial interests of shareholders are protected either by their participation in the remaining assets (Art. 380 CCA) or by receiving substitute shares and, if needed, an additional financial compensation (Art. 514, 532 CCA).

[110] Barbić, fn. 7, pp. 578-584; VTS, Pž-7385/05-3 of 13 May 2008.

[111] With certain exceptions, e.g. if the management board itself asks for the consent of the general meeting or when the management board is required by the statute to obtain such a consent (e.g. Art. 552 CCA).

[112] Barbić, fn. 7, p. 914.

3.4. SPECIFIC VS ABSTRACT SHAREHOLDERS' INTERESTS

This dichotomy partly overlaps with the dichotomy between the company's short-term and long-term interests and the one between the majority and all shareholders. Shareholders' interests concerning company purpose do not cover only shareholders who have shares at a specific moment in time, but also persons who will become shareholders in the future. More precisely, shareholders are treated as an abstract notion, irrespective of their personal characteristics and wishes.

This also means that the shareholder is treated as the same person even if the share changes hands. E.g., a current shareholder might want to receive a dividend before it sells its share. Vice versa, the acquiring shareholder might prefer that the dividend remains unpaid. However, when determining the interest of a company, they are seen as the same person. I.e., if the overall financial benefit to the abstract shareholder would be greater if the dividend is paid, the directors should propose the payment of the dividend. If, on the other hand, the benefit would be greater if the company retains its profit, the directors should act accordingly.[113] At least in the case of perfect competition, this should benefit everyone. Although the former shareholder might not get its dividend, it should be able to sell the share at a market price that would be higher than it would be if the dividend was paid.

Such understanding is especially important for the trading of shares in the capital market. Investors will feel comfortable investing in a company only if they can count that the company is managed in the objectively best interests of all shareholders. This is the principal reason why the management board manages the company independently from the instructions of the general meeting. Somewhat simplified, the management board protects abstract shareholders from specific shareholders. This is also the reason why the statutory provisions regulating joint stock companies are mostly mandatory.

In the following text, the purpose of the company will be analyzed by taking into account specific mechanisms pertaining to takeover law. An earlier analysis of Croatian company law will be used to demonstrate the inherent interconnection of company, takeover, and capital market law and their overall impact on the position of the management board of the target company.

[113] Similarly Barbić, fn. 7, p. 1564, when he mentions the criterion of commercial justification and commercial reasonability.

4. TAKEOVER LAW

Once analyzed from the perspective of takeover law, the somewhat elusive definition of a company's purpose takes on an additional layer, presenting the previously mentioned conflict between shareholders and stakeholders as a subtle issue of the inherent conflict between shareholders and the management board. This conflict, together with the interconnected issue of stakeholders' interests, is best shown in the example of the legislative process that led to the adoption of Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids (hereinafter: Takeover Directive).[114] As the Takeover Directive was transposed into Croatian law, the reasons that led to the adoption of specific European solutions are, at the very least, instructive for the national legislator. To that extent, the Croatian Act on the Takeover of Joint Stock Companies (hereinafter: Takeover Act)[115] will primarily be used to analyze the notion of company purpose within the context of takeover law. At the same time, however, the analysis will be based upon the inherent interconnectedness of takeover and company law, which indicates that the determination of a company's purpose, as defined by national law, does not substantially change once the joint stock company becomes subject to takeover.

Analysis firstly highlights characteristics pertinent to takeover law, most notably the economic background of the market for corporate control and the effect it has on the position of the management board of the target company (4.1.). After that, the primacy of shareholder decision-making is analyzed by reference to legal arguments put forward in the legislative process which preceded Takeover Directive (4.2.). Finally, the analysis briefly evaluates the implementation of European solutions in the Croatian takeover law, with special emphasis on the purpose of the target company (4.3.).

4.1. MARKET FOR CORPORATE CONTROL AND THE POSITION OF THE MANAGEMENT BOARD

Shareholders of the target company are at the central point of the takeover process. Conventional wisdom dictates that faced with a takeover offer and decision whether to sell their shares to the offeror, shareholders of the offeree company will be primarily guided by their short-term financial interests.[116] As

[114] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ L 142, 30.4.2004, p. 12-23.

[115] *Zakon o preuzimanju dioničkih društava*, NN No. 109/2007, 36/2009, 108/2012, 90/2013, 99/2013, 148/2013.

[116] See Sections 3.1. and 3.2.

previously mentioned, shareholders are generally free to sell their shares.[117] After all, the offer is addressed directly to them and the mechanics of the takeover process largely lies on the premise that the price offered for the shares will be above the market one, as the offeror will try to provide an incentive in the form of a premium to the current market price.[118] Since shareholders are the main risk bearers[119] and have the legal title to shares, they are fully entitled to decide whether, and under what conditions, to dispose of them. Consequently, any interference with the takeover process (especially on behalf of the management board, trying to frustrate the offer by means of defensive measures) may weaken their position, ultimately robbing them of the possibility to dispose of shares in the manner they originally anticipated. Translated to the field of company law, this advances the argument that shareholders, deciding in the general meeting, should be primarily authorized to decide whether the takeover offer will be accepted or, alternatively, frustrated by means of defensive tactics.

The position of the management board of the target company seems to be somewhat different. Although it does not take away from directors' standard corporate fiduciary duties,[120] it has been repeatedly suggested that the takeover process may have serious and direct consequences in respect of their immediate behavior. More specifically, legal theory, with its origins in the field of law and economics, makes a persuasive link between corporate takeovers and agency costs by focusing on the market for corporate control and perceived economic values that are to be expected as the result of a successful takeover. Best explained in the words of its founder and one of its most prominent advocates, Professor Manne, "a fundamental premise underlying the market for corporate control is the existence of a high positive correlation between corporate managerial efficiency and the market price of shares of that company".[121] In other words, the fact that the company is inadequately managed inevitably

[117] See Sections 2.2. and 2.3.

[118] For factors that go into the quantification of premium, as well as an extensive analysis relating to premiums in European takeover law, McCahery, J. A.; Renneboog, L.; Ritter, P.; Haller, S.: *The Economics of the Proposed European Takeover Directive*, CEPS Research Report in Finance and Banking, No. 32 2003, pp. 25-42.

[119] See Section 2.4.

[120] See Section 2.3.

[121] Manne, H. G.: *Mergers and the Market for Corporate Control*, Journal of Political Economy, Vol. 73, No. 2 1965, pp. 112, 113. Professor Manne concludes that "the lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe that they can manage the company more efficiently". For the sake of clarity, when discussing the issues relating to take over activities, he refers to three distinct mechanisms: proxy fights, direct purchase of shares, and the merger.

reflects on the price of its shares, which in turn makes that company a potential takeover target.[122] To that extent, the acquirer will have the incentive to change the management once it takes over the control of the company, as it will look to make a profit on subsequent appreciation of shares' value (which is expected to take place once the acquired company is managed more efficiently). The next step pertinent to this line of reasoning is that directors of the target company will have a strong motive to oppose the takeover and, if possible, fight against the change of corporate control by employing various defensive measures to disrupt the offer. It follows that those managerial decisions would not necessarily be driven by shareholders' interests, which then by implication means that they would also not be in line with the company's purpose. It is precisely these premises that form the basis of one of the most controversial issues in takeover law – the issue of whether the management board should remain neutral throughout the takeover process. Indeed, if the underlying purpose of a takeover is to create additional value by curing managerial shirking and consequently displacing inefficient directors, then (as a policy argument) one can convincingly argue in favor of the board neutrality rule.[123] At the very least, such a position would be in line with the above-outlined arguments in favor of shareholder decision-making, positioning the general meeting as the instance which has the primary say regarding the employment of defensive measures and consequent acceptance or rejection of a takeover offer.

However, if the application of the board neutrality rule ultimately depends on identifying who gets to decide on defensive measures (shareholders in the general meeting or the management board), it is only appropriate to further explore how and to what extent either of these options influences the shareholder v. stakeholder dilemma which, as previously explained, lies at the heart of the ongoing discussion relating to the purpose of the company.

Before exploring the specific European solutions introduced by the Takeover Directive, it must however be noted that both the problem and perceived solution(s), to a certain extent, rest on a presumption that the authority to decide on defensive measures somehow directly influences the ultimate position of stakeholders. Or to be more specific, the problem is often portrayed as a two-dimen-

[122] Bainbridge, S. M.: *Mergers and Acquisitions*, Foundation Press, 2021, pp. 43-46; Easterbrook, F. H.; Fischel, D. R.: *The Economic Structure of Corporate Law*, First Harvard University Press, 1996, pp. 171-174; Mukwiri, J.: *The End of History for the Board Neutrality Rule in the EU*, 21 European Business Organization Law Review 2020, pp. 262-266.

[123] Board neutrality rule (sometimes also referred as the non-frustration rule) provides that the management board of the target company must remain neutral during the course of the offer and, unless given prior authorisation by the general meeting, restrain from taking any actions which may end in offer's frustration, thus enabling the shareholders to decide on its merits.

sional scenario in which the management board, once given the authority to decide on defensive measures, will almost inevitably do so by considering the "broader" purpose of the company, which then automatically includes protection of various stakeholders' interests (even if the managerial decision goes to the detriment of financial interests of shareholders).

Namely, the popular criticism of the model where the shareholders' general meeting has the authority to decide on whether the company should oppose a takeover argues that shareholders' motives are primarily financial. In other words, shareholders give precedence to their short-term financial interests, effectively foregoing long-term benefits that successful resistance to takeover may have for the company. In this scenario, the management board is, as a rule, in a better position to comprehensively analyze the benefits and drawbacks of the potential takeover. That is to say, the management board's decision will consider circumstances that shareholders, eager to sell their shares with the premium, will simply not deem relevant. The inherent danger is that, after the successful takeover, the new majority shareholder will look to maximize its profit with no, or very little, concern for stakeholders (primarily employees of the target company).

However, proper analysis of the argument shows that it rests upon an unsubstantiated premise that the purpose of the company, presumably followed by the management board when deciding on defensive measures, must favor stakeholders' interests by automatically making them part of the managerial decision-making process (up to and including the scenario where decisions are possibly taken to the detriment of shareholders' financial benefits). In other words, for this line of reasoning to work – one must embrace the idea that the company is primarily managed in the interest of its stakeholders, i.e. employees, creditors, customers, society at large, etc.[124] The argument thus does nothing in terms of solving the shareholder v. stakeholder dilemma, but only reinforces the above-outlined views advanced by one part of legal theory which argues against the shareholders (and in favor of stakeholders) model. In addition, it ignores convincing economic arguments specific to the position of the management board in takeovers. Namely, it does not address the inherent conflict between shareholders and the management board and ignores that members of the management board may have a motive to actively oppose the takeover on account of their interest to remain part of the company's management. Consequently, the argument does not only assume that the purpose of the company reflects broader stakeholders' interests but at the same time uncritically assumes that members of the management board will not have

[124] For summary of legal theories in support of such a proposition, see: Mukwiri, fn. 122, p. 263, 264.

self-serving interests to oppose takeovers. Unless one tries to argue that the takeover process somehow automatically changes the purpose of the target company (the view which should be rejected *a limine*, as it makes the purpose of the company dependent on the actions of specific shareholder(s), or even worse, third party looking to become majority shareholder), it must be defined within the constraints of national company law. As for the position of the management board of the target company, the text will show that its motives were rightfully addressed throughout the process of drafting the Takeover Directive, indirectly confirming previously analyzed elements pertaining to the purpose of the company.

4.2. PRIMACY OF SHAREHOLDER DECISION MAKING

The primacy of shareholder decision-making, and its rightful role within the context of takeover law, will be analyzed by considering the legislative history of the Takeover Directive (4.2.1.), with special emphasis being given to the Report of the High-Level Group of Company Law Experts (4.2.2.). After analyzing legal arguments voiced during the drafting process, the text outlines specific solutions of the Takeover Directive (4.2.3.).

4.2.1. LEGISLATIVE HISTORY AND MAIN OBSTACLES ON THE ROAD TO HARMONIZATION

In the laborious course of making the Takeover Directive (dating back to 1989 and its first proposal)[125], the board neutrality rule represented one of the main legislative challenges. At the core of the problem were differences between common and civil law legal traditions, accentuated by the fact that the first draft of the Directive followed the blueprint set forth by the London City Code on Takeover and Mergers which contained a set of rules and principles followed in one of the most active capital markets in EU at that time. Not surprisingly, Commission's 1989 draft (officially titled *Proposal for a Thirteenth Council Directive on Company Law concerning takeover and other general bids*)[126] recognized shareholders' primacy by expressly providing in its Preamble that, when joint stock companies are the subject of a takeover or other

[125] For legislative history of the Takeover Directive, see: Edwards, V.: *The Directive on Takeover Bids – Not Worth the Paper It's Written On?*, ECFR, Vol. 1, Issue No. 4 2004, pp. 418-431; Knudsen J. S.: *Is the Single European Market and Illusion? Obstacles to Reform of EU Takeover Regulation*, European Law Journal, Vol. 11, No. 4 2005, pp. 509-514.

[126] Proposal for a Thirteenth Council Directive on Company Law concerning takeover and other general bids, [1989] OJ C64/8; COM (88) 823 final.

general bid, *it is necessary to protect the interests of their shareholders*.[127] In addition, it opted for a solution which, in anticipation of possible hostility towards the takeover offer, provided that the management board must remain neutral unless given prior general meetings' authorization. To that extent, then Art. 8 (*Restriction of the powers of the board of the offeree company*) stated that after receiving the information relating to the offer and until the expiry of the period for accepting the bid, *the board of the offeree company shall not, without the authorization of the general meeting of shareholders, decide: (a) to issue securities carrying voting rights or which may be converted into such securities; (b) to engage in transactions which do not have the character of current operations concluded under normal conditions unless the competent supervisory authority has authorized them, giving its reasons for such authorization*.

Although it is quite clear that, when it comes to activities that may impede the offer, the proposed board neutrality rule gave precedence to the authority of the general meeting (the principle which will, although in a changed form, survive future textual iterations), the draft proposal also addressed the issue of stakeholders, namely employees of the target company. Specifically, the Preamble noted the obligation to inform, stating that, *taking into account the social policy of the Community, it is necessary that representatives of the employees of the offeree company be informed concerning the bid and that they should receive all the documents concerning that bid*. Consequently, the draft proposal provided for the offeror's obligation to draw up an offer document in respect of the offer stating, among other things, *the intentions of the offeror, explicitly expressed, regarding the continuation of the business of the offeree company, including the use of its assets, the composition of its board and its employees*,[128] and for an obligation on behalf of the board of the offeree company to communicate to its workers' representatives offer documents and other appropriate information.[129] Although the Parliament amended and approved the proposal, it was met with general disapproval. Among other things, provisions aimed at protecting employees' rights caused disagreements between Members States.[130]

[127] Preamble of the 1989 Proposal for a Thirteenth Council Directive on Company Law concerning takeover and other general bids.

[128] Art. 10 (1) (l) of the 1989 Proposal for a Thirteenth Council Directive on Company Law concerning takeover and other general bids.

[129] Art. 19 of the 1989 Proposal for a Thirteenth Council Directive on Company Law concerning takeover and other general bids.

[130] For amendments to the first draft and points of discord, Edwards, fn. 125, pp. 419, 420.

In its second 1996 draft proposal,[131] Commission tried to address several issues, primarily by realigning the text so that it would provide a workable framework and enable Member States to implement solutions characteristic to their legal systems.[132] Although the proposal, among its general principles, expressly stated that *the board of an offeree company is to act in the interests of the company as a whole*,[133] it did not substantially change the impact of the board neutrality rule. Quite to the contrary, it reaffirmed shareholders' position by stating that the management board of the offeree company must have a general meeting's prior authorization relating to any actions *which may result in the frustration of the offer, and notably from the issuing of shares which may result in a lasting impediment to the offeror to obtain control over the offeree company*.[134] However, Commission was careful to remove from the proposal's Preamble any mention of employees. Also, it limited their role by merely reiterating that the Member States will ensure that the offeror draws up and make public an offer document containing the information necessary to enable the addressees of the offer to reach a properly informed decision on the offer and that such a document must, among other things, state *the offeror's intentions concerning the future business and undertakings of the offeree company, its employees and its management*.[135] However, surprisingly enough, the issue of stakeholders was again put in the focus only a year later by the way of Parliament's amendments which clearly indicated that the future legislation is to encompass stakeholder protection.[136] In addition to bringing the issue back within

[131] Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids, [1996] OJ C 162/5; COM (95) 655.

[132] For criticism of the second 1996 proposal on behalf of UK, Netherlands, Germany, and Sweden; Edwards, fn. 125, p. 421, 422, including detailed references the author quotes.

[133] Art. 5 (1) (c) (*General principles*) of the 1996 Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids.

[134] Art. 8 (*Obligations of the board of the offeree company*) of the 1996 Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids underwent modifications inasmuch as it grouped board's obligations. Remodelled provision stated: "Member States shall ensure that rules are in force requiring that: (a) after receiving the information concerning the bid and until the result of the bid is made public, the board of the offeree company should abstain from any action which may result in the frustration of the offer, and notably from the issuing of shares which may result in a lasting impediment to the offeror to obtain control over the offeree company, unless it has the prior authorization of the general meeting of the shareholders given for this purpose; (b) the board of the offeree company shall draw up and make public a document setting out its opinion on the bid together with the reasons on which it is based.".

[135] Art. 6 (2) of the 1996 Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids.

[136] 1997 Parliament's amendments to the Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids, [1997] OJ C 222/20.

the Preamble,[137] Parliament proposed an amendment to the general principles. The board of an offeree company was still to act in the interests of the company as a whole, but this time also *included safeguarding jobs*.[138] In addition, Parliament reinstated the obligation of the board of the offeree company to inform the representatives of its employees or, where there are no representatives, employees themselves and to communicate the offer document.[139] Also, the offer document, drawn by the offeror to enable *the addressees of the bid to reach a properly informed decision on the bid*, among other things had to state *the offeror's intentions about the future business and undertakings of the offeree company, its employees and its management including any changes to the terms and conditions of employment and any envisaged dismissals*.[140] In a comparable manner, an obligation to disclose all information or documents (required in order to ensure that they are both readily and promptly available to the addressees of the offer) was amended to include the *representatives of the employees of the offeree company or, where there are no representatives, the employees themselves*.[141] Lastly, the Parliament amended the provision concerning the obligation of the management board of the offeree company to draw up and make public a document setting out its opinion on the bid together with the reasons on which it is based. The new provision provided that before finalizing this document *the board shall consult with representatives of the employees or, where there are no representatives, the employees themselves*.[142] Needless to say, amendments relating to the position of employees were regarded as particularly controversial.[143]

[137] Amendment 2 to Recital 9 of the 1997 Parliament's amendments to the Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids.

[138] Amendment 11 to Article 5 (1) (c) of the 1997 Parliament's amendments to the Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids.

[139] Amendment 14 to Article 6 (1) and Amendment 15 to Article 6 (2) of the 1997 Parliament's amendments to the Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids.

[140] Amendment 16 to Article 6 (3), eight indent of the 1997 Parliament's amendments to the Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids.

[141] Amendment 19 to Article 7 (2) of the 1997 Parliament's amendments to the Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids.

[142] Amendment 21 to Article 8 (b) of the 1997 Parliament's amendments to the Proposal for a 13th European Parliament and Council Directive on company law concerning takeover bids.

[143] For additional amendments to the role of employees made on behalf of Mr. Monti, Internal market Commissioner, and in particular his intervention to expand on the general principle requiring target boards to act in the interests of the company in a way which would expressly include the interests of employment, Edwards, fn. 125, p. 423.

After a substantial political compromise, a common position was adopted and the text was sent again to the Parliament.[144] In its second reading, Parliament once more proposed amendments, this time relating to both the board neutrality rule and the position of stakeholders. On German initiative, and with the presumed aim to ensure the level playing field with US takeover legislation, amendment proposed radical changes and opened the door for the management board to take defensive measures without prior authorization from shareholders.[145] And in line with German civil law tradition, it also gave stronger position to stakeholders by providing that the board, now free from the strict neutrality obligation, must (while considering the offer) consider future job availability and obtain employees' agreement prior to the actual acceptance of the offer.[146]

Gravity of the proposed amendments was at once recognized by both the Commission and the Member States. It was clear that the possibility that the board may unilaterally apply defensive measures without prior consultation with shareholders of the target company was unacceptable and would not find its way into the final text of the Directive.[147] Initial compromise which was agreed upon largely served the purpose of keeping the legislative process alive, with the rule on board neutrality remaining unchanged (but with an added option for Member States to postpone its application) and the right of employees to be informed about the effect the offer may have on jobs within the target company.[148] Nevertheless, the fact that the text ultimately failed to obtain a simple majority in the Parliament was a clear (if not ominous) reminder that individual Member States were still far from being ready to fully accept the ramifications of harmonized rules pertaining to takeover. Apart from accentuating the need to have rules which would consider specifics of US takeover regulation, the Parliament expressly noted that its rejection was motivated by the fact that the final text did not provide adequate answers relating to the position of shareholders and their authority to approve the employment of effective defensive measures (most notably, poison pills), which in turn led to the failure

[144] Ibid., pp. 424, 425.

[145] It has been suggested that legislative amendments were sponsored by German representatives in the wake of Germany's first hostile takeover, when UK Vodafone took over German Mannesmann, Ibid., p. 425.

[146] Legislative history suggests that German delegates were under intense pressure from both industry and union representatives, Ibid., pp. 425-427.

[147] For more details on the position of German delegation, Ibid., p. 426.

[148] Member states could postpose application of the board neutrality rule for maximum of one year after the deadline for its implementation, Ibid., p. 426.

to create a level playing field for target companies in the European market.[149] In addition, it stressed the importance of obtaining a future agreement on rules protecting the employees of the target company in a satisfactory manner.[150]

Despite the obvious legislative failure, the Commission continued with its efforts to work on a text of the future directive. The astonishing level of political compromise that followed, which ultimately led to the adoption of the Takeover Directive, goes well beyond the scope of the present paper. The effect of Article 12 Takeover Directive[151] and how optional arrangements undermined the proclaimed aim of integration did not go unnoticed.[152] However, the specifics of the legislative process that followed are indicative of the broader issues that are of utmost importance when analyzing the purpose of the company in European takeovers.

The focus of the following discussion considers the findings of the expert analysis prepared during the legislative process which, although largely undermined by the ensuing political compromise, outlined the key elements that future directive should have had to achieve proclaimed aims of integration. As will be seen from the following text, it not only gave precedence to the model of shareholder decision-making, but also reaffirmed that the interests of stakeholders do not justify specific legal solutions which would enable the management board of the target company to employ defensive measures to the detriment of shareholders' right to dispose of their shares.

4.2.2. REPORT OF THE HIGH-LEVEL GROUP OF COMPANY LAW EXPERTS

The decision to consult legal experts was made by the Commission before the last proposal failed to obtain Parliamentary approval, to obtain much needed

[149] Ibid., p. 427.

[150] Ibid.

[151] Art. 12 of the Takeover Directive provides for optional arrangements which give the Member States the right not to require companies to apply either the board neutrality rule from Art. 9 or breakthrough rule from Art. 11. Provision also provides for a reciprocity rule (Art. 12 (3)), which provides that Member States may, under the conditions determined by national law, exempt companies which apply board neutrality and breakthrough rules from applying them if they become the subject of an offer launched by a company which does not apply the same rules as they do, or by a company controlled, directly or indirectly, by the latter.

[152] Gatti, M.: *Optionality Arrangements and Reciprocity in the Takeover Directive*, 5 EBOR 2005, pp. 553-579; Gerner-Beuerle, C; Kershaw, D.; Solinas, M.: *Is the Board Neutrality Rule Trivial? Amnesia About Corporate Law in European Takeover Regulation*, LSE Working Papers 3 2011; Mukwiri, fn. 122, pp. 269-271.

feedback which could serve as a blueprint for future legislative activity. Despite obvious setbacks, Commission thus in 2001 formed a special group of legal experts, the High-Level Group of Company Law Experts, hereinafter: Expert Group) which one year later delivered its Report on issues related to takeover bids (hereinafter: the Report).[153] The fact that the political compromise ultimately led to the adoption of divergent solutions does not take away from the legitimacy of the legal analysis and arguments that Expert Group put forward in its Report.

Expert Group neither had a mandate to address the issue of the purpose of the company nor problems about the position (and potential protection) of stakeholders in takeovers. However, as its mandate did, among other things, encompassed the question of how to ensure the existence of a level playing field in the EU concerning the equal treatment of shareholders across Member States,[154] it was inevitable that both issues would have to be addressed in the Report itself.

Recognizing various obstacles standing in the way of the European integrated capital market, in particular those relating to different legal solutions that are in force in Member States,[155] Expert Group recognized the beneficial effects of mechanisms that facilitate takeover offers.[156] At the same time, however, it recognized the potentially detrimental conflict between the management board and shareholders of a target company, accentuating that takeover law plays an important role in terms of disciplining the management of listed companies.[157] It is along those lines that the principle of shareholder decision-making was recognized as one of two fundamental guiding principles which must be fol-

[153] Winter, J. et al.: The High Level Group of Company Law Experts: *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids*, Brussels, 10 January 2002.

[154] Expert Group has been asked to consider the following three issues: (1) how to ensure the existence of a level playing field in the European Union concerning the equal treatment of shareholders across Member States; (2) the definition of the notion of an "equitable price" to be paid to minority shareholders; and (2) the right for a majority shareholder to buy out minority shareholders ("squeeze-out right"). Ibid., p. 70.

[155] Expert Group detected a number of general and company specific barriers standing in the way of achieving the level playing field in European takeover arena, taking into account that its mandate primarily relates to and encompasses company related factors. Ibid., pp. 18-20 and 74.

[156] It however also recognized potential detrimental effects it may have for shareholders of the offeror, placing these kinds of concerns firmly within the realm of general corporate governance principles applying to the offeror and outside of the scope of the Takeover Directive. Ibid., p. 19.

[157] For obvious reasons, Expert Group found this problem to be especially troublesome in listed companies with dispersed ownership. Ibid.

lowed by European takeover law regulation.[158] Expert Group's legal analysis considered the importance of shareholders' primacy on a level that is more substantial than the one encountered in contemporary debates. Departing from vague ethical concepts, it considered essential characteristics of companies whose shares are traded on a stock exchange and the importance of functioning capital markets, concluding that adherence to the principle of shareholder decision-making is crucial for securities markets, the capacity of European industry to finance itself, satisfactory level of investors' protection and overall integration of European securities markets.[159] At the same time, while clearly stating that the management board should not be allowed to either frustrate or facilitate (preferred) takeover offers, Expert Group outlined the role that management should have in takeovers. Namely, it recognized its importance in terms of utilizing its knowledge about the company to advise shareholders, giving them an expert opinion regarding the viability of the offer, and even searching for an alternative offer(s) which would be more beneficial for shareholders.[160] The usual counterarguments (e.g., pressure which is exerted upon shareholders by a takeover offer, presumed management board's ability to raise a premium, and the need to protect stakeholders) were found to be substantially unclear and linked with unacceptable costs and risk.[161] Finally, Expert Group's firm view that the management board should not be allowed to pre-empt shareholders' decisions was underlined by its recognition that the management board indeed has an inherent conflict of interest which must be recognized and properly weighed because it otherwise may lead to a market failure.[162] As clearly stated in the Report, managers' "interest is in saving their jobs and reputation instead of maximizing the value of the company for shareholders"[163], while "their claims to represent the interests of shareholders or other stakeholders are likely to be tainted by self-interest"[164].

Expert Group specifically analyzed the application of the principle of shareholder decision-making in the context of takeovers.[165] By recognizing the particularities of pre-offer and post-offer defenses, it reaffirmed the requirement

[158] The other is the principle of proportionality between risk bearing and control. Ibid., p. 21.

[159] Ibid., p. 23.

[160] Ibid., p. 20.

[161] Ibid., p. 21.

[162] Ibid., p. 22.

[163] Ibid., p. 21.

[164] Ibid.

[165] For the analysis of general application of both the principle of shareholder decision making and principle of proportionality between risk bearing and control, with special emphasis on the duty to disclose, Ibid., pp. 23-26.

that the management board stays neutral after the takeover offer is announced, extending the such obligation to the implementation of decisions that were taken before the announcement of the offer but not yet implemented.[166] Consequently, the management board should obtain prior authorization of the general meeting of shareholders before taking any action, other than seeking alternative bids, which may result in the frustration of the bid and notably before the issuing of shares which may result in a lasting impediment to the offeror's acquiring control of the offeree company.[167] Regarding decisions that were taken before the announcement of the offer, not yet partly or completely implemented, the general meeting of shareholders should be required if such a decision was made outside of the normal course of the company's business and if its implementation may result in the frustration of the bid.[168] Lastly, the importance of shareholder decision-making was underlined in course of the evaluation whether the management board could take actions that would frustrate a takeover offer in situations when a shareholders' general meeting has authorized such actions in a period of eighteen months before the offer.[169] Expert Group rejected such a possibility, highlighting shareholders' need to assess information at the time the offer is made, including general market conditions and the performance of the target company.[170] Their decision on whether the management board may frustrate the takeover offer should take into account all relevant and current information prevalent at the time the offer is announced.[171]

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[166] Ibid., p. 27.

[167] The solution was retained in the final text of the Takeover Directive, see Art. 9 (2) Takeover Directive.

[168] The solution was retained in the final text of the Takeover Directive, see Art. 9 (3) Takeover Directive.

[169] This analysis referred to Art. 9 (2) of Takeover Directive Proposal, Annex 6 to the Report (*European Parliament and Council Directive on Company Law Concerning Takeover Bids: Joint Text Approved by the Conciliation Committee on 6 June 2001)*), Ibid., p. 80. It provided for the following solution: "Member States may allow the board of the offeree company to increase the share capital during the period for acceptance of the bid on the condition that prior authorization has been received from the general meeting of shareholders not earlier than 18 months before the beginning of the period of acceptance of the bid, with full recognition of the right of pre-emption of all shareholders as provided for in Article 29(1) of Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (OJ L 26, 30.1.1977, p. 1. Directive as last amended by the 1994 Act of Accession)".

[170] Winter, J. et al., ft. 153, pp. 27, 28.

[171] Consequently, Art. 9 (2) of Takeover Directive Proposal was not included in the final text of Takeover Directive. Compare with Art. 12 (5) Takeover Directive.

Turning back more specifically to the issue of stakeholders, it must be stated that the Expert Group recognized potential detrimental effects that may occur as a result of takeovers.[172] To that extent, it once again successfully bypassed the discussion concerning the viability of direct protection of stakeholders, underlining that the specific position of the management board in takeovers must be resolved precisely because the "discipline of management and reallocation of resources is in the long term in the best interests of all stakeholders, and society at large"[173]. Such indirect protection of stakeholders (in particular of employees of the target company, which are, as already explained, stakeholders who exert limited corporate powers)[174] undeniably recognized overarching company law setting in which management primarily acts as an agent of shareholders.[175] With its roots in economic theory, it served as a convincing background for Expert Group's conclusion that the interest of stakeholders „in itself does not justify defensive measures by the board which denies shareholders the opportunity to successfully tender their shares to a bidder who is willing to buy their shares"[176]. As the proposal, as well as the final text of the Takeover Directive, did provide for an obligation to inform the employees about the takeover process, Expert Group stated that further concerns for employees' interests should be addressed "by specific legislation providing for information and consultation of employees and their protection in the event of a bid leading to restructuring"[177], noting that many Member States already provided for these solutions in their legislation. Consequently, by stating that shareholders' decision to sell their shares "does not affect the legal protections afforded to employees and other stakeholders"[178], Expert Group reaffirmed previously suggested top-down mechanism as not only justified but also a viable method of stakeholders' protection. Finally, and in line with its previous view that the management board must nevertheless be tasked with specific obligations in takeovers,[179] Expert Group stressed its obligation to draw up and make public a document setting out its opinion on the offer, together with the reasons on which it is based, including its views on the effects of implementation on all the interests of the company, including employment, and on the offeror's strategic planning for the offeree company and its likely impact on jobs and locations as

[172] Winter, J. et al., ft. 153, p. 16.

[173] Ibid., p. 19.

[174] See Section 2.2.

[175] Winter, J. et al., ft. 153, p. 19.

[176] Ibid., p. 16.

[177] Ibid.

[178] Ibid., p. 17.

[179] See fn. 160.

set out in the offer document.[180] The board of the offeree company at the same time must communicate this opinion to the representatives of employees or, where there are no such representatives, to the employees themselves. Where a separate opinion of the employees' representatives on the effects of implementation on employment is made available to the board of the offeree company in sufficient time, it must be enclosed.[181] These rules were made to function in cohesion with the offeror's obligation to include in the offer document, among other things, its intentions with regard to the continuation of the business of the offeree company and, so far as affected by the offer, of the offeror company, and regarding the continued employment of their employees and their management, including any material change in the conditions of employment and in particular to the offeror's strategic planning for those companies and the likely impact on jobs and locations.[182]

Lastly, it should be stressed that Expert Group's legal analysis and proposed solutions must not be understood to represent a (political) compromise. After all, Expert Group was not tasked to propose a solution acceptable to (majority of) Member States, but rather because of the impeccable legal qualifications and expertise of its members.[183] In today's discourse where political agendas often aim to gain legitimacy by masking themselves as (more or less) convincing legal arguments, it seems useful to remind oneself that functional legal system primarily rests upon well thought norms, capable of producing desired legal effects once they are fully integrated in the existing legal framework. Ill-conceived and vague legal solutions that do neither follow nor complement legal architecture, which is already in place, will in the long run inevitably

[180] Pursuant to Article 6 (3) (h) of Takeover Directive Proposal, Annex 6 to the Report (*European Parliament and Council Directive on Company Law Concerning Takeover Bids: Joint Text Approved by the Conciliation Committee on 6 June 2001)*), Winter, J. et al., ft. 153, p. 80, which provided for information which the offeror must include in the offer document. The solution was retained in the final text of the Takeover Directive, see Art. 9 (5) and Art. 6 (3) (i) Takeover Directive.

[181] The solution was retained in the final text of the Takeover Directive, see Art. 9 (5) Takeover Directive.

[182] The solution was retained in the final text of the Takeover Directive, see Art. 6 (3) (i) Takeover Directive.

[183] Members of the Expert Group were: (1) chairman Jaap Winter, Professor at the Erasmus University of Rotterdam and legal advisor Unilever, Netherlands, (2) José Maria Garrido Garcia, Professor at the University of Castilla-La Mancha, Spain, (3) Klaus J. Hopt, Geschäftsführender Direktor Max Planck-Institut, Germany, (4) Jonathan Rickford, Consultant for the Department of Trade and Industry, United Kingdom, (5) Guido Rossi, former President of the Italian stock exchange supervisory body CONSOB, Italy, (6) Jan Christensen, Professor at the University of Copenhagen, Denmark, and (7) Joëlle Simon, Legal Affairs Director, French Business Confederation - MEDEF, France.

prove to be impractical and ultimately harmful. To the extent that legal system reflects politically mandated views, responsibility of legal experts is indeed enormous, as they must (at least in democratic societies) resist the pressure to give legal justification to solutions which do not enjoy political consensus in the first place.

4.2.3. TAKEOVER DIRECTIVE

Expert Group's views relating to shareholder decision-making are (with minor modifications) part of the Takeover Directive. Subject to previously mentioned optional arrangements,[184] the board neutrality rule provides that the management board needs to seek shareholders' general meeting authorization before any actions which may frustrate the offer.[185] Although Takeover Directive does sporadically use language which might be considered ambiguous, and thus subject to interpretation, there is little doubt that precedence is given to shareholder decision-making.[186] The diffuse notion of stakeholders is reduced to include only the employees of the target company, and their interests are protected using provisions relating to disclosure and the right to be informed.[187] It

[184] See fn. 151.

[185] Art. 9 Takeover Directive.

[186] Clarke, B. *The EU Takeovers Directive: a shareholder or stakeholder model?*, in: C. A. Williams, C. A.; Zumbansen, P. (eds,), *The Embedded Firm*, Cambridge University Press, 2011, p. 233, 246-248.

[187] More specifically, company's employees or, failing that, employees directly, must be appropriately informed of the terms of the offer by means of an offer document (Point 13 of the Preamble and Art. 6 (1) Takeover Directive), and offeror is thus tasked with making a public document setting out its reasoned opinion of the offer, including its views on the effects of implementation on all the company's interests, and specifically on employment (Point 17 of the Preamble and Art. 6 (2) Takeover Directive). Mentioned offer document must, among other things, state the offeror's intentions with regard to the future business of the offeree company and, in so far as it is affected by the offer, the offeror company and with regard to the safeguarding of the jobs of their employees and management, including any material change in the conditions of employment, and in particular the offeror's strategic plans for the two companies and the likely repercussions on employment and the locations of the companies' places of business (Art. 6 (3) (i) Takeover Directive). Likewise, for the purpose of implementing the Takeover Directive, Member States must ensure compliance with general principle according to which shareholders of target company must have sufficient time and information to enable them to reach a properly informed decision on the offer and, where it advises the holders of securities, the board of the target company must give its views on the effects of implementation of the offer on employment, conditions of employment and locations of the company's places of business (Art. 3 (1) (b) Takeover Directive). Management board of the offeree company must thus both draw up and make public a document setting out its opinion of the offer and the reasons on which it is based, including its views on the effects of its implementation on all the

is thus primarily along those lines that one must interpret both the Preamble and specific provisions of the Takeover Directive. Namely, when Preamble provides that Member States are tasked to coordinate certain safeguards *for the protection of the interests of members and others*, this does not relate to the purpose of the company (as defined by national law) but rather indicates the intended scope of Takeover Directive. Likewise, when Takeover Directive provides that one of its general principles is that the management board of the target company *must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid*, this formulation is not an open invitation to reformulate the purpose of the target company but rather an indication that precedence is given to shareholders decision making, with full recognition that stakeholders' interests must not be uncritically employed to shareholders' detriment. One can thus rightfully expect that the Court of Justice of the European Union, should it ever be asked to interpret whether relevant provisions of the Takeover Directive reflect on the company's purpose, will answer in the negative and uphold the stand that definition of company's purpose is defined by national company law of Member States.

If one considers that board neutrality was perceived to be the rule, and optional arrangements provided for possibility to opt-out of an exception, it follows that Takeover Directive was mainly drafted along the lines of the traditional model which envisages that the purpose of the company aligns with financial interests of its shareholders. However, since the notion of the purpose of the company was not directly addressed by Takeover Directive, but rather left to national law, the scope of the board's decision-making may differ according to the national corporate law setting.

It is obvious that national company law can define the purpose of the company in a manner that relates to various stakeholders' interests. Although, as out-

company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business as set out in the offer document in accordance with Article 6 (3) (i) Takeover directive (Art. 9 (5) Takeover Directive). The board of the offeree company must at the same time communicate that opinion to the representatives of its employees or, where there are no such representatives, to the employees themselves and where the board of the offeree company receives in good time a separate opinion from the representatives of its employees on the effects of the offer on employment, that opinion must be appended to the document (Art. 9 (5) Takeover Directive). National law is deemed applicable to issues of disclosure of information to and the consultation of representatives of the employees of the offeror and the offeree company, and the employees of the companies concerned, or their representatives, must be given an opportunity to state their views on foreseeable effects of the offer on employment (Point 23 of the Preamble and Art. 8 Takeover Directive.

lined above, such an approach raises legitimate concerns (primarily due to the vagueness of the notion of stakeholders and problems which are to be expected once stakeholders' interests are weighed against each other),[188] there should be no doubt that national legislators can opt for such an intervention. If that is the case, and if Member State takes advantage of Art. 12 Takeover Directive optional arrangements, it follows that the management board of the target company can decide on defensive actions without prior authorization of the shareholders' general meeting. However, while deciding on those actions, the management board of the target company would not only be free but also obliged, to decide by considering the purpose of the company, as defined by national company law. However, if Member State excludes the application of the board neutrality rule by virtue of optional arrangements in Art. 12 Takeover Directive, but still defines the company purpose in line with the shareholder model, the management board of the target company would not have the mandate to introduce defensive actions by considering interests of all stakeholders. The previously mentioned general principle according to which the management board "must act in the interests of the company as a whole" would then merely indicate the board's obligation to act by relying on company purpose, as that notion is defined by national company law. Lastly, one could also envision a situation in which national company law defines the purpose of the company in line with the shareholder model, but then directly provides for a stakeholder model in takeover law. Aside from the fact that previous analysis clearly showed that this was not the intended purpose of the Takeover Directive, national courts would have to use two different models as takeover law would appear to have a *lex specialis* effect. However, this option is not expected to be common as it is hard to imagine a convincing setting where national legislator deliberately provides two different definitions of the purpose of the company. As far as European law is concerned, the such scenario would most likely be attributed to a legislative oversight, which in turn highlights the overarching need to fully understand and appreciate the intended scope and meaning of relevant European legislation (here, Takeover Directive) in the process of its implementation in national law.

4.3. CROATIAN TAKEOVER LAW

Various problems relating to the implementation of the Takeover Directive in the Croatian Takeover Act have been recognized in legal theory.[189] Not surpris-

[188] See Section 2.3.

[189] Ivkošić, M.: *Obrana dioničkog društva od neprijateljskog preuzimanja*, doktorska disertacija, Pravni fakultet Sveučilišta u Zagrebu, 2013; Ivkošić, M.: *Pravilo neutralnosti upra-*

ingly, this primarily relates to the application of the board neutrality rule and the national legislator's omission to take advantage of Art. 12 Takeover Directive optional arrangements in order to adjust takeover law mechanisms with its corporate legal framework and capital market characteristics. With strong indications that much-needed overhaul of the Takeover Act will take place,[190] the existing model of board neutrality rule dictates that the management board of the target company must obtain prior authorization of shareholders' general meeting to: (1) increase equity capital, (2) enter into transactions outside the regular business operations of the target company, (3) act in a manner that could seriously threaten further operations of the target company or enter into transactions that could seriously threaten further operations of the target company, (4) decide on the acquisition and disposal of treasury shares of the target company or securities conferring rights to these shares, and (5) act in a manner which might result in an impediment to or frustration of the takeover offer.[191] Additionally, and in line with Takeover Directive, Takeover Act provides for the protection of only one group of stakeholders, the employees of the target company, prescribing appropriate disclosure mechanisms as well as provisions intended to safeguard their right to be informed about the takeover.[192]

Croatian takeover law thus unequivocally gave precedence to shareholder decision-making, aligning itself with not only Takeover Directive's intended purpose but also with specific solutions contained in its national company law. To that extent, one of the general principles which must be respected by takeover participants (both during the takeover process and in terms of exercising their respective rights and obligations) is that management and supervisory board of the target company must, during the takeover process, act in the best interest of the target company.[193] What is in *the best interest of the (target) company* is defined in line with company law (CCA), which in turn furthers the originally

vljačke structure u hrvatskom pravu preuzimanja, Zbornik Pravnog fakulteta Sveučilišta u Splitu, Volume 50, Number 5 2013; Ivkošić, M.; Šumanović, I.: *Položaj organa ciljnog društva u postupku preuzimanja*, Pravo u gospodarstvu 5 2020; Jurić, D.; Zubović, A.: *Protupreuzimateljske mjere i položaj uprave ciljnog društva u postupku preuzimanja dioničkog društva*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, Volume 30, br. 1 2009; Miladin, P.: *Protuponuditeljske mjere prema Nacrtu Zakona o izmjenama i dopunama Zakona o preuzimanju dioničkih društava*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, Volume 39, br. 3 2018.

[190] Ministry of Finance in 2016 formed Task Group to analyse potential amendments to Takeover Act. Although its work was delayed (especially during COVID pandemic), Task Group is expected to continue with its work and propose number of substantive changes to existing legislation.

[191] Art. 42 (1) Takeover Act.

[192] Art. 11 (2), Art. 22 (1) (15), Art. 41 Takeover Act.

[193] Art. 3 (1) (3) Takeover Act.

envisaged shareholder model. Consequently, both boards must render their respective decisions with the primary aim of furthering shareholders' financial interests which relate to the increase of the company's profits and, by implication, the value of the company's shares. As previously explained, shareholders' interests (defined concerning the purpose of the company) relate to abstract shareholders, i.e. both present and future shareholders of the target company.[194] In other words, company purpose, as defined by CCA and analyzed in the previous text, does not change once the joint stock company becomes the subject of a takeover.

5. CONCLUSION

The debate of whether company purpose should be interpreted as to reflect shareholders' or stakeholders' interests can hardly be solved on an abstract level, detached from specific social, historical, and geographical factors that helped shape various national company laws. Although the proponents of each model seem to be sharply opposed, perceived dichotomy will often lead to the same results. Nevertheless, when defining company purpose, one must be careful not to try to extensively interpret the notion by detaching it from the underlying meaning it has in a specific national company law. Leaving aside the ethical undertones, often associated with the stakeholder model, a legal analysis must always be grounded within the boundaries of the national legal framework.

As for Croatian law, the analysis showed that relevant company law provisions provide for the primacy of the shareholder model. Such a conclusion follows from the notion of the company itself as well as several specific CCA provisions pertaining to functions and powers of corporate actors (management board, supervisory board, and general meeting). It is along those lines that the paper further analyzed the notion of shareholders' interest, recognizing its primary long-term financial component which is ultimately reflected through an increase in price of the company's shares which benefits all (existing, as well as future) shareholders. This is not to say that shareholders do not have the authority to depart from the statutory meaning of company purpose. However, should they choose to do so, the proper way would be to insert the specific intended purpose in the articles of association. Without such an intervention, which indicates shareholders' intent that the company is run by taking into account the interests of (preferably well-defined) group of stakeholders, neither management nor the supervisory board of joint stock company have the

[194] See Sections 3.4.

mandate to neglect fundamental statutory elements which define the notion of company purpose.

Company purpose was further analyzed in reference to the Croatian takeover law. As Croatian Takeover Act was modeled upon Takeover Directive, the analysis took into account a variety of legal arguments put forward in the drafting process preceding its adoption. Although the company purpose *per se* was not in the drafters' focus, the particularities of takeovers indirectly reflected on the notion, primarily by recognition of the specific position of management boards of target companies. Although the question of the authority to decide on defensive measures (and whether it should lie with shareholders' general meeting or the management board), most likely, influenced the ensuing debate which encompasses the need to protect stakeholders' interests, the analysis showed that there is no legal justification for an overly extensive interpretation which would ultimately go against shareholders right to either accept or reject the takeover offer. In addition, Takeover Directive recognized only one group of stakeholders (employees) and appropriately afforded them protection using disclosure mechanisms and the right to be properly informed about the takeover offer. Other issues were left to be dealt with within the framework of national law. Croatian Takeover Act consistently followed the solutions of the Takeover Directive and also reflects primacy of the model of shareholder decision-making. The notion of company purpose must be afforded the meaning it has in CCA, and neither Takeover Directive, nor Takeover Act, can be used to later change (much less broaden) it.

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CORPORATE GOVERNANCE CHALLENGES IN RELATION TO THE ESG REPORTING

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ABSTRACT

Over the last decade, there has been an increasing emphasis on corporate social responsibility in business. The idea has evolved from CSR (Corporate Social Responsibility) to ESG Reporting (Environment, Social, Governance), with the latest trends developing towards a green transition. This genesis of development has been followed by corporate practice and legislation at European and national levels. Consequently, ESG and Green Transition guidelines have been incorporated into the liabilities and duties of the management and supervisory bodies of the company, resulting in a new view of the performance of these functions and their accountability. In this paper, the authors outline the basic postulates and roles of corporate governance bodies and their respective responsibilities for the implementation of ESG and the Green Transition. Sustainability as a value is highlighted in the EU and companies are committed to respecting human rights and reducing their impact on the planet. However, progress by companies (corporates) in integrating sustainability into their governance processes, in particular human rights and environmental due diligence, is still slow, and progress is visible with the drafting of the Corporate Sustainability Due Diligence Directive (CSDD) as a follow-up to the Directive 2014/95/EU (NFRD). The new rules are intended to provide companies with legal certainty and a level playing field. It should provide greater transparency for consumers and investors and should accelerate the green transition and protect human rights in Europe and beyond. These tasks are directly linked to the responsibilities of the authorities in society, who will have to respect these rules and be held accountable for failing to enforce them or for failing to achieve a transfer of capital to the green transition.

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KEYWORDS: *CSR (corporate social responsibility), ESG (environment, social, governance) Reporting, Green Transition, liabilities and duties, management, supervisory board, Corporate Sustainability Due Diligence Directive (CSDD)*

1. INTRODUCTION

Preserving and protecting the environment is one of the biggest challenges that "modern generations" will and are already facing.[1] Climate change, natural disasters, the unpredictability and extremity of weather events, and the COVID-19 pandemic have once again exposed society to a whole set of challenges that will require them to rethink their existing economic, business, and lifestyle habits.[2]

One of the key changes in the goal of preserving the ecosystem and the planet as a whole is highlighted as the transition of the existing economy towards more sustainable business through the so-called "green transition". There are many definitions of sustainable development in the world. The most common ones define it as an effort to meet the needs of the present without compromising the needs of future generations, as the World Commission on Environment and Development[3] stated in its report as early as 1987. If the economy is to move towards this transition, it will therefore need to define clear and precise operational objectives, the mechanisms by which it will achieve them, and, ultimately, the responsibilities and sanctions for non-compliance.

The transition towards sustainable business will also require a change in the fundamental paradigms on which the traditional economy is based. Such changes will undoubtedly pose a particular challenge and will undoubtedly seek the support of society as a whole, irrespective of national, regional, and local differences.[4]

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[1] European Union: European Commission, *Communication from the commission to the european parliament, the european council, the council, the european economic and social committee and the committee of the regions, The European Green Deal,* 11. December 2019, COM(2019) 640 final available at:[https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52019DC0640&from=EN], accessed 30.10.2022].

[2] According to a study by the United Nations [available at: https://www.un.org/development/desa/es/news/population/2018-world-urbanization-prospects.html], accessed: 17.8.2022, cities today consume more than 75% of natural resources, emit between 60% and 80% of greenhouse gases and produce more than 50% of the world's waste. By 2050, two thirds of the world's population is expected to live in cities, 20 percent more than today.

[3] WCED Report of the World Commission on Environment and Development, available at: [https://www.are.admin.ch/are/en/home/media/publications/sustainable-development/brundtland-report.html], accessed 17 August 2022.

[4] European Union: European Commission, Communication from the commission to the European Parliament, the European Council, the Council, the European Economic and So-

The central path to a sustainable economy emphasizes a change in the fundamental concept of economic development to date, namely its linearity. Namely, in a linear economy, raw materials are collected and transformed into products which, after use, are discarded as waste without any possibility of reuse. On the other hand, a sustainable economy is characterized by circularity, in which we close the cycles of raw materials, changing the way we create and preserve value towards more sustainable production and more appropriate business models.[5]

Along with the concept of linear development, we will also have to consider the concept of infinite growth. The challenges mentioned above have undoubtedly raised the question of the purpose and role of the economy in society in general and, consequently, the purpose and role of corporations.

In the context of these changes, the paper will focus on how the economy's orientation towards sustainable development and the creation of a green transition in the economy are linked to issues of corporate non-financial reporting (Environmental Social Governance reporting) and what are the possible models of accountability of the management and supervisory bodies as the main decision-makers in the company.[6] In fact, the usual practice of incorporating "new-age" corporate institutes and determining their direction has generally evolved from full autonomy to the relative cogency of corporate reporting, and therefore the latter corporate institutes and their implementation are likely to follow this path as well.

In this way, the authors highlight the key mechanisms and challenges that arise in connection with the development and implementation of future European and Slovenian legislation in this area (draft CSDD Directive). Finally, through examples of positive practices, they highlight possible trends and the direction that should be followed.

2. THE GREEN TRANSITION

Before addressing the issue of corporate sustainability reporting in-depth, it is necessary to at least briefly explain the concept of the so-called "Green Transition" and its basic premises.

cial Committee and the Committee of the Regions, The European Green Deal, 11. December 2019, COM(2019) 640 final available at:[https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52019DC0640&from=EN], [accessed 30.10.2022].

[5] See more at [https://kenniskaarten.hetgroenebrein.nl/en/knowledge-map-circular-economy/how-is-a-circular-economy-different-from-a-linear-economy/], accessed 17.8.2022.

[6] Grove, H. & Clouse, M.: *Focusing on sustainability to strengthen corporate governance*, Corporate Governance and Sustainability Review 2, 2018.

The Green Transition refers to a strategy for social change that will enable the world's current environmentally unsustainable situation to be transformed into a new sustainable paradigm "that promotes development and peace and seeks to improve the livelihoods of all", according to the manifesto published by UN-Habitat in its 2020-2023 Strategic Plan.[7] Namely, with the current concept of the economy and life in general, society consumes more resources every year than nature can regenerate, which means that the rest of the resources are actually taken from future generations. In this context, we highlight the so-called "Earth Overshoot Day"[8] i.e. the date when humanity's demand for ecological resources and services in a given year exceeds what Earth can regenerate in that year, which is getting shorter - year by year.[9]

The foundations of what we now call the Green Transition were already set up in the Paris Agreement.[10] The priorities of the Climate Action Plan include:

- promoting decarbonization and favoring green energy over fossil fuels,
- commitment to green transport,
- increasing investment in energy efficiency,
- supporting business and scientific innovation,
- creating competitive electricity markets
- preparing action plans and national strategies for the circular economy,
- increasing green public investment, etc.

The Paris Agreement and the United Nations Agenda: "Transforming our world: the 2030 Agenda for Sustainable Development"[11] , have set the path for the European Union, which has based itself on them, published a Communication[12] presenting the European Green Deal as an integral part of the European Union's strategy to integrate the Agreement and the Agenda.

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[7] See [https://unhabitat.org/], accessed 17.8.2022.

[8] Earth Overshoot Day is hosted and calculated by Global Footprint Network, an international research organization that provides decision-makers with a menu of tools to help the human economy operate within Earth's ecological limits, for more information on Earth Overshoot Day, see [https://www.overshootday.org/about-earth-overshoot-day/], accessed 30.10.2022.

[9] In 2022, the date was 28 July; in 2012, 4 August; in 2002, 21 September; and in 1992, 15 October.

[10] For more details on the 2015 Paris Agreement, see [https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement], accessed 17.8.2022].

[11] UN General Assembly, Transforming our world : the 2030 Agenda for Sustainable Development, 21 October 2015, A/RES/70/1, available at: [https://www.refworld.org/docid/57b6e3e44.html], accessed 30 October 2022.

[12] European Union: European Commission, Communication from the commission to the european parliament, the european council, the council, the european economic and so-

Among other things, the target is to reduce greenhouse gases by 55% by 2030 and to make Europe a "negative" emitter from 2050, with a greater capacity to offset emissions than it produces.[13]

The Agreement and the Communication commit each country to promote the green transition on its territory, thus ensuring a new, sustainable reality for our planet. Slovenia is no exception to this and can follow the examples of European countries, and there is also an individual race *to the top* for companies wishing to follow ESG and green transition trends and good practices, for example by awarding scholarships to promote green transition (Santander Bank[14]), rewarding management according to the achievement of green transition targets (Mastercard[15], Apple,[16] Deutsche Bank[17]), etc.

There are many definitions of sustainable development around the world. The most common ones define it as the effort to meet the needs of the present without compromising the needs of future generations, as the World Commission on Environment and Development[18] put it in its report as early as 1987.

3. SUSTAINABILITY (CORPORATE) REPORTING - *QUO VADIS*?

Sustainability reporting means reporting to external stakeholders, whereby companies report on economic, environmental, and social impacts in addition to financial information. Non-financial information is also becoming important.[19] These concepts and definitions have recently been followed by a legislative approach, which is still evolving. [20]

cial committee and the committee of the regions, The European Green Deal, 11. December 2019, COM(2019) 640 final available at:[https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52019DC0640&from=EN], [accessed 30.10.2022].

[13] See [https://www.becas-santander.com/en/blog/green-transition.html], accessed 17.8.2022.

[14] *Ibid*.

[15] See [https://fortune.com/2022/04/27/bonuses-linked-esg-goals-mastercard/] accessed: 17.8.2022.

[16] See [https://www.esgtoday.com/apple-introduces-esg-modifier-to-executive-compensation/], accessed 17.8.2022.

[17] See,[https://www.db.com/news/detail/20201207-deutsche-bank-plans-to-link-compensation-to-sustainability-criteria?language_id=1], accessed 17.8.2022.

[18] WCED Report of the World Commission on Environment and Development, available at: [https://www.are.admin.ch/are/en/home/media/publications/sustainable-development/brundtland-report.html] accessed 17.8.2022.

[19] S. Fink Babič, R. Biloslavo, *Sustainability Reporting by Companies - Opportunities and Challenges,* Organization p. A 14-A 26, No. 1, 2012.

[20] Corporate governance first started to develop at the level of autonomous regulation in companies and later through the enshrinement of best practices in corporate governance codes un-

ESG investing is growing exponentially also, as more investors and issuers utilize ESG and climate data and tools to support their investment decision-making. The practice of ESG investing began in the 1960s as socially responsible investing, with investors excluding stocks or entire industries from their portfolios based on business activities such as tobacco production or involvement in the South African apartheid regime[21].

The importance and rapid development of non-financial reporting are best illustrated by Ken MacKenzie, Chairman of BHP, quote:

«Every non-executive director would also attest, as would every CEO who goes out and engages with shareholders, that the change in the tone in the marketplace around ESG has been remarkable. Go back 15 years ago, I›m not even sure we would have known what the ESG acronym meant«.[22]

The main objective is to promote sustainable and responsible corporate behavior in all global value chains. And it is companies (businesses) that have a key role to play in creating a sustainable economy and society.

To organize and render consistent the diversity of non-financial information potentially available, several sustainability accounting frameworks have evolved over the last quarter-century.[23]

Therefore, we argue that companies must be asked to provide data that are more timely, relevant, credible, and comparable and that demonstrate improved ESG performance. With this information, financial analysts and investors can redirect and accelerate capital flows towards corporate investments that help

der the *comply or explain* principle (Cadbury Code 1992), and only later on through legislation to make corporate governance reporting mandatory for so-called public limited companies. Similarly, a reporting system on non-financial data is now being introduced at the level of sustainability reporting through EU legislation and embedded in national systems. The placement of reporting for public interest entities thus transfers the obligation to comply with certain standards that improve and commit to socially responsible corporate behaviour. In addition, the Code of Corporate Governance for Publicly Listed Companies [Code 2021, available at: https://ljse.si/UserDocsImages/datoteke/Pravila,%20Navodila,%20Priro%C4%8Dniki/Slovenski%20kodeks%20upravljanja.pdf?vel=795437], for example, also introduces respect for human rights in business (due to the adoption of the National Action Plan for Respect for Human Rights in Business in 2018), as well as sustainable business and the existence of a sustainable business policy, which is supposed to incorporate the social, environmental and governance aspects of a company‘s business.

[21] See: [https://www.msci.com/esg-101-what-is-esg/evolution-of-esg-investing], accessed: 30.10.2022.

[22] Ken MacKenzie, Chairman of BHP, The Australian Financial Review Business Summit, 10 March 2020.

[23] Bose, S. Evolution of ESG Reporting Frameworks, In: Esty, D.C., Cort, T. (eds) Values at Work. Palgrave Macmillan, Cham, 2020.

tackle important problems related to climate crises and the reaching of sustainable development.[24]

Considering the critical role corporate ESG information will play in assessing a company's long-term performance, companies must ensure that not only do they provide more information but also that the information is relevant and of high quality. [25]

In addition to the efforts of companies, it is also necessary to develop and follow legislative trends in the field of ESG, which can be more or less binding.

3.1 EU LEGISLATION ON NON-FINANCIAL AND SUSTAINABILITY REPORTING

Normative activity on social responsibility - formerly CSR, now ESG - has been going on for a considerable time, as already mentioned, also in the European Union. The basic idea of the EU Commission's Green Paper on the promotion of a European framework for CSR[26] was to go beyond mere legal norms. In this manner, CSR was to make a significant contribution to the Lisbon Strategy's objective of building a dynamic, competitive, and cohesive knowledge-based economy. This was followed by a White Paper,[27] which contained an EU strategy to promote social responsibility. Consequently, the EU has further defined social responsibility as the accountability of companies for their impact on society in its renewed acts (the so-called Renewed EU Strategy).[28] More recent regulatory efforts in the field of CSR include the adoption of several European Parliament Resolutions, European Commission Communications, and various Strategies.[29] The use and implementation of these legal acts are voluntary.[30]

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[24] Arvidsson, S., & Dumay, J., Corporate ESG reporting quantity, quality and performance: Where to now for environmental policy and practice? Business Strategy and the Environment, 31(3), p. 1091, 2022.

[25] *Ibid*, p. 1093.

[26] Green paper on Promoting a European framework for Corporate Social Responsibility, COM(2001) 366 final, 18.7.2001.

[27] Communication from the Commission concerning Corporate Social Responsibility: A business contribution to Sustainable Development, COM(2002) 347 final, 2.7.2002.

[28] Communication from the Commission to the European Parliment, The Council, The European Economic and Social Committee and the Committee of the Regions. A renewed EU Strategy 2011-2014 for Corporate Social Responsibiliti. Brussels, COM(2011) 681 final, 25.10.2011.

[29] Čertanec, A., *Ensuring respect for human rights in the activities of economic operators by concluding a contract*, Podjetje in delo, No. 1., p. 46-71., 2015.

[30] Also, Gale, M. *Legal aspects and pitfalls of corporate social responsibility*. Company and Labour, vol. 3-4. p. 450 ff., 2019.

Historical developments, more recent findings, and different (economic, health) circumstances have led to a new approach to corporate social responsibility, which has flourished in the EU with Directive 2014/95/EU,[31] also known as the Non-Financial Reporting Directive (NFRD), and the subsequent proposal for a Corporate Sustainability Reporting Directive (CSRD).[32]

The NFRD lays down rules on the disclosure of non-financial and diversity information of certain large companies. This Directive also amends the Accounting Directive 2013/34/EU, all of which has already been taken into account in the amendments to the Slovenian Companies Act (ZGD-1I[33]) and the Companies Act (ZGD-1J,[34]), so that these provisions are now contained in the revised Article 70c of the Slovenian Companies Act (hereinafter: ZGD-1).[35]

However, the European Commission is even more aware of the need to pursue CSR principles in pursuit of economic objectives. Corporate social responsibility, also known as corporate consciousness, corporate citizenship, or responsible business conduct, is a form of self-regulation by a company that is integrated into its business model.[36] A CSR policy acts as a self-regulatory mechanism by which a company monitors and actively ensures compliance with the spirit of the law, ethical standards, and national or international norms. In this context, it is the non-financial report that is becoming an increasingly important "statement" of the company's performance, which not only looks at financial performance but also at the company's performance in protecting the environment and caring for employees and society. The European Commission proposes that the non-financial report should become key information on a company's commitment to sustainable development, its vision, and strategy, as well as its resilience and capacity to identify and respond to environmental and social risks. In this context, the European Commission has also adopted a

[31] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information on certain large undertakings and groups, OJ L 330, 15.11.2014.

[32] Proposal for a Directive of the European Parliament and of the Council of 21 April 2021 amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014 as regards corporate sustainability reporting, COM(2021) 189 final.

[33] Official Gazette of the Republic of Slovenia, No 55/15.

[34] Official Gazette of the Republic of Slovenia, No 15/17.

[35] Official Gazette of the Republic of Slovenia, No 65/09 - UPB et seq.

[36] ISO (The International Organization for Standardization) describes social responsibility as „a balanced approach for organisations to address economic, social and environmental issues in a way that aims to benefit people, communities and society". International Organization for Standardization strategic advisory group on corporate social responsibility, preliminary working definition of organisational social responsibility, ISO/TMB AGCSR N4, 2002.

CSRD proposal that would amend the current reporting requirements and will significantly complement the legal basis for quality sustainability reporting.

The proposed CSRD would further broaden the set of business entities that are obliged to publish non-financial information. Sustainability reporting would initially be mandatory for large companies[37] (expected in 2023), but also for SMEs from January 1, 2026.[38] As the Directive is also expected to specify reporting obligations, a single standard for sustainability reporting will be developed at the EU level.[39] The sustainability report will be an integral part of the management report and the management report will have to be published in a single electronic format and a machine-readable format.[40] The Directive is also expected to introduce new requirements for auditors to audit the sustainability information in the sustainability report and to provide assurance on sustainability reporting.[41]

3.1.1 PROPOSAL FOR A DIRECTIVE ON CORPORATE DUE DILIGENCE

A new proposal from the EU Commission, which further complements the CSRD proposal, is the proposal for a Corporate Sustainability Due Diligence Directive (CSDD) and amending Directive (EU) 2019/1937.[42] The proposal

[37] This is currently expected to cover around 11,000 companies - but the wish is to cover listed SMEs other than micro companies; see [https://ec.europa.eu/commission/presscorner/detail/en/QANDA_21_1806], accessed 17.8.2022.

[38] The consultations carried out by the Commission showed that many stakeholders are in favour of extending the reporting requirements to additional categories of companies. Therefore, the proposal includes an extension of the scope of the requirements to include all large companies, whether listed or not, and without the previous threshold of 500 employees. This change would mean that all large companies are publicly accountable for their impact on people and the environment, thereby responding to investors' requests for information on corporate sustainability. *Ibid*.

[39] The European Financial Reporting Advisory Group (EFRAG), a private association set up in 2001 at the Commission's instigation to serve the public interest, will be responsible for the development of the standards.

[40] Oryszczuk, S., Mertenskötter, P., Sijmons, R., Brand, M., *The EU's Green Capitalism Takes Shape: Taxonomy Screening Criteria and Corporate Sustaiability Reporting*., 2021, Available at: [https://www.covfinancialservices.com/2021/05/the-eus-green-capitalism-takes-shape-taxonomy-screening-criteria-and-corporate-sustainability-reporting/] Accessed:17. 8. 2022.

[41] Kunšek, M., Sustainability Reporting - soon to be a mandatory element of annual reporting. FinD-INFO, 2021. Available at:[https://www.findinfo.si/medijsko-sredisce/v-sredisciu/290415] (accessed: 17.8.2022).

[42] Proposal for a Directive of the European Parliament and of the Council on corporate sustainability due diligence and amending Directive (EU) 2019/1937 of 23.2.2022, COM(2022) 71 final.

aims to promote sustainable and responsible corporate behavior across global value chains. The implementation of the CSDD would be overseen by national supervisory authorities (Article 17), which would have the power to impose a combination of criminal and civil liability for failure to prevent (Article 7) or reduce and remedy (Article 8) impacts on human rights and the environment, through the imposition of fines. Victims of the breaches themselves would have the possibility to sue for damages, which could be avoided through proper due diligence measures. Article 25 of the CSDD proposal provides for a clear duty of care for directors, as they are expected to act in the best interests of the company in fulfilling their duty of *care*, taking into account the short-, medium-, and long-term implications of their decisions for sustainability considerations.

The proposed CSDD requires Member States to include these provisions in all existing laws and regulations relating to breach of directors' duties. In addition, Article 15 of the proposed CSDD makes variable remuneration of directors contingent on the achievement of business strategy and long-term interests and sustainability.[43]

3.2 EXISTING LEGAL BASIS FOR SUSTAINABILITY REPORTING AND THE GREEN TRANSITION IN THE REPUBLIC OF SLOVENIA

According to Article 54 of the ZGD-1, companies and entrepreneurs are required to keep books of account and to close them annually under the law and Slovenian accounting standards or international financial reporting standards. Based on the closed accounts, an annual report must be drawn up for each financial year within three months of the end of that financial year.

The annual report must be clear and transparent and give a true and fair view of the company's assets and liabilities, financial position, and profit or loss. In this respect, the ZGD-1 specifies the indications and explanations to be given in the financial report according to the size of the business entities, and Article 70 of the ZGD-1 also specifies the necessary elements of the financial report. The reporting in management report is based on a balanced and comprehensive analysis of the development and results of the Company's operations and its financial position, which includes key accounting, financial and other indicators, ratios, and other indicators, including information related to en-

[43] The European Independent Directors' Association ecoDa is highly critical of the CSDD's proposal on directors' liability and damages actions due to the vagueness and inconsistency of the statements. For more details see: [https://ecoda.eu/wp-content/uploads/2019/08/20220520-ecoDa-Position-Paper-on-CSDD-3.pdf] accessed: 17.8.2022.

vironmental and employee protection, the Company's expected development, the Company's financial risk management objectives and measures, and the Company's exposure to price, credit, liquidity, and cash flow risks. Companies subject to audit are required to include a *corporate* governance statement in their annual report.

Additional annual report requirements apply to public-interest entities[44] whose average number of employees during the financial year at the balance sheet cut-off date is greater than 500: they must comply with Article 70(1)(b) of the Financial Regulation of the European Parliament and the Council. Article 70c of the ZGD-1, they must also include in their annual report a statement of non-financial performance which, insofar as is necessary to understand the development, performance, and position of the company and the impact of its activities, shall include at least information on environmental, social and human resources matters, respect for human rights, and anti-corruption and anti-bribery matters, and, in so doing, on the main risks relating to those matters, related to the Company's activities, including its business relationships, products or services, where relevant and proportionate, that could cause serious adverse effects in these areas, and the ways in which the Company manages these risks and the key non-financial performance indicators relevant to each activity.[45]

Thus, for companies (for which the management report is an integral part of the annual report), the ZGD-1 already provides a loose legal basis for reporting and information on environmental impacts or environmental matters.

4. CHALLENGES AND MODELS OF LIABILITY OF THE COMPANY AND ITS BODIES CONCERNING ESG REPORTING

The two key challenges authors want to highlight and to identify solutions in comparative practices are:

- regulating and making accountable the governing bodies for non-implementation or lack of commitment to the Green Transition; and
- correlation of the lucrative purpose of companies vs. sustainable development (in particular the definition of an appropriate (acceptable) ratio and the consequent responsibility of the company's bodies and the role of legislative solutions).

[44] For more details see Bratina, B., Jovanovič, D. *Novelties and Connections of Institutes with the Amended Auditing Act and the Companies Act*. Company and Labour, No. 6-7. p. 1204 ff., 2019.

[45] Kunšek, M., Sustainability Reporting - soon to be a mandatory element of annual reporting. FinD-INFO, 2021. Available at:[https://www.findinfo.si/medijsko-sredisce/v-sredisciu/290415] (accessed: 17.8.2022).

The current legal status of the sustainability transition with reporting goes through the phases of defining sustainability, concern for reporting on the sustainability transition and the resulting accountability, which is in principle an ad hoc relationship without a systematic embedding of the achievement of measurable sustainability transition objectives.

Corporate social responsibility is the duty of every corporate body to protect the interests of society as a whole. Thus, the liability of the company itself as a legal person must be distinguished from the liability of its management and supervisory bodies for the company's business. Their work may, however, be subject to corporate and civil liability or liability for misdemeanors or even criminal offenses. Liability may be moral (public condemnation, disgrace, etc.) or legal (disciplinary, indemnification, or criminal).[46] In this paper, we limit ourselves to civil (indemnification) liability.

The legal status of the members of the management or supervisory bodies[47] is defined on the one hand by their powers and duties and on the other by their responsibility for the exercise of those powers and duties. The object of the obligations of members of management or supervisory bodies is, by its very nature, a service, that is to say, the performance of a specific act in order to achieve or attempt to achieve a purpose. The acts of the management or supervisory bodies are directly binding on the company (duty of endeavor), as are the tortious acts of the members of those bodies. The appointment of a person as a member of a management or supervisory body and the assumption of office creates a corporate law relationship between them, which is already regulated more or less in mandatory terms by law. The same applies to the question of the liability of members of management or supervisory bodies.

In performing their duties, members of the management and supervisory bodies must act in the best interests of the company with the care of a conscientious and honest businessman (*duty of care*)[48] and must protect the company's business secrets (Article 263(1) of the Companies Act-1).[49] They shall be joint-

[46] Bohinc, R., *Corporate Social Responsibility*, Ljubljana: Faculty of Social Sciences, p. 209, 2016.

[47] *Mutatis mutandis,* the concept of management and supervisory bodies applies to all companies.

[48] This provision provides a yardstick for assessing fault and, in the form of a general clause, also describes an objective duty to act. Podgorelec, P., *The role and powers of individual management or supervisory bodies in capital companies - the corporate aspect of the offence under Article 240 of KZ-1.* Odvetnik, No. 90, p. 47., 2019.

[49] These are professional persons who provide their services on the market for a fee and are presumed to have the professional skills necessary to provide the services properly. These practices are therefore judged against the abstract criteria of the profession for the areas in

ly and severally liable to the company for damages resulting from a breach of their duties unless they prove that they have performed their duties honestly and conscientiously (Article 263(2) ZGD-1). However, they shall be exempt from liability for damages if the act is based on a lawful decision of the General Meeting. The management itself (the management board or the executive directors) is not exempted from liability, even if the supervisory board or the board of directors has approved or consented to their actions (Article 263(3) of the German Companies Act).

Liability for damages is established against the company, which also has the legal standing to bring an action against the responsible members of the management or supervisory bodies. This liability is subject to the general presumptions for the creation of a liability for damages under civil law (the occurrence of certain legal facts)[50], namely:

- harmful fact,
- cause unacceptable damage,
- the causal link between the harmful act and the impermissible harm; and
- liability for damages.[51]

Article 265 of the Companies Act-1 clearly stipulates that the board of directors shall manage the company's affairs independently and on its responsibility. The Supervisory Board supervises the management of the company's affairs (Article 281(1) ZGD-1), but the management of the company's affairs cannot be delegated to the Supervisory Board (Article 281(5) ZGD-1). Among its recommendations, the 2021 Code also assigns to the Supervisory Board the power to review and supervise the sustainability policy (recommendation 7), which, as an integral part of the annual report, is subject to review by the Supervisory Board.

As Article 263 of the ZGD-1 stipulates that members of the management or supervisory body must act in the best interests of the company with the care of a conscientious and honest businessman in the performance of their duties, this can be regarded as a legal standard of conduct, which is further supplemented

which the expertise is required to provide these services. This is in principle an objective criterion of professionalism, but the liability of members of the management or supervisory bodies is nevertheless culpable (subjective).

[50] Thus Bratina, B., *Aspects of the liability of the board of directors of a joint-stock company and recall relationships,* Podjetje in delo, No. 6-7. p. 640 ff., 1995.

[51] For more details, Bratina, B., Jovanovič, D. (ur.) et al., *Corporate Law and Commercial Contract Law,* Maribor: De Vesta. p. 723 ff., 2018.

by descriptions in other provisions (e.g. 70. [52] Breach of these provisions gives rise to the liability of the members of the management to the company they manage and, additionally, to the members of the Supervisory Board for failure to exercise due diligence in the supervision of the conduct of business. The above provision also gives rise to criminal liability for the offense of abuse of position or trust in the exercise of economic activity under Article 240 of the Slovenian Criminal Code (KZ-1).

Article 14 of the Slovenian Minor Offences Act (ZP-1)[53] also establishes the liability of a legal person for an offense. A legal person is liable for an offense committed during its business by an offender in its name or on its behalf or for its benefit or with its funds. The person responsible for a particular offense committed by a legal person may also be punished. Under Article 15 of the ZP-1, the responsible person is the person who is authorized to carry out work in the name of, on behalf of, for the benefit of, or with the funds of the legal person. A person who is authorized to exercise over a legal person a duty of supervision that is capable of preventing an offense is also liable. Pursuant to Article 15(3), the management body (in the case of a public limited liability company, the management board) shall be deemed to have the power to exercise the duty of supervision, and the supervisory body (in the case of a public limited liability company, the supervisory board) shall be deemed to have the power to exercise the duty of supervision over the management body. A person who is liable shall be held liable for an offence which he or she commits by his or her act (act or omission) while carrying on the business of a legal person.[54]

The members of the management and supervisory bodies are therefore required by explicit legal definition to draw up, verify and adopt the annual report. It also includes a management report with a management declaration (prepared by the management), which must give a true and fair view, a balanced and comprehensive analysis of the development and results of the company's business and its financial position, proper to the scale and comprehensiveness of its operations. To the extent necessary for an understanding of the development and results of the Company's business and its financial position, the analysis must include key accounting, financial and, if necessary, other indicators, ratios, and other indicators, including information relating to environmental protection

[52] The duties of *care primarily relate to* the legality of actions defined by law, statutes, rules of procedure, etc., but secondarily, the duties also arise from the general clause and depend on the specific case and other factors (economic rules, professional rules, sustainability policy rules, etc.).

[53] Official Gazette of the Republic of Slovenia, No 29/11 - UPB et seq.

[54] For more details see Bratina, B., *Offences of Management and Supervisory Bodies under ZGD-1*. Company and Labour, No. 6-7. 2022.

and employees (Article 70, paragraph 2, of the ZGD-1). The management report is reviewed by the Supervisory Board and falls within the scope of the supervision of the Company's management of its affairs. Specifically for public interest entities, it is stipulated (Article 70c of the ZGD-1 - more detail supra) that the bodies must also prepare a statement on non-financial performance in the business report, which should include at least information on environmental, social, and human resources matters, respect for human rights and on matters relating to the fight against corruption and bribery. In this way, the ZGD-1 has defined very clearly the obligations of management and supervisory bodies (in particular for public interest entities) which, if the conditions for claiming indemnification are met, give rise to the liability of management and supervisory bodies under Article 263 of the ZGD-1. If the management and supervisory bodies, while fulfilling the elements for the imposition of liability for damages, also fulfill the conditions for the imposition of the exculpatory cause of action for the free exercise of their entrepreneurial discretion, their liability for damages will not arise despite the fact that the other conditions for the imposition of liability for damages may have been fulfilled.[55]

4.1. EXAMPLES OF POSITIVE PRACTICES RELATED TO THE IMPLEMENTATION OF THE GREEN TRANSITION

4.1.1. INDIA

Examples of good (innovative) approaches to sustainable development include the case of India, where the Companies Act (last amended in 2021) introduced a mandatory obligation for a company that meets the size, number of employees, and turnover criteria[56] to create a special fund and to establish a policy for the distribution of the fund's assets in the next financial year. At least 2% of the average net profit of the last three financial years must be allocated annually to the fund, and a special committee of board directors must be appointed (three members, one of whom must be independent). They draw up the CSR policy and submit it to the Board of Directors for adoption, after which they monitor its implementation. Reports are to be drawn up on the implementation of CSR and the consequent liability for failure to carry out these works and tasks.

[55] In more detail Jovanovič, D. *et al*., Corporate and Takeover Law. Maribor, Založba WD, p. 209, 2020.

[56] Jovanovič, D., Bratina, B., *The importance of public interest entities for increasing social responsibilities,* The welfare state and poverty - monograph, UM, Univerzitetna založba, 2022.

4.1.2. SWITZERLAND

In Switzerland, in addition to the changes for public interest entities and whistleblowing through compliance with EU Directive 2014/95/EU, a specific amendment to the criminal law was adopted in 2022, focusing on sustainability reporting and the value chain of companies, namely those based in Switzerland that deals in so-called toxic minerals (importers of certain conflict minerals) or offer products or services that are reasonably suspected of having been produced or provided using child labor. Such companies are required to carry out specific due diligence and report on these situations if these "toxic" entities appear in their value (supply) chains, to be audited and reported to the Boards of Directors for approval and to be made public. If there is any misstatement, non-publication, or false information in the reports on non-financial matters, the person responsible shall be liable to a fine (Article 325 of the Criminal Code).

4.1.3. USA

With new climate-related disclosure rules in the making, the Securities and Exchange Commission has signaled greater enforcement ahead of environmental, social, and governance disclosures.[57]

The SEC has proposed new climate-related disclosure requirements for public companies. In March 2022, with the "issuer rule," the SEC proposed rule amendments that would require public companies to provide certain climate-related financial data, and greenhouse gas emissions insights, in public disclosure filings. As part of the issuer rule, companies would have to disclose emissions they are directly responsible for, as well as emissions from their supply chains and products.[58]

According to Farient's ESG Tracker, 240 of 416, or 58 percent, of S&P 500 companies releasing proxies in 2022 have used ESG measures.[59]

In addition, they have linked sustainable development and the remuneration of management and supervisory bodies in such a way that on average 46% of companies reward their executives with variable rewards (5-15% of total salary) depending on their compliance with ESG standards.[60]

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[57] Read more: [https://pro.bloomberglaw.com/brief/proposed-sec-climate-disclosure-rule/], accessed 31.10.2022.

[58] *Ibid.*

[59] Read more: [https://tax.thomsonreuters.com/news/more-executives-could-see-their-compensation-tied-to-esg-goals-if-sec-finalizes-climate-disclosure-rules/], accessed 31.10.2022.

[60] *Ibid.*

6. CONCLUSION

Sustainability reporting and reporting of non-financial data have been implemented in the EU and individual Member States (including non-member countries - Switzerland) as a standard that forces companies to operate more responsibly by making their business moves more transparent. Thus, the implementation of the NFRD in Slovenia has also brought about a significant shift.

As the perception that "going green is expensive" is still entrenched, companies rarely report on the green transition without "coercion". Therefore, national legislation should be further amended to make it compulsory (at least for public interest entities) to have investment plans (policies) for the green transition, which would also have accountable managers ("green companies require green management"). These would be obliged to report on non-financial performance on an ongoing basis through the company, and to produce a report which should at least include information on environmental, social, human resources, respect for human rights, and anti-corruption and anti-bribery issues. In addition, the State could also ensure that appropriate legal changes are made to the taxation of corporations and individuals to make the green transition and reporting policy attractive to other companies, while at the same time making socially responsible business a *race* to the top between individual companies, competing not only in profitability but also in the transformation from a linear to a circular economic system.

On the other hand, legislation should also ensure that the relationship between profitability and investment in sustainable development is defined in a way that does not interfere with the doctrinaire concept of responsibility and the principal-agent relationship. It is essential to enable the management and supervisory bodies of the company to take proper business decisions that are sustainable while at the same time not directly affecting the profitability of the companies and stakeholders. This can be done with the help of the legislator, who must, through proper subsidies, tax incentives, and exemptions, reliefs, more accessible resources, enable companies to "spread" the costs of sustainable development between stakeholders and the State while keeping decisions on this in the corporate decision-making sense and the consequent reliefs of responsibility.

The lack of regulation at the EU level (CSRD and CSDD) should not stop the Slovenian legislator from autonomously trying to transpose good practice at the ESG level into Slovenian corporate law. As an alternative, another form of regulation is proposed, i.e., autonomous regulation in codes and soft *law* acts at the company level, which would then be translated into corporate law through the legislative process over time. Certainly, the Republic of Slovenia could at least summarise good practice for a part of public interest entities

(companies whose shares are owned by the State or local authorities), which it would oblige through the Slovenian Sovereign Holding, either in a mandatory instruction or in the Code of Corporate Governance of State Invested Enterprises in the form of a summarized good practice. The liability of the management and supervisory bodies for the green transition is currently justified both by the regulation of the breach of the ground rules and by the general due diligence clause, but further pragmatic consideration of the change will be needed due to the requirement under the CSDD proposal.

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CORPORATE SUSTAINABILITY AND ESG FACTORS IN GREECE AND CYPRUS: COMPLIANCE, LAWS AND BUSINESS PRACTICES, TOWARDS A HOLISTIC APPROACH

Charalampos Stamelos *

ABSTRACT

E, S, and G: Environmental, Social, and Governance is a framework regarding the sustainability of legal entities. The EU through Regulations and Directives by setting a minimum mandatory threshold for environmental protection, climate change, green deal, social responsibility, and corporate governance aims to unify the rules in member states towards a holistic approach relating to economic growth and social fairness. In that regard, Greece and Cyprus hold obligations to adopt the EU legislation and policies. This paper focuses on two objectives, i.e., the analysis of compliance in terms of Greek and Cypriot laws and the broader response of business practices to embrace the EU and national laws and policies for ESG investments, operations, and growth. The paper uses two main methods, i.e., a review the of literature and qualitative methods of legal and comparative analysis under a holistic approach. As a conclusion of the findings of this paper, it is stated that the ESG factors regarding corporate sustainability are now a general framework of guiding principles in the EU and both in Greece and Cyprus both at legislative and practical levels under a broader, holistic approach. This approach further guides the interconnection of environmental protection, climate change issues, social responsibility, and corporate governance as key factors for sustainability, growth, and wealth for the future in the EU, in Greece and Cyprus.

KEYWORDS: *Corporate sustainability, ESG factors, Greece, Cyprus, environmental protection, climate change, social responsibility, corporate governance, compliance, business practices, holistic approach*

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1. INTRODUCTION: THE GROWING IMPORTANCE OF ESG FACTORS IN THE CONTEXT OF CORPORATE SUSTAINABILITY

Environmental, social, and governance ('ESG') factors refer to corporate sustainability[1]. Sustainability factors mean environmental, social, and employee matters, respect for human rights, anti-corruption, and anti-bribery matters according to article 2 number 24 of Regulation 2019/2088[2] in force since March 2021.

ESG factors regarding corporate sustainability[3] are not just a trend[4] in the EU. It is at the core of a new approach, *a holistic approach*[5], to the EU laws and policies[6] and worldwide. Such an approach establishes the idea of an alternate philosophy for simultaneous multiple factors towards an alternate analysis for moral[7] growth, fair wealth, and green prosperity of the next generations of

[1] The internal market works for the sustainable development of Europe (article 3(3) TEU) based on balanced economic growth and a high level of protection of the environment (Preamble of Regulation (EU) 2020/852, par. 1).

[2] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, OJ L 317, 9.12.2019, p. 1-16.

[3] Wilson, M.: *Corporate sustainability: What is it and where does it come from?* Ivey Business Journal, [https://iveybusinessjournal.com/publication/corporate-sustainability-what-is-it-and-where-does-it-come-from/]-accessed on 11/11/2022, March-April 2003, p. 1: "A review of the literature suggests that the concept of corporate sustainability borrows elements from four more established concepts: 1) sustainable development, 2) corporate social responsibility, 3) stakeholder theory, and 4) corporate accountability theory."

[4] Pietrancosta, A., Marraud des Grottes, A.: *Trends-What the boards of all companies should know about ESG regulatory trends in Europe*, Harvard Law School, [https://corpgov.law.harvard.edu/2022/11/01/esg-trends-what-the-boards-of-all-companies-should-know-about-esg-regulatory-trends-in-europe/] Draft August 2022.

[5] For the holistic analysis of law see Stamelos, H.: *A holistic analysis of law as a general theory and its application to private law in civil law and mixed law systems (by reference to examples)*, International Journal of Legal Studies and Research, 9(2) 2020, p. 89. Stamelos, H.: *Universal solutions to global problems, A holistic analysis of law, connecting theory and practice,* Cambridge Scholar, 2023 (*forthcoming*). Stamelos, H.: *The holistic analysis as a scientific method*, Athenian Academic Periodical, 1(1) 2021, p. 75.

[6] Peterdy, K.: *What is ESG (Environmental, Social and Governance)?* Corporate Finance Institute, [https://corporatefinanceinstitute.com/resources/esg/esg-environmental-social-governance/]-accessed on 11/11/2022, 26 October 2022: "ESG takes the *holistic* view that sustainability extends beyond just environmental issues."

[7] Pietrancosta, id: "The evolution of capitalism is not driven by a scientific or utilitarian conviction that companies with a good ESG rating perform better financially. Nor is it inspired by a political agenda that could be attributed to the left/right or conservative/progressive wing. The

European societies regarding the everyday life and practices of the businesses against the traditional analysis of profit maximization. The good news is that such an approach grows also in the United States and worldwide. ESG factors refer either to specific obligations of large companies or indicative activities of smaller companies. For example, there are provisions for financial products and ESG data reports of companies. Recently, many companies now operate ESG departments to comply with all soft law international rules and EU hard rules, hereinafter mentioned Regulations and Directives[8].

Significant literature on corporate sustainability includes, inter alia, Sjåfjell, B., Bruner, C. (eds): The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability, Cambridge University Press, 2020.

In this paper, we shall explain the specific laws in Greece and Cyprus. In specific, we shall argue that the specific laws as they stand in Greece and Cyprus fully embody the EU legislation. Thus, we shall review the specific laws as they have been published in Greek and Cypriot official governmental documents and the relevant literature, such as Lazarakou, V.: *Adoption of ESG criteria poses a big opportunity,* [https://www.businessdaily.gr/english-edition/54160_v-lazarakou-adoption-esg-criteria-poses-big-opportunity]-accessed on 11/11/2022, 10 December 2021 for Greece, and Choutris, P.: *ESG Transition,* EY Cyprus, ESG Cyprus Forum, 12/05/2022, Louropoulou, E.: *ESG considerations in sustainable finance and the role of climate change*, ESG Cyprus Forum, 12/05/2022 for Cyprus.

In Greece[9], there are laws and policies which prove that this member state complies with the EU rules and regulations. Similarly, businesses in Greece adopt this *holistic* approach by operating ESG departments in their organizations. In parallel, Cyprus is also a member state which adopts both the public level and the private sector ESG factors, laws, regulations, and business practices.

The message against fear for the future is now hope for the future: in a green Europe based on choices that improve the lives of *all* Europeans simultaneously.

Green deal for Europe is a very ambitious project and is well founded on principles, rules, and regulations and also on the will of businesses to adopt such good practices for the protection of the environment, in parallel to the realization of the social responsibility and the good democratic, open and fair corporate governance.

major driving force is a moral one and a conviction that capitalism must evolve responsibly". The writers use the term 'responsible capitalism' to describe a part of the idea of a *holistic* approach.

8 See Chapter 2 hereinafter.

9 For example, for France see Pietrancosta, id.

Europe is once again at the forefront of a peaceful project for green prosperity which may become a paradigm[10] for other jurisdictions.

The main purpose of this paper is the analysis of the measure of compliance in Greece and Cyprus. The methodology applied here is a review of the literature and the qualitative method of legal analysis in the context of a *holistic* approach. References are made to bibliographies, scientific papers, and other documents published on the internet[11].

The qualitative method of legal analysis refers to the legal compliance of Greece and Cyprus regarding the EU laws and at the same time, the comparison of the compliance between Greece and Cyprus refers not only to national laws but also to business practices in both member states of the EU to conclude that in these two member states the harmonization of EU laws and policies grows steadily under the light of a general, *holistic* approach.

2. ESG FACTORS IN THE EU: CORPORATE SUSTAINABILITY

In the European Union, the idea of ESG factors in corporate sustainability has grown gradually since 2003[12].

The approach is now *holistic*: it is not just about adding different factors, it is about taking into deep consideration the simultaneous combination of all these significant factors to establish fair, just, green, and social economic growth through the democratic process. In the past, if anyone talked about the 'green economy', the others would simply laugh at him or her. Even today, some people disagree with the idea of a green economy. However, it is now the official policy of the EU to go for a green deal. A sustainable world needs sustainable finance.

[10] Wilson, M., *as above*: "Corporate sustainability can be viewed as a new and evolving corporate management paradigm. The term 'paradigm' is used deliberately, in that corporate sustainability is an alternative to the traditional growth and profit-maximization model."

[11] Many resources are published in the internet as it is a very modern subject which attracts the attention of the public increasingly as the 'next big thing' of the 2020 decade (following digitalization of the 2010s and globalization of the 2000s). See 'The Trends of Next Decade, The ESG Factors' in the presentation by Iliopoulos, G.: *The new framework and the necessity of a holistic ESG strategy*, Cyprus ESG Forum 2022, 12 May 2022, p. 2 [in Greek].

[12] Wilson, M., *as above*: "In recent years there has been significant discussion in the business, academic, and popular press about "corporate sustainability." This term is often used in conjunction with, and in some cases as a synonym for, other terms such as "sustainable development" and "corporate social responsibility." But what is corporate sustainability, how does it relate to these other terms, and why is it important? This paper addresses these questions". Much later, in 2015, the UN General Assembly adopted the 2030 Agenda for Sustainable Development. The first paragraph of the Preamble of Regulation (EU) 2019/2088 refers to this UN 2030 Agenda.

At a global scale, investors incorporate ESG. The estimated asset growth in ESG funds by 2025 is $20 trillion[13].

After the war in Ukraine in early 2022, the urgent need for a green economy is now obvious to all. This is why the EU shall move forward faster to a *holistic* approach to growth and wealth. More specifically, the legal entities of the EU must embrace, and actually have already embraced to a great extent, the idea of ESG factors regarding corporate sustainability. This includes the everyday operation of almost every company, even the small or medium-sized companies, and the investments, the projects, the processes, the human resources management, the materials, and the buildings used, the paying back to society, and the democratic and transparent operation of corporations.

ESG is a major theme and a clear strategic priority for investors.

Apart from the Commission's Proposal Directive for a Corporate Sustainability Reporting Directive ('CSRD')[14] and Directive 2014/95[15], the EU has implemented three related hard law instruments, namely:

(a) Regulation (EU) 2019/2088, also known as the 'Sustainable Finance Disclosure Regulation'[16], ['SFDR']

(b) Regulation (EU) 2019/2089, also known as the 'Climate Benchmarks Regulation'[17],

(c) Regulation (EU) 2020/852, also known as the 'Taxonomy Regulation'[18].

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[13] Choutris, P.: *ESG Transition,* EY Cyprus, ESG Cyprus Forum, 12/05/2022, p. 4.

[14] Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) 537/2014, as regards corporate sustainability reporting, COM2021/189 final.

[15] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ L 330, 15.11.2014, p. 1. In Greece: Law 4403/2016. In Cyprus: Law 3/2017 amending Chapter 113 for companies.

[16] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, OJ L 317, 9.12.2019, p. 1-16. The Regulation purports "to re-orient capital flows towards sustainable investments by increasing transparency by financial market participants and advisers on sustainability risks, whilst ensuring a more uniform protection of end investors.". Euronext, *Guide to the latest ESG EU Regulatory initiatives,* [https://www.euronext.com/en/news/esg-laws-regulation] -accessed on 11/11/2022, 04/08/2022, p. 1.

[17] Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for Benchmarks, OJ L 317, 9.12.2019, p. 17-27.

[18] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Reg-

Under paragraph 14 of the Preamble of Regulation 2019/2088: "A sustainability risk means an environmental, social or governance event or condition that, if it occurs, could cause a negative material impact on the value of the investment, as specified in sectoral legislation, in particular in Directives 2009/65/EC, 2009/138/EC, 2011/61/EU, 2013/36/EU, 2014/65/EU, (EU) 2016/97, (EU) 2016/2341, or delegated acts and regulatory technical standards adopted pursuant to them".

Effective from March 2021, the SFDR requires EU investment funds and asset managers to disclose on their websites how they factor "sustainability risks" into their investment decision-making process. Large financial market participants (more than 500 employees) are legally required to publish and keep on their websites a statement on their due diligence policies concerning the principal adverse impacts of investment decisions on sustainability factors.

In the context of the European Commission's Action Plan on Financing Sustainable Growth and the EU Green Deal, Directive (EU) 2017/593 was set. Commission Delegated Directive (EU) 2021/1269 amended the previous Directive by adding paragraph 5 to article 1 of the 593 Directive. Now, paragraph 5 provides as follows: "' sustainability factors' means sustainability factors as defined in article 2, point (24) of Regulation (EU) 2019/2088". The amended articles include articles 9(9), 9(11), 9(13), 9(14), 10(2), and 10(5) (by adding 'sustainability factors of financial instruments', and 'products and services of investment firms shall be compatible with any sustainability objectives').

Article 2(24) of Regulation (EU) 2019/2088 provides that sustainability factors mean environmental, social, and employee matters, respect for human rights, anti-corruption, and anti-bribery matters ['ESG'].

Thus, ESG factors are related to hard law obligations of companies (e.g., the publication of an ESG annual report[19] by large companies in principle) and the avoidance of ESG risks. Further, ESG risks may affect negatively the value of an investment and the related reporting standards[20]. The EU, apart from

ulation (EU) 2019/2088, OJ L 198, 22.6.2020, p. 13-43. Gortsos, Ch.V.: *The EU Taxonomy Regulation: more important than just an element of the Capital Markets Union*, in Busch, D., Ferrarini, G. and S. Grünewald (eds): *Sustainable Finance in Europe: Corporate Governance, Financial Stability and Financial Markets*, Palgrave Macmillan, Cham – Switzerland, 2021, Chapter 11, p. 351-395.

[19] Each member state sets rules for large, medium or small companies to publish such reports. Similar rules apply for other obligations relating to ESG regarding, for example, investments and finance products. For large companies (500 or more employees) there are specific obligations for publishing ESG data and reports in all EU member states. CSRD provides for further obligations of all listed companies.

[20] According to the Commission [CSRD Preamble]: "There are a number of important international initiatives in place. Their aim is to help to achieve the worldwide convergence and

the *holistic* approach, connects the ESG factors directly to the possible negative economic impact on investments. In that regard, ESG factors shall be taken into consideration not only for the protection of the environment itself, the society, or the corporation but also for the economic efficiency of investments in parallel to the protection of the investors. Thus, a *holistic* approach includes economic, social, environmental, and democratic elements of the fair operation of businesses in the new era of the green deal. Indeed, in the effort to protect the environment, people and capital are significant for a sustainable future of the EU, the member states, the corporations, the citizens, and their assets. Leaders are deeply integrated with ESG culturally embedded in their companies. Common characteristics include ESG analysis as part of the portfolio manager and analyst research[21]. Firms adapt to a constantly evolving regulatory framework, such as Regulation (EU) 2019/2088.

In specific, article 1 of Regulation (EU) 2019/2088 provides the following:

> "This Regulation lays down harmonised rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products."

Regulation 2019/2088 provides for transparency of sustainability in risk policies[22], transparency of the promotion of environmental or social characteristics, and sustainable investments on websites and in reports[23], and it has been applied since 10 March 2021.

Regulation (EU) 2020/852 (taxonomy) provides for the establishment of a framework to facilitate sustainable investment by establishing a 'green list', a classification system ("taxonomy") for sustainable economic activities, which

harmonisation of sustainability reporting standards. The EU fully supports this ambition. EU companies and investors that operate globally will benefit from such convergence and harmonisation. The Commission supports initiatives by the G20, the G7, the Financial Stability Board and others to generate international commitment to develop a baseline of global sustainability reporting standards that would build on the work of the Task Force on Climate-related Financial Disclosures. The proposals of the International Financial Reporting Standards Foundation to create a new Sustainability Standards Board are especially relevant in this context, as is the work already carried out by established initiatives including the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the International Integrated Reporting Council (IIRC), the Climate Disclosure Standards Board (CDSB) and CDP (formerly the Carbon Disclosure Project)."

[21] Choutris, *id.*, p. 3.

[22] Ibid, article 3.

[23] Ibid, articles 9 and 10.

requires large companies to disclose the extent to which their sales, investments and/or expenditures are linked to activities defined in the EU taxonomy[24]. The Preamble of the Regulation refers to the 2030 Agenda of the UN[25] for sustainable development[26] and the three dimensions of sustainability: economic, social, and environmental and also refers to the Paris Agreement[27] for low greenhouse gas emissions, climate-resilient development, a climate-neutral Union by 2050 based on the European Green Deal[28].

ESG factors for sustainable corporate regard both public authorities, the member states, and the EU itself and private individuals, mostly legal entities and corporations as to investing.

While the term ESG is often used in the context of investing, stakeholders include not just the investment community but also both natural persons and legal entities, customers, suppliers, and employees. *All* of them are increasingly interested in how sustainable an organization's operations are[29]. Again, it is about a *holistic* approach concerning everyone.

Under EU legislation, large listed corporations (more than 500 employees) are required from January 1, 2022, to disclose, gradually, data on the manner and extent to which their activities are related to environmentally sustainable economic activities. Moreover, under the Proposed Directive on Corporate Sustainability Reporting [CSRD] large EU corporations and all listed firms (apart from listed small companies) will be required to report based on standard reporting and external auditing standards. On the contrary, the draft Directive

[24] See Commission Delegated Regulation (EU) 2021/2178 supplementing Regulation (EU) 2020/852, OJ L 443, 10.12.2021, p. 9.

[25] For Cyprus and Greece see UN, *Sustainable Development Goals, Knowledge Platform, Cyprus 2021*, [https://sustainabledevelopment.un.org/memberstates/cyprus]-accessed on 11/11/2022. UN, *Sustainable Development Goals, Knowledge Platform, Greece 2021*, [https://sustainabledevelopment.un.org/memberstates/greece]-accessed on 11/11/2022.

[26] Par. 2 of the Preamble of Regulation 2020/852.

[27] The United Nations Framework Convention on Climate Change was approved by the EU on 5 October 2016. Decision (EU) 2016/1841 of the Council of 5 October 2016 on the conclusion, on behalf of the European Union, of the Paris Agreement adopted under the United Nations Framework Convention on Climate Change, OJ L 282, 19.10.2016, p. 1. Bodansky, D.: *The Legal Character of the Paris Agreement*, Review of European, Comparative, and International Environmental Law (2016).

[28] Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, The European Green Deal, COM/2019/640 final.

[29] Peterdy, id.

[CSRD][30] provides for the later application of the listed small and medium size enterprises in relation to ESG issues. Today, the sustainability standards for smaller firms seem to be simpler[31].

ESG is related to climate change, EU taxonomy[32], compliance, internal auditing, financial and non-financial reporting, materiality, and risks.

Environmental issues include climate change, greenhouse gas emissions, energy, and water resources, social responsibility matters include human rights, equality, data protection, quality of products, health, safety, and social welfare, and governance issues include ethics, transparency, intellectual property, anti-corruption and anti-bribery, regulatory framework, and sustainable policies and strategies[33].

Further, the European Commission adopted a proposal of a Directive of the European Parliament and the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937[34] (regarding the duty of care).

The explanatory note of this proposed Directive starts with a clear view in its first paragraph depicting the *holistic* approach of the Commission and the EU by reference to the Green Deal of the EU and the UN Sustainable Development Goals[35]:

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[30] Commission [CSRD]: "The proposal's legal basis rests on Articles 50 and 114 of the Treaty on the Functioning of the European Union (TFEU). Article 50 of the TFEU is the legal basis for adopting EU measures aimed at attaining the right of establishment in the single market in company law. It is also the legal basis for Directives 2013/34/EU, 2006/43/EC, 91/674/EEC, 86/635/EEC, and t is part of the legal basis for Directive 2004/109/EC. Article 50 of the TFEU mandates the European Parliament and the Council to act by means of directives. In addition, Article 114 of the TFEU is a general legal act with the objective of establishing or ensuring the functioning of the single market – in this case, the free movement of capital. Article 114 of the TFEU is included as the legal basis for this directive amending Directive 2004/109/EC."

[31] Lazarakou, V.: *Adoption of ESG criteria poses a big opportunity,* [https://www.businessdaily.gr/english-edition/54160_v-lazarakou-adoption-esg-criteria-poses-big-opportunity] accessed on 11/11/2022, 10 December 2021.

[32] Gortsos, Ch.V.: *The EU Taxonomy Regulation: more important than just an element of the Capital Markets Union*, in Busch, D., Ferrarini, G. and S. Grünewald (eds): *Sustainable Finance in Europe: Corporate Governance, Financial Stability and Financial Markets*, Palgrave Macmillan, Cham – Switzerland, 2021, Chapter 11, p. 351-395.

[33] Louropoulou, E.: *ESG considerations in sustainable finance and the role of climate change*, ESG Cyprus Forum, 12/05/2022, p. 4.

[34] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, COM 2022/71 final.

[35] For Cyprus and Greece see UN, *Sustainable Development Goals, Knowledge Platform, Cyprus 2021*, [https://sustainabledevelopment.un.org/memberstates/cyprus]-accessed on 11/11/2022. UN, *Sustainable Development Goals, Knowledge Platform, Greece 2021*, [https://sustainabledevelopment.un.org/memberstates/greece]-accessed on 11/11/2022.

> "The behaviour of companies across all sectors of the economy is key to succeed in the Union's transition to a climate-neutral and green economy in line with the European Green Deal and in delivering on the UN Sustainable Development Goals, including on its human rights- and environment-related objectives. This requires implementing comprehensive mitigation processes for adverse human rights and environmental impacts in their value chains, integrating sustainability into corporate governance and management systems, and framing business decisions in terms of human rights, climate, and environmental impact, as well as in terms of the company's resilience in the longer term"[36].

Human rights, climate, and environmental impact, and corporate governance are recognized by the EU institutions as established and widely accepted ESG factors for corporate sustainability in the context of the proposed Directive on corporate sustainability due diligence.

The purpose of the EU Directive is to promote and establish sustainable and responsible corporate practices and to ensure that human rights and environmental issues are significant elements in corporate governance. The new rules may safeguard and enforce that businesses address adverse effects of their behavior, including in their value chains inside and outside Europe[37].

The benefits for citizens of these new rules, under the view of a *holistic* approach of the Commission, shall be the better protection of human rights, including labor rights, a healthier environment for present and future generations, increased trust in corporations, increased transparency enabling informed choices, and better access to justice for victims of wrongdoings or criminal acts[38]. The proposal will proceed to the European Parliament and the Council for approval. If it is adopted, then EU member states shall have a period of two years to embody the settled Directive into their domestic legal orders and further inform the Commission respectively.

Corporate sustainability is not a vague notion; it is understood under a *holistic* approach including the ESG factors in the EU applied by the EU hard law legislation for the benefit of companies and citizens[39].

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[36] First paragraph of the explanatory note of the proposed Directive

[37] European Commission, *Corporate Sustainability Due Diligence,* [https://ec.europa.eu/info/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en], accessed on 11/11/2022.

[38] Ibid. There also benefits for corporations and for third (developing) countries including the improvement of living conditions for people (this is an obvious *holistic* approach under the sense that it relates green economic growth with the people of third countries outside the EU).

[39] For example, see Directive 2019/944, article 9(1) for the environmentally sustainable market for electricity and Annex I(5) for the information to the customers regarding the environ-

The member states should harmonize their laws in the EU in that framework of sustainable corporate and at the same time businesses should embrace such EU initiatives for ESG factors affecting corporations. Both Greece and Cyprus have positively responded to these challenges at the public and private level. The laws of Greece and Cyprus have embodied the EU rules and regulations and in parallel, the Greek and Cypriot businesses pay much attention to the ESG factors regarding corporate sustainability by operating specific ESG departments within their organizations as it is argued in the two following chapters.

3. ESG FACTORS IN GREECE: COMPLIANCE AND BUSINESS PRACTICES

3.1. CORPORATE SUSTAINABILITY, ESG FACTORS: COMPLIANCE IN GREECE

Greece is a member state of the EC since 1981 and a founding member state of the EU since 1993. Thus, Greece follows EU laws. Many member states on some occasions fail to comply with the EU Directives. Greece is no exception and does not comply with EU law rarely. However, as regards corporate sustainability and ESG factors and relevant EU laws, Greece has fully complied with such EU laws, Directives, and Regulations[40].

The aforementioned Directives 2009/65/EC[41], 2009/138/EC[42], 2011/61/EU[43], 2013/36/EU[44], 2014/65/EU[45], (EU) 2016/97[46], (EU) 2016/2341[47], (EU) 2019/1937[48] have incorporated into the Greek legal order, whilst the aforementioned Regulations (EU) 2019/2088, 2019/2089, 2020/852 have direct applicability to all legal orders of member states, thus to the Greek legal order.

mental impact (at least for CO2 emissions). Directive (EU) 2019/944 of the European Parliament and of the Council of 5 June 2019 on common rules for the internal market for electricity, OJ L158, 14.6.2019, p. 125.

[40] See also Regulations 2021/2139, 2021/12566, 2021/12577.

[41] Law 4099/2012, Official Gazette ('FEK') A' 250, 20.12.2012, as amended and in force. In Cyprus: 78(I)/2012 as amended and in force.

[42] Law 4364/2016, FEK A' 13, 05.02.2016, as amended and in force. In Cyprus: Law 38(I)/2016, as amended and in force.

[43] Law 4209/2013, FEK A' 253, 21.11.2013, as amended and in force.

[44] Law 4261/2014, FEK A' 107/05.05.2014, as amended and in force. In Cyprus: Law 38(I)/2017.

[45] Law 4514/2018, FEK A' 14, 30.01.2018, as amended and in force.

[46] Law 4583/2018, FEK A' 212, 18.12.2018, as amended and in force.

[47] Law 4680/2020, FEK A' 72, 23.03.2020, and Law 4921/2022, FEK A' 75, 18.04.2022.

[48] Law 4920/2022, FEK A' 74, 15.04.2022, as amended and in force.

The Proposed Directive on Corporate Sustainability Reporting is not yet settled law. However, if this becomes official legislation of the EU, Greece is expected to incorporate it into its legal order. This prediction is based on the history of the incorporation of EU legislation in Greece and also on the fact that enterprises, corporations, firms, and companies constantly follow practices harmonized with EU laws, rules, and regulations regarding corporate sustainability and ESG factors.

Further, article 14 of Law 4892/2022[49] provides for a new public entity aiming at the exploitation of the public property of the Greek social insurance fund that:

"By a Regulation approved by the General Assembly, the rules and procedures are decided concerning, in particular:

(i) The sustainability development policy of the company, if needed, according to criteria Environmental, Social, Governance (ESG)[50]".

To this company which is public and run according to private law rules the laws for corporate governance (Law 4548/2018 and Law 4706/2020) apply.

Moreover, article 5(2)(f) of Law 4972/2022[51] for the corporate governance of SA companies controlled by the Greek government provides that in the statement of purpose and special obligations of the companies with the supervision of the Ministry of Finance, there is also a statement for the sustainable development policy of each company taking into consideration the ESG criteria.

Article 7(4) of Law 4864/2021[52] for private investments provides that proposed investment plans and projects shall include a sustainable development strategy based on ESG criteria and file annually sustainability report based on GRI standards.

Article 32 of Law 4706/2020[53] on corporate governance incorporates article 3g of Directive 2017/828 by repeating the wording of article 3g:

[49] Law 4892/2022, FEK A' 28, 22.02.2022, as amended and in force.

[50] The Greek text is followed by the English words "Environmental, Social, Governance (ESG)". It is not usual for Greek laws to include English words as the only official language in Greece is Greek. However, this article of law includes these terms in English.

[51] Law 4972/2022, FEK A' 181, 23.09.2022, as amended and in force. Law 4986/2022, FEK A' 204, 28.10.2022, incorporated Directive (EU) 2019/944 on electricity markets and citizen energy communities (article 2).

[52] Law 4864/2021, FEK A' 237, 02.12.2021, as amended and in force.

[53] Law 4706/2020, FEK A' 136, 17.07.2020, as amended and in force.

> "Institutional investors and asset managers shall develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy. The policy shall describe how they monitor investee companies on relevant matters, including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact, and corporate governance […]".

Article 151 of Law 4548/2018[54] on the new rules for SA companies provides that companies with more than 500 employees are obligated to prepare an annual report on issues regarding the environment, social responsibility, corporate governance, human rights issues, anti-corruption, and anti-bribery matters.

Greece has followed Directive (EU) 2021/1269[55].

Greece also supports many international initiatives for green growth, such as the Green Shipping Challenge proposed by the United States in cooperation with Canada, Korea, Norway, the United Kingdom ('Green Shipping Corridors'), and other nations[56].

As is argued hereinbelow, in Greece there is a corporate culture fully aligned with European standards of ESG in corporate sustainability. Business practices, investments, and departments of companies dedicated to ESG show that in Greece the future of ESG is the only way for the private sector to grow green and under social fairness and democratic values.

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[54] Law 4548/2018, FEK A' 104, 13.06.2018, as amended and in force.

[55] Hellenic Capital Markets Authority, *Decision* 3/960/4.8.2022, FEK B' 812, 23.08.2022. See also Kyriazis, D.: *Law of sustainable finance, a new concept, new issues*, Etaireia Dioikitikon Meleton, Climate Crisis and Law, 2022, p. 129 [in Greek].

[56] US Department of State, *Green Shipping Challenge*, [https://www.state.gov/u-s-announcements-under-the-green-shipping-challenge-at-cop27/]-accessed on 11/11/2022, November 7, 2022. "Greenhouse gas emissions from the shipping sector are significant, increasing, and on a trajectory that is not compatible with the goals of the Paris Agreement. To help place the sector on a pathway to align with the goal to limit global temperature rise to 1.5 degrees Celsius, the United States and Norway organized the Green Shipping Challenge at COP27. The Challenge encouraged governments, ports, and companies to prepare commitments to spur the transition to green shipping. On November 7, Norwegian Prime Minister Jonas Gahr Støre and US Special Presidential Envoy for Climate John Kerry chaired the launch of the Green Shipping Challenge during the World Leaders Summit of COP27. Countries, ports, and companies made more than 40 major announcements addressing innovations for ships, expansion in low- or zero-emission fuels, and policies to help promote the uptake of next-generation vessels. The United States is leading the transition to zero-emission shipping as part of our commitment to tackle the climate crisis at home and internationally."

3.2. CORPORATE SUSTAINABILITY, ESG FACTORS: BUSINESS PRACTICES IN GREECE

In Greece, apart from the aforementioned hard law, there are soft law instruments to encourage the application of ESG factors in business practices.

One such instrument is the Greek Code of Sustainability ('Ellinikos Kodikas Viosimotitas'). There are twenty criteria for each business in Greece according to the Greek Code of Sustainability. There are four classes of companies. To class A belong all companies that have more than 500 employees. Such companies are listed on the stock exchange and they are either Greek or foreign companies which have activities in Greece. These companies must fully comply with the sustainability criteria in the sense that the level of compliance is the highest and they have to publish an annual report regarding their sustainability policies on goals and value chains and KPIs (key performance indicators) for sustainability, and the use of renewable energy resources. Only these companies must also report on the degree of involvement of the directors in the sustainability policies of the companies and the interrelation between innovative products and sustainability policies based on ESG factors. Class B is for companies that are listed on the stock exchange and have less than 500 employees. These companies must also report annually on their sustainability policies on goals and value chains and KPIs (*key performance indicators*) for sustainability and the use of renewable energy resources. Class C includes small (10-49 employees), medium (50-249 employees), or big enterprises (250-499 employees) which are not listed on the stock exchange. These companies must also report on their sustainability policies on goals and value chains and KPIs (key performance indicators) for sustainability and the use of renewable energy resources. Class D includes very small businesses which have no obligation to report on sustainability issues, but they want on a voluntary basis to follow sustainability standards to improve their image and activities.

Apart from soft law instruments, businesses in Greece adopt ESG practices in the context of sustainable corporate.

Many Greek companies operate a special ESG department. They participate in ESG forums and they invest in a green economy, they take into consideration human rights and set rules for fair corporate governance.

The specific examples presented hereinafter include Enterprise Greece, Mytilineos, Motor Oil, Alpha Bank and Eurobank, and the ESG Forum.

For example, Mr. Georgios Filiopoulos, CEO at *Enterprise Greece*, pointed out in ESG Greece Conference on the 1st of December, 2021: "In recent years, ESG standards have become key in business decision-making worldwide. The need to adopt ESG standards has become imperative in the last two years, as

global community faces the urgent need of accelerating climate change. Now, in the aftermath of the COVID-19 pandemic breakout, there is renewed international commitment to green, sustainable and inclusive growth."[57]

Mytilineos[58] is included in the "list of Industry Top Rated Companies by the international ESG rating agency Sustainalytics, as a result of its very good performance in the ESG and Sustainable Development criteria for 2021.

According to *Sustainalytics*, which is one of the world's leading ESG rating agencies, the Industry Top Rated Companies badge is awarded to "Strong outperformers in their respective industries out of the Sustainalytics comprehensive coverage universe". Mytilineos ranks 2nd in a total of 114 Companies in the "Industrial Conglomerates" category; this performance displays the Company's commitment to integrating and developing the ESG culture across all its activities.

Sustainalytics assesses companies based on their ability to manage ESG risks. Depending on the field of activity, each organization is exposed to ESG risks of different types and intensities. Mytilineos is assessed at the highest and most demanding level (comprehensive) in 11 different ESG thematic areas, including: Corporate Governance, Climate Change & Environmental Management, Health & Safety, Human Rights, Business Ethics, which also constitute the maximum number of ESG thematic areas for which a Company can be rated. According to Sustainalytics, Mytilineos effectively manages 70% of the ESG risks faced; such a performance is above the average of the companies within the Industrial Conglomates category. As stated by Mr. Dimitris Papadopoulos, Mytilineos' General Manager of Corporate Governance & Sustainable Development: "We are very pleased with the continuous improvement in our performance in the assessment of one of the most important ESG rating agencies such as Sustainalytics, where we have achieved an overall improvement of 56% since 2019. At Mytilineos the ESG criteria are set as an integral part of their business strategy and operations, thus contributing to strong returns for their shareholders, as well as attracting investors, customers, and talented employees."[59]

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[57] Enterprise Greece and Eurobank, *ESG* [https://www.eurobank.gr/en/group/grafeio-tupou/deltio-tupou-03-12-21]-accessed on 11/11/2022.

[58] (RIC: MYTr.AT, Bloomberg: MYTIL.GA, ADR: MYTHY US).

[59] Mytilineos, *ESG* [www.mytilineos.gr/news/press-releases/mytilineos-on-the-list-of-industry-top-rated-companies-by-sustainalytics/]-accessed on 11/11/2022, [www.mytilineos.gr/news/sustainable-development/net-zero-action-the-1st-virtual-summit-powered-by-mytilineos-focusing-on-environmental-social-and-governance-criteria-esg/]-accessed on 11/11/2022.

In her message the Head of the ESG Department of Motor Oil notes:

> "2021 was the year that the global economy recovered strongly, supported by unprecedented fiscal and monetary stimulus in major economies, pent-up demand, and increased public and private investments. The large-scale vaccination campaigns that took place during the year put the pandemic in relative check since new variants forced governments, on several occasions, to implement restrictive measures to limit contagion.
>
> Furthermore, early 2022 brought new uncertainties and challenges: The dramatic Russian – Ukraine conflict, apart from leading to intolerable loss of human life, has put the world at a significant risk of an energy crisis and associated economic costs. Indeed, the energy crisis has curbed some of the momentum behind sustainability in the interest of energy security but the direction for Motor Oil Group remains the same: As the world faces new challenges, we must not lose sight of the significance of taking clear action on climate change and designing a sustainable energy transition.
>
> In light of the above, *Motor Oil Group* has developed an effective strategy, to support *sustainable development*."

The manager of the Motor Oil ESG Department further notes that "We implement a *holistic* approach to sustainable development, with specific targets, goals, action plans, goal alignments, and related impacts. Our energy transition strategy is based on resilience and sustainable growth."[60]

> "We continue to operate our refinery while making investments aiming to improve operational efficiency and flexibility as we implement digital transformation projects and assess carbon capture and storage investments.
>
> We continue to invest in E-Mobility by developing strategic partnerships and equipping our retail gas stations with EV charging points – we expect almost 1,000 EV charging points by 2023 and 4,000 in the longer term. We continue to diversify in Renewable Energy Sector through a series of acquisitions in RES leading to an expanded energy portfolio. In this context, in 2021 MORE owned a RES operating portfolio of 279MW. The total energy production from RES resulted in 585 GWh with CO2 avoidance of 360,000 tons of CO2e while our portfolio in 2030 is expected to exceed 2GW.
>
> Finally, the Group is working to enhance its value proposition by expanding its product offering and manufacturing processes into the area of alternative energy sources where we invest in the field of natural gas, with

[60] The actual wording of the manager of ESG Department of this company "a holistic approach" actually strongly indicates that the ESG policies apply in the context or under the philosophical trend of a holistic analysis. For the holistic analysis of law see Stamelos, id, footnote 5.

the construction of a CCGT plant in Komotini and we continue with the development of a floating storage and regasification unit (FSRU).

Furthermore, Motor Oil Group is paving the way in investing and operating in the renewable and alternative fuels sector and circular economy through the utilization of bio-based products, and waste products to produce energy and more environmentally friendly fuels. Moreover, we are planning an integrated large-scale hydrogen project while we will establish the Hellenic Hydrogen SA, (JV with PPC) with the main objective of the production and storage of green Hydrogen.

Our energy transition strategy as briefly described above is inextricably linked with our decarbonization targets which aim for absolute GHG emissions reduction (Scope 1&2) by 2030 and support a net zero target by 2050 (vs. 2021).

In Motor Oil Group we believe that this is the path to a sustainable energy transition, and we pivot our efforts towards a future that embrace both sustainability and a shared value for all stakeholders."[61]

Alpha Bank and *Eurobank* grant 'green' loans to their customers in Greece[62].

The aforementioned reveals that ESG policies according to international and European laws and policies are widely followed by business practices under a *holistic* approach in Greece.

[61] Motor Oil, *ESG* [www.moh.gr/en/environment-society/esg-and-sustainability/]-accessed on 11/11/2022.

[62] Alpha Bank, *Recovery and resilience facility (RRF) loans* [www.alpha.gr/en/business/recovery-and-resilience-facility-rrf-loans] -accessed on 11/11/2022, [www.sustainable-greece2020.com/en/sdgevent2022] -accessed on 11/11/2022. E-ON integration provides services for ESG reports in Greece, E-ON, *ESG* [www.e-on.gr/ribia-esg?gclid=EAIaIQobChMIjbf-y8Pw9gIV2eR3Ch1vsQnQEAAYAyAAEgIBT_D_BwE]-accessed on 11/11/2022. See also Enterprise Greece and Eurobank, *ESG* [https://www.eurobank.gr/en/group/grafeio-tupou/deltio-tupou-03-12-21]-accessed on 11/11/2022.

4. ESG FACTORS IN CYPRUS: COMPLIANCE AND BUSINESS PRACTICES

4.1. CORPORATE SUSTAINABILITY, ESG FACTORS: COMPLIANCE IN CYPRUS

Cyprus[63] is a member state of the EU since 2004. Thus, Cyprus follows EU laws. Many member states on some occasions fail to comply with the EU Directives. Cyprus is no exception and rarely fails to comply with EU law. However, as regards corporate sustainability and ESG factors and relevant EU laws, Greece has fully complied with such EU laws, Directives, and Regulations.

The aforementioned Directives 2009/65/EC[64], 2009/138/EC[65], 2011/61/EU[66], 2013/36/EU[67], 2014/65/EU (known as MiFID II)[68], (EU) 2016/97[69], (EU) 2016/2341[70], have incorporated into the Cypriot legal order, whilst the aforementioned Regulations (EU) 2019/2088, 2019/2089, 2020/852 have direct applicability to all legal orders of member states, thus to the Cypriot legal order. Directive's (EU) 2019/1937 incorporation is pending[71].

The Proposed Directive on Corporate Sustainability Reporting is not yet settled law. However, if this becomes official legislation of the EU, Cyprus is expected to incorporate it into its legal order. This prediction is based on the

[63] The Republic of Cyprus is the only legitimate government for Cyprus. The administration is mainly Greek-Cypriot. The Turkish Cypriot community is not recognized as a state by the UN or other countries apart from Turkey. Nicosia is a divided city by the presence of UN forces. The ongoing negotiations for a united Cyprus since 1974 have not led to a solution. The Greek-Cypriot propose a federation, the Turkish-Cypriot propose two sovereign states and a divided island. Moreover, the English sovereign bases operate in South (Greek) Cyprus. After Brexit these bases are not EU territory and there is a special appendix in the official text for Brexit regarding the relations between Cyprus and the English bases. The UN resolutions recognize the illegal invasion of Turkey against Cyprus since 1974 and set the rules for negotiations and peaceful resolution of the Cyprus Problem. For all UN resolutions on Cyprus see [https://unficyp.unmissions.org/resolutions]-accessed on 11/11/2022 and [https://en.wikipedia.org/wiki/List_of_United_Nations_Security_Council_resolutions_concerning_Cyprus]-accessed on 11/11/2022.

[64] Law 78(I)/2012 as amended and in force.

[65] Law 38(I)/2016, as amended and in force.

[66] Law 56(I)/2013, as amended and in force.

[67] Law 38(I)/2017, as amended and in force.

[68] Law 87(I)/2017, as amended and in force.

[69] Law 38(I)/2016, as amended and in force.

[70] Law 10(I)/2020, as amended and in force.

[71] Law under review and public consultation until 02.12.2022.

history of the incorporation of EU legislation in Cyprus and also on the fact that enterprises, corporations, firms, and companies constantly follow practices harmonized with EU laws, rules, and regulations regarding corporate sustainability and ESG factors.

Cyprus has complied with Directive (EU) 2021/1269[72].

As is argued hereinbelow, in Cyprus there is a corporate culture fully aligned with European standards of ESG in corporate sustainability. Business practices, investments, and departments of companies dedicated to ESG show that in Cyprus the future of ESG is the only way for the private sector to grow green and under social fairness and democratic values.

4.2. CORPORATE SUSTAINABILITY, ESG FACTORS: BUSINESS PRACTICES IN CYPRUS

In Cyprus, apart from the aforementioned hard law, there are soft law instruments to encourage the application of ESG factors in business practices.

Apart from soft law instruments, businesses in Cyprus adopt ESG practices in the context of sustainable corporate.

The specific examples presented hereinafter include Cyprus Investment Funds Association, Bank of Cyprus, and the ESG Forum.

Cyprus Investment Funds Association's legal advisor Nicole Kallasides notes that:

> "When a trend showcases continued value extending into the future, then the trend in question becomes a norm. Such is the case with sustainable investing, or "ESG investing", as the term has evolved and used within the financial sector: The infrastructure, mechanism, and consumer demands developing around it project that it is here to stay. ESG is an umbrella term for a *broad* range of environmental, social, and governance factors against which investors can assess the behavior of the entities they are considering for investment. The environmental aspect of ESG is a measure of a company's impact on the natural environment. It takes into account factors including its carbon footprint, its impact on biodiversity, and its production of wastes and pollution. The social aspect measures how a company treats people such as employees, customers, and the communities in which it operates, while the governance aspect measures how a company operates in terms of audits, board

[72] Cypriot Securities and Exchange Commission, *Directive OD87-01(A)*/4.8.2022, EE Par. III(I) 576/295, 22.07.2022.

diversity, internal controls, and shareholder rights. These factors enable investors and other stakeholders to measure the performance and ensure the accountability of companies. Hence, one crucial aspect of ESG is that it is not simply about seeking compliance with current regulations but rather, it focuses on the potential for a company to have a more positive impact alongside seeking to make a financial return.

ESG's rise in importance has been driven by several key factors. First, there has been a rise in public concern for the environment and social equity. This has been reflected in an increasing desire to see that investments are ethically placed. Millennial investors, for instance, are more likely to invest in companies targeting social or environmental goals. Moreover, the growth of the ESG agenda has been influenced by several key organizations and regulator drivers, including the UN Principles for Responsible Investment (UNPRI) and the package of EU sustainable Regulations which seeks to integrate ESG considerations into the investment and advisory process in a consistent manner across sectors. Last but not least, and simply put, the driver amongst many people working in the sector to *simply do the right thing*.

Given the substantial attention towards sustainability and its relative immaturity as an investment trend, ESG is having a fast-growing impact on the investment funds sector on a worldwide basis. At a national level, and in light of the newly enforced Sustainable Finance Disclosures Regulation (EU) 2019/2088 ("SFDR" or "Disclosure Regulation"), the Cyprus Securities and Exchange Commission ("CySEC") has recently reinstated in a recent announcement its commitment and focus to fostering compliance with sustainable finance standards. The Disclosure Regulation has imposed harmonized transparency and disclosure requirements on financial market participants and financial advisers and requires firms within scope to consider how sustainability risks are incorporated into the investment decision-making process and even how the remuneration of individuals is consistent with sustainability issues. As such, the SFDR is expected to affect a large proportion of the financial services industry in Cyprus."[73]

Bank of Cyprus notes that "it has already covered the considerable distance in our ESG journey. We have an 'A' rating from MSCI, which is the global benchmark on ESG. The company has also started a few years ago shifting towards a more mature model in our charitable work. We are now focused on generating Social Capital through long term partnerships and structured cooperation with

[73] Cyprus Investments Funds Association, *ESG* [www.cifacyprus.org/en/news/esg-moves-into-the-mainstream-how-the-esg-revolution-is-shaping-the-fund-industry] - accessed on 11/11/2022.

other organizations-including businesses, customers, NGOs, and the state" [74]. Bank of Cyprus having a sustainability committee in its organization grants green loans to its customers in Cyprus.

The aforementioned reveal that ESG policies according to international and European laws and policies are widely followed by business practices under a *holistic* approach in Cyprus.

5. CONCLUSION: ESG FACTORS, TOWARDS A HOLISTIC APPROACH REGARDING CORPORATE SUSTAINABILITY

Despite the questioning of the validity of ESG factors for corporate sustainability[75], it is today a fact that the EU and its member states (including Greece and Cyprus) accept a *holistic* approach both at the public level (public authorities, laws, and regulations) and at the private level (corporations) considering ESG factors necessary for corporate sustainability.

ESG is not only an established department under this name in many companies, but it is also taught as a seminar. Institutes, such as the Corporate Governance Institute[76], offer diplomas in ESG for any interested person and directors of companies.

The implementation of ESG standards is leading to the gradual establishment of an ecosystem with a significant increase in the number of people dedicated to ESG in companies and a concentration of the non-financial rating market, with the ESG analysis and investment recommendation market growing exponentially[77].

It seems that in the next years, ESG factors will affect under a *holistic* approach corporate sustainability, reporting standards, investments, corporate

[74] Bank of Cyprus, *ESG* [www.bankofcyprus.com.cy/en-gb/group/news-archive/cyprus-4.0-bank-of-cyprus-forges-ahead-with-esg-policy-and-products/]-accessed on 11/11/2022.

[75] Arguments against ESG include that ESG is a distraction, is not feasible, is not meaningful for financial performance, or is not measurable. These arguments are proposed by the economic approach and ignore the fact that ESG is based on a *holistic* approach including economic, environmental, social and democratic elements of businesses and growth. For more on the arguments against ESG see Perez L, et al, *Does ESG really matter -and why?* McKinsey, August 10, 2022, p. 4.

[76] The Corporate Governance Institute is a global educational technology company specializing in training and certifying the next generation of company directors and board members. Corporate Governance Institute, *Diploma in ESG, ESG for Directors,* [https://www.thecorporategovernanceinstitute.com/esg-for-directors/]-accessed on 11/11/2022.

[77] Pietrancosta, id.

governance, and green economic growth, and last but not least, the everyday[78] choices of *all* people[79], in the EU and worldwide.

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[78] Both in the framework of the EU hard law and the UN soft law. For example, for Cyprus and Greece see UN, *Sustainable Development Goals, Knowledge Platform, Cyprus 2021*, [https://sustainabledevelopment.un.org/memberstates/cyprus]-accessed on 11/11/2022. UN, *Sustainable Development Goals, Knowledge Platform, Greece 2021*, [https://sustainabledevelopment.un.org/memberstates/greece]-accessed on 11/11/2022.

[79] Pietrancosta, id: "it remains important to understand that, if managers generally take the initiative to move in a new direction, it is generally under pressure from their customers, employees and even shareholders. In reality, the consumer is a "consumer-actor" who demands that carbon emissions, pollution, diversity, and disability issues be addressed within the company. The shareholders themselves understand this necessary evolution that are imposed on the company by its stakeholders and sometimes even amplify them. The State itself is under media pressure in its spending choices (orders or public aid) and consideration for the society and the environment. More than a mere choice, ESG has become an issue that is imposed on *all* actors, even beyond companies, since the matter concerns us *all*, from individuals to States". A *holistic* approach refers both to the broad analysis and to the fact that the matter concerns us *all*.

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