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EDITORIAL

Dear readers, colleagues and friends,

On the occasion of INTEREULAW EAST –Journal for the International and European Law, Economics and Market Integration, fifth anniversary we are glad to introduce to you our special issue dedicated to the European Company Law and Corporate Governance. This topic has been chosen because it constitutes important part of European Law and because it is of outmost importance for market integration. Also there is on-going regulatory proposal "European Company Law package" with an aim to cover important gaps remaining in the area of law applicable to companies and set up the rules regarding online tools throughout the companies' lifecycle including cross-border mobility (mergers, divisions, conversions). As stated in the Commission's proposal*: "The EU economy needs healthy and flourishing companies which can easily operate in the Single Market. Such companies play a crucial role in promoting economic growth, creating jobs and attracting investment in the European Union. They help to deliver greater economic as well as social value for society at large. To achieve this end, companies need to operate in a legal and administrative environment which is both conducive to growth and adapted to face the new economic and social challenges of a globalised and digital world, while pursuing also other legitimate public interests such as the protection of employees, creditors and minority shareholders and providing authorities with all necessary safeguards to combat fraud or abuse"*. We have gathered quite a number of interesting articles covering these topics and we hope you will enjoy reading it.

Celebrating five years of publishing the Journal is great achievement but also great responsibility. During these five years we have managed to obtain financial stability, sustainability and quality, recognized by the authors, readers and distinguished legal databases.

On this occasion I would like to thank the publisher, the Faculty of Economics and Business, University of Zagreb and the Dean, Professor Jurica Pavičić for continuous support as well to the Ministry of Science and Education of the Republic of Croatia. For all efforts and continuous work I would like to thank our great team Mrs. Zrinka Udiljak Bugarinovski, Mrs. Silvana Brozović and Mr. Željko Sirk. And last but not least, I would like to express my deep gratitude to my dear colleague Zvonimir Šafranko, PhD, Technical Editor of the Journal, to whom I'm grateful for his continuous hard work, efforts, ideas and improvements during this precious five years.

Prof. Dr. Hana Horak,
Editor-in-Chief

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A NEW (?) FRAMEWORK (?) ON DIGITALIZATION IN EUROPEAN (?) COMPANY (?) LAW?

Alessio Bartolacelli *

ABSTRACT

In this paper, I consider the digital tools present in the European Company law currently in force, and those that have been proposed in several occasions and by different bodies during the last fifteen years. I will focus in particular on the European Commission's Proposal issued on April 25th, 2018, showing that it does not provide a comprehensive and innovative framework on digitalization in Company Law. On the contrary, its main purpose is to suggest the introduction of a harmonized system of online registration for companies throughout Europe, directly descending from the last available version of the repealed Proposal for the amendment of Single-Member companies directive. Such a procedure, nonetheless, is dealing just partially with Company Law, as it involves a public procedure, usually part of administrative law, and, even more meaningfully, it needs to develop a role for notaries where the intervention of such subjects is required by domestic law.

Furthermore, besides highlighting the momentous role the domestic registers and the business registers' interconnection system have achieved in the European Company Law, I will discuss some points in the latest Proposal and its Annex that seem to need a reconsideration.

KEYWORDS: *Digitalization, Company Law, Company's Registration, Online Filing, Disqualified Directors, Business Registers' Interconnection System, ICLEG Group, Company's Website, Notaries*

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1. INTRODUCTION

When dealing with the issue of digitalization in European Company Law, one could be tempted to consider only the latest "Digital Company Law Package" issued by European Commission on April 25th, 2018.[1] It must nonetheless be noted that digitalization is an issue rather widely considered by European institutions at least in the last fifteen years. Many hints regarding an interest in the subject were present already in the so-called "Winter report", as of 2002, when considering a few domestic experiences.[2] Similarly, in the Action Plan consequently developed by the Commission in 2003[3] – and to a much lower extent in that issued in 2012, too[4] – many digital issues were present as well. And, even if it has not a direct link with Company Law, we must furthermore point out that the European Commission developed and launched a Digital Agenda for Europe[5] (and very recently even a Digital Agenda for Western Balkans[6]) as a part of the Single Digital Market.

For this reason, in this article I will consider first the "theoretical sources" of the digitalization, by examining the just mentioned documents, focusing in particular on the experts' reports and their fallouts in official European documents.

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1 Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards the use of digital tools and processes in company law, of 25 April 2018, COM (2018) 239 final, [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018PC0239&from=EN], accessed on 06/08/2018.

2 Report of the high level group of company law experts on a modern regulatory framework for company law in Europe, of 4 November 2002, [http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf], accessed on 06/08/2018. In particular, the German Corporate Governance Codex was considered in the Consultative Document, as it is referred at p. 142.

3 Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to move Forward, of 21 May 2003, COM (2003) 284 final, [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52003DC0284&from=EN], accessed on 06/08/2018.

4 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies, of 12 December 2012, COM (2012) 740 final, [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0740&from=EN], accessed on 06/08/2018.

5 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A Digital Agenda for Europe, of 26 August 2010, COM (2010) 245 final/2, [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52010DC0245&from=FRF], accessed on 06/08/2018.

6 Statement of Support: the Digital Agenda for the Western Balkans, of 17 May 2018, [https://ec.europa.eu/commission/sites/beta-political/files/statement-support-digital-agenda-western-balkans_en.pdf], accessed on 06/08/2018.

I will then move to the analysis of the "status quo", i.e. those profiles of digitalization that can already be found out in the European Law currently in force, starting from the Codified Directive 2017/1132/EU, but also looking at the directives on shareholders' rights and accounts in particular.

The next step will be the consideration of the draft legislation currently under discussion at an advanced stage by European institutions in the area of digitalization, mainly the Single Digital Gateway proposal, focusing on the impact of such proposal on Company Law.

Finally, the analysis will move to the newest Commission's comprehensive draft proposal of April 2018, highlighting in particular the proposed process of online company's registration, discussing its origins from the withdrawn *SUP* directive draft proposal,[7] and its strict dependence from the so-called e-IDAS Regulation,[8] concerning the identification of persons throughout the Union, and its full implementation as of September 29th, 2018.

2. THE THEORETICAL FRAMEWORK OF DIGITALIZATION IN EUROPEAN COMPANY LAW

2.1 THE WINTER REPORT (2002)

If it is true that European Company Law's golden era has probably ended in the early Nineties of the last century,[9] since the dawn of the years 2000 the attention of European institutions focused on several digital profiles of Company Law. This happened not only because of the technological revolution taking place in those years by itself, but due to the digital attitude some Member States had already started to develop in their domestic law.

[7] Proposal for a Directive of the European Parliament and of the Council on single-member private limited companies, of 9 April 2014, COM (2'14) 212 final, [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0212&from=EN], accessed on 06/08/2018, hereinafter: also "*SUP* proposal, original version".
In this essay I will also refer to a later version of the same proposal, coming from the General approach issued by the Council of the European Union in its meeting of May 29th, 2015, [http://data.consilium.europa.eu/doc/document/ST-9050-2015-INIT/en/pdf], accessed on 06/08/2018, hereinafter also "*SUP* proposal, G.A. version".

[8] Regulation (EU) No 910/2014 of the European Parliament and of the Council of 23 July 2014 on electronic identification and trust services for electronic transactions in the internal market and repealing Directive 1999/93/EC, (OJ L 257, 28/8/2014).

[9] Rondinelli, M.: L'armonizzazione nel diritto delle società: evoluzioni e prospettive, in: Pederzini, E. (ed.): *Percorsi di diritto societario europeo*, Turin, 2016, p. 53 ss.

Probably looking at the difficulties arisen in the development of new political initiatives in the area of Company Law, since the beginning of the new century the European institutions decided to create many subsequent commissions or steering groups. They have been formed by high level experts coming from many Member States' universities and research institutions, in order to try to develop a technical "to-do agenda" in the field, elaborated by such expert, with scientific criteria. The very first of those steering groups was the "High Level Group of Company Law Experts", operating mainly between 2001 and 2002, and chaired by Dutch professor Jaap Winter, hence the common definition of the group as "the Winter Group".

In November 2002, the Group issued a "Report […] on a modern regulatory framework for company law in Europe", commonly known as "the Winter Report", intended to be a milestone for the subsequent proposals in the area of Company Law developed by the European Commission. The report was not, by itself, an official European document, but its content served at large for the elaboration of the Action Plans in the area during the following years, in particular the 2003 one.

The issue of digitalization was not a core point of the report; it was nonetheless present regarding a few subjects, in particular dealing with the participation of the company's members to the company's activities and to the meetings in particular, highlighting the possible use of ICT for pre-meeting information, participation in the meeting, and voting rights.[10] In general, the Report recognized that "Modern information and communication technology has a profound impact on our society. Law should adapt to this in that, on the one hand, it should ensure that legal norms and values are also applied in a digital or virtual environment, and, on the other hand, it should facilitate exploitation of the new possibilities which modern technology offers".[11]

Nevertheless, this does not mean, by itself, that specific steps had to be taken in the field by the European institutions: the Report distinguishes between "form", "time", "place" and "function" related issues, the modern technologies were likely to have an impact on. The attitude of the Group on that was that there was no need of a European initiative regarding the chapters "form" – as Member States were already acting by themselves on that – and "time" – due to the fact that "law should not force citizens to act quicker now that modern technology allows speedier actions and decisions. Law may even wish to protect citizens against overhasty actions and decisions that are prompted by fast-

[10] On members' information, p. 49; voting right, p. 10; participation to the meeting, p. 8, 52 e 74.

[11] Page 36 of the Report. The entire paragraph is of the utmost importance to the extent of this analysis.

er communication methods"[12]; while, on the contrary, it was part of a priority initiative to consider the chapters "place"[13] and "function" – i.e. the one related with participation of members in a company's life based on the use of ICT. At the same time, the Report stresses that a great role for modern technologies could have been played in the filing and disclosure phase, which is properly what has been happening with the registers' interconnection system currently in force since July 2017.[14]

In any case, it seems that the continuous attention the Report devotes to the role of modern technology in companies with reference to shareholders' information and exercise of rights can be held as the inspiration of many of the provisions contained in the "shareholders' rights Directive" either in its original[15] and amended[16] versions.[17] This, naturally, leads to more general remarks on the foreseeable role and way of actual development of the shareholders' meeting as we usually intend it, as modern technologies could easily lead to fully not-in-presence meetings.[18]

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[12] Page 37 of the Report.

[13] Having the strong transnational character now present in the Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions, of 25 April 2018, COM (2018) 241 final, [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018PC0241&from=EN], accessed on 06/08/2018.
In this draft too many references to digitalisation are present as well, with the same leading lines we can find in the Digitalisation Proposal. In particular see proposed arts. 86e.3, 86f.3, 86h.2, .3(d), and .4, 86m.3, 86o.2, 86p.3, and 86q.2 and .3 for conversions; proposed arts. 123.1, .2, and .4, 124.3, 124a.3, 126a.3, 127.1 and .2, and 128.3 and .4 for amendments to cross-border mergers; proposed arts. 160g.3, 160h.3, 160j.1, .2, .3(d), and .4, 160l.3, 160o.3, 160q.2, 160r.3, and 160s.2 and .3 for divisions.

[14] We are going to discuss this issue more in depth in the next chapter 3, but see p. 39 of the Report.

[15] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, (OJ L 184, 14/7/2007).

[16] 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 (Text with EEA relevance), (OJ L 132, 20/5/2017).

[17] A balance is specifically considered as far as the right to ask questions is concerned, in order to avoid that "The company could virtually be flooded with questions and proposals" (p. 51). With this regard, a specific instrument by the EU was hot held necessary by respondent stakeholders: "The rights to ask questions and table resolutions are often difficult to exercise, but responses to the consultation did not call for mandatory provisions at EU level in this area. In practice, the exercise of these important rights may be facilitated by modern technology, but companies should be able to take measures to keep the whole process manageable", p. 7.

[18] "The development of technological means through which shareholders can communicate with management and each other and can take decisions without actually meeting, and the

As for the listed companies in particular, the information to be provided in the company's website is highly stressed,[19] along with the links to be maintained with public registers and authorities. However, the Winter Group points out that from the consultation they carried out with stakeholders, a trend emerged that a simply enabling provision would have been preferable instead of a compulsory one regarding the use of modern technologies by listed companies.[20]

2.2 THE 2003 ACTION PLAN

As it was easily expectable, the Winter Report was used by European Commission in order to develop an Action Plan in the field of modernization of European – and by this means, of Member States' too – Company Law; the Action plan was issued in May 2003.[21] The issue of modern technologies, tracing back to the title of the Communication focused on Company Law modernization, is one of the core parts of the Plan, even if not all the suggestions and remarks on the issue present in the Winter Report are contained in it too.

The approach the Commission had in the 2003 Action Plan is the acknowledgment of the modern technologies and the fact that they were "affecting the way company information is stored and disseminated, as well as the way corporate life is conducted (e.g. virtual general meetings, video-link board meetings, exercise of cross-border voting rights)".[22] From this starting point, the Communication adopts the balanced solution the Winter Group advocated for too: general encouragement for the use of modern technologies by the companies

facilitating of these developments in law, inevitably lead to the question whether a physical meeting of shareholders still plays any useful role", p. 53.

[19] See for instance p. 6.

[20] "In our Consultative Document, we asked whether listed companies should not only be entitled to use modern technology as suggested above (*i.e.* that the use should be permitted by Member States' Company Laws – the "enabling" approach), but should be compelled to do so. Many respondents have expressed the view that use of modern technology should be a matter for the companies and their shareholders to decide and not for the Member States or the EU to determine", p. 49. Again, more in general, "Many respondents to our Consultative Document stressed that, at the current stage of development and availability of new technologies, the use of modern technology should not be imposed but should merely be facilitated. We agree that an appropriate balance must be struck", p. 28.

[21] See above, ref. 3.

[22] 2003 Action Plan, p. 7, where in footnotes there is a cross reference to a Proposal for amendments to the First Company Law Directive, issued in June 2002, introducing modern technologies in the trade registers. It is possible to see in such proposal the seed of the Business Registers' Interconnection System eventually approved by the Parliament and the Council and now part of the codified Directive (EU) 2017/1132.

in their relationships with members and third parties; mandatory provisions regarding the use of such technologies where "the protection of shareholders and third parties [makes] it necessary to compel companies" to use them.[23] In any case, a general imposition for companies for a systematic use of modern technologies towards all members and third parties was still deemed as premature.

As for the actual solutions proposed, the 2003 Action Plan deals with the issue of shareholders' rights, mainly in listed companies. In them, the pre-meeting information could be provided for by means of "electronic facilities",[24] being thus the first step for further measures in the field of shareholders' information. Some additional issues, for instance on the right to ask questions, vote in absentia and taking part to the meetings by means of electronic technologies were to be dealt with by means of a then forthcoming Directive.[25]

2.3 THE 2010 DIGITAL AGENDA FOR EUROPE

In 2010 the Commission took entirely acknowledgment of the importance of digital issues for the contemporary Company Law by issuing the Communication: "A Digital Agenda for Europe", drafting a complete line of intervention of European institution in the coming years. Such document is not focused

[23] Citation from the 2003 Action Plan, p. 8 *seq.*, where the mentioned compulsory rule seems to be applicable mainly to listed and open companies, sounding a solution similar to the one later adopted in the shareholders' right Directive.

[24] 2003 Action Plan, p. 13.

[25] Properly the Shareholders' rights Directive, which finally dealt also with pre-meeting information, where in the Action Plan such issue was said to be regulated by the Transparency Directive (Directive 2004/109/EC, of 15 December 2004, (OJ L 390, 31/12/2004), actually containing just partial rules about that. This Directive, aiming at harmonising "transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market", lays down some digitally-related provisions with reference to listed companies. Among them, we can find: the encouragement to the Member States' *SUP*ervisory authorities "to formulate guidelines for setting up electronic networks" (*Whereas* 26; article 22); rules on instructions regarding the exercise of voting rights to be *SUP*plied to the shareholders also "by electronic means" (articles 9.4; 11.5); the provision regarding electronic proxy forms (articles 17.2[b]; 18.2[b]); conveying of information to shareholders via electronic means, upon a general meeting's decision and the shareholders' consent, on an equal treatment basis (articles 17.3; 18.4).
Besides that, the possibility to file information to the national competent authority via electronic means is affirmed (article 19.4[a]), while in general "electronic mean" is defined – rather generically – as: "means of electronic equipment for the processing (including digital compression), storage and transmission of data, employing wires, radio, optical technologies, or any other electromagnetic means" (article 2.1[l]). This means that, for instance, a normal e-mail is already fulfilling the requirements for being an electronic mean for the Transparency Directive.

on Company, nor Business, Law in particular, but many of the issues it deals with are closely related to this sector. In particular, the very first area of action mentioned in the document is the enhancement of a "vibrant Single Digital market", which is naturally linked to the entire field of Business Law. However, in such Communication no anticipation of foreseeable actual rules in the field of Company Law is present, while in the broader area of Business Law there were: the idea of "pan-European licensing" and other copyright related issues; the enhancement of electronic payments and eInvoicing;[26] the focus on online shopping as a consequence of an higher degree of trust in online shops to be achieved by European citizens; telecommunication services.[27]

Anyway, with reference to Enterprise Law, an obiter in the Communication leads to a subject we are going to analyze in depth in a while. When dealing with eGovernment, it is said that "Member Stated should […] agree by 2011 on a common list of key cross-border public services that correspond to well defined needs – *enabling entrepreneurs to set up and run a business anywhere in Europe independently of their original location*, and allowing citizens to study, work, reside and retire anywhere in the European Union. These key services should be available online by 2015".[28] This means that, in the original idea of the Commission, the possibility for the creation of new businesses throughout Europe regardless to the nationality and location of the founder should have been a duty of Member States, with no need of intervention by European institutions. The subsequent story shows that these expectations were not met, and European Commission assumed that, due to the evident lack of interest in the subject by each Member State, a European intervention should take place.[29]

[26] With a special focus on identification of people in the EU, which is the starting point of the e-IDAS Regulation, extremely important to the extent of digitalisation in Company Law.

[27] A Digital Agenda for Europe, p. 7-14.

[28] A Digital Agenda for Europe, p. 32 *seq*. The italicisation is mine.

[29] As already mentioned, in May 2018 a Statement of Support on a Digital Agenda for the Western Balkans was issued as well. The statement is not properly "European", as it is signed by the Heads of Government or State of six Balkan Countries, and it does not deal with Company Law in particular, even if the "capacity building in digital trust and security, in parallel to efforts to enhance digitalisation of industries" is mentioned. A truly "European" Digital Agenda for the Western Balkans was eventually launched on June 25th, 2018, and seems to be an initiative for a stronger regional implementation of the principles stated in the general "A Digital Agenda for Europe" Communication, for the development of the Single Digital Market. More details are available in the Commission Staff Working Document – Measures in support of a Digital Agenda for the Western Balkans, SWD (2018) 360 final, (https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/swd_measures_in_support_of_a_digital_agenda_for_the_western_balkans.pdf), accessed on 08/08/2018, where at p. 8 there is a new statement on "the development of digital solutions that enable public administrations,

2.4 THE 2011 GREEN PAPER ON CORPORATE GOVERNANCE, THE 2012 ACTION PLAN AND THE 2015 SINGLE DIGITAL MARKET STRATEGY FOR EUROPE

In 2011, the European Commission issued a Green Paper on Corporate Governance issues[30]; in spite of the specialty of the subject there considered, the issues related to digitalization are almost absent in the paper. The structure of the Green Paper suggests several questions for a subsequent consultation in the area of corporate governance; while dealing with the obstacles to shareholders' cooperation, the Paper states the setting up of "shareholder cooperation fora" or listed companies' proxy solicitation system "where listed companies would be required to set up a specific function on their website enabling shareholders to post information on particular agenda items and seek proxies from other shareholders",[31] alike already suggested in the Winter Report and in the 2003 Action Plan.

Also in the 2012 Action Plan issued by the Commission, the digital-related issues are almost unconsidered. As this document reports the stakeholders' replies to the 2011 Green Paper, in it the Commission takes a position on the need of shareholders' identification in order to facilitate the dialogue on corporate governance issues. Among the respondents, many advocated for the shareholders' fora to be hosted on corporate websites, as a minimal, but perhaps useful, solution. The Commission recognizes that, at least in listed companies, additional information on shareholders' identity can be useful for improving the dialogue within the company, announcing a proper initiative in 2013, but without a specific reference to digital issues.

Furthermore, in 2015 the Commission issued a Communication that could potentially deal with Company Law, focused on a Strategy for the Single Digital Market.[32] In this case too, however, the connection with Company Law is just occasional, when the communication reminds that "Many Member States have

businesses and citizens in Europe to benefit from interoperable cross-border and cross-sector public services"; among them, in the field of eGovernment, the actions aiming at the online establishment of new companies.

[30] Green Paper – The EU corporate governance framework, of 5 April 2011, COM (2011) 164 final, (http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf), accessed on 08/08/2018.

[31] Green Paper, p. 14.

[32] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions - A Single Digital Market Strategy for Europe, of 6 May 2015, COM (2015) 192 final, (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0192&from=IT), accessed on 10/08/2018.

called for action including helping companies to be formed quickly (e.g. in 24 hours). The Commission considers that any established company should be able to expand its operations cross-border online and be pan-European within a month building on the interconnection of business registers and the 'Once-Only' principle".[33] We are going to see how we can find again these principles and this kind of effort in the withdrawn *SUP* Proposal, the Single Digital Gateway Proposal, and the Digitalization Proposal, among the others.

2.5 THE 2016 ICLEG REPORT ON DIGITALIZATION

After many years – at least from the 2003 Action Plan to 2015 – without a specific focus on the issue of digitalization,[34] the most important document was issued in March 2016. It is the "Report on digitalization in company law", prepared by the Informal Company Law Expert Group established by the European Commission, and again formed by academics coming from different European Member States[35].

The Report is the response to a specific request made in January 2015 by the Commission to ICLEG regarding the role of digitalization in Company Law, and deals with many different issues going from the use of emails for communications to the company's website, to the shareholders' meeting. The most relevant issue the report deals with is, however, the online establishment of companies; regarding this issue in particular the Report served as inspiration for the April 2018 Proposal for a Directive in the field of Digitalisation in Company Law.

From a systematic point of view, the Report contributes with its own structure to shed a light on the core distinction to be made when approaching the issue of digitalization in Company Law. On the one hand, we have the area of the "digitalization of communication between a company and the State";[36] and, on the other hand, the "electronic communication between a company and its shareholders and other stakeholders".[37] In other words, we can say that it is

[33] Communication "A Single Digital Market for Europe", p. 17.

[34] Perhaps with the exception of the 2014 *SUP* Proposal, where digital incorporation of the company was one of the core points of the draft, as we are going to point out in the next Chapter 5.

[35] The report is available online, (https://ec.europa.eu/info/sites/info/files/icleg-report-on-digitalisation-24-march-2016_en.pdf), accessed on 08/08/2018. A list of the group's members is available at p. 2, while the paper has been produced mainly by Vanessa Knapp and Jesper Lau Hansen.

[36] Title of part III of the Report.

[37] Title of part IV of the Report.

possible to distinguish, in the general area of digitalization of Company Law, a digitalization on business environment (external digitalization); and the digitalization of companies in themselves, as for their internal structure (internal digitalization).

We are going to mention the proposals present in first part of the Report, regarding the information between the company and the State, when examining the Digitalization Proposal in next Chapter 5. We will highlight there the many similarities that can be found in such documents, bearing nonetheless in mind that such kind of digitalization deals, from a theoretical perspective, more with Public and Administrative Law than with Company Law.[38] Here it seems more appropriate to focus on the intra-company communication and the ICLEG proposals, which have not been transposed in the April 2018 Proposal.

On this issue, the Report is extremely detailed and proposes several solutions for the improvement of the internal digital environment of companies, having as a guiding principle that "company law, which regulates the relationship between a company and its shareholders and which may require companies to provide information to other stakeholders, should allow for such electronic communication among these private parties".[39] This means that, except for some specific remarks addressed to publicly traded companies, the Report's proposals are intended to be applicable to all companies[40] – regardless their being private or public – and to all their shareholders. The increased digitalisation the Report advocates for is intended to go along with, and not to replace, the traditional means of information and communication between the company and its shareholders: a further option for the enhancement of the quality and quickness of communication and not some kind of a "duty to update" imposed to both company and shareholders.

This being said, the core general point of the Report on this issue is to find an acceptable balance between traditional and modern views of a company that are likely to coexist in every corporate environment. This means that the European approach, in the ICLEG's idea, should be not to impose to the companies the duty to make digital procedures and tools available, that could be disproportionate; but, on the contrary, to require that the Member States "ensure that

[38] The issue, in fact, is linked with the relationship between a public authority, the business register, and private bodies, *i.e.* the companies and the shareholders, dealing with procedures that the latter ones have to complete at the former's offices.

[39] ICLEG Report, p. 23.

[40] In the field of shareholders' permanent representatives, to be appointed also by means of electronic procedure, as a proposed amendment to the Shareholders' Rights Directive: ICLEG Report, p. 37 *seqq*.

it is possible to use electronic communication"[41] at least in a series of core areas identified by the Report itself.[42] Once that the Member States guarantee that the information in such areas *can* be exercised by electronic means, it will be up to each company to decide whether it is interested in using digital tools for it, or preferable to maintain, fully or partially, the traditional "hardcopy way".

The Report shows very well to be aware of the difficulties of a choice for full digitalization in existing companies, where not all the shareholders will necessarily be in favor of such modification of their information rights.[43] In this case, there is the suggestion to apply the rules "in accordance with the national corporate governance system as decided by national law"[44], meaning this also with the qualified majorities possibly required by Member States,[45] which "should be permitted to require additional protections for shareholders not voting in favor of full digitalization".[46]

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[41] ICLEG Report, p. 25.

[42] The Report states (p. 25) almost all the events of information or exercise of rights by a company's member or shareholder:
"i. any notice of a meeting of shareholders or of a class of shareholders;
ii. any form to appoint a proxy or representative to attend a meeting or otherwise exercise the shareholder's rights or revoke their appointment;
iii. voting (both to adopt a resolution and, where this is done other than by resolution, to appoint a candidate as a director);
iv. a shareholder's right to add an item to the agenda of a meeting or add a resolution to be put at a meeting or to ask a question at a meeting;
v. a shareholder's right to participate at a meeting;
vi. the passing of a resolution other than at a meeting, for example by a written resolution;
vii. the right (if any) to receive notification of the results of a meeting;
viii. any right to receive the company's accounts, annual report or other financial information;
ix. any information provided by the company relating to the exercise of rights by a share-holder, for example to convert a share into a different class of share;
x. any exercise of rights by a shareholder by giving notice to the company or to a regulatory authority in relation to the company, for example to call for someone to be appointed to investigate the company's affairs;
xi. to communicate a takeover offer to the shareholders of the offeree company and for the offeree company to communicate to shareholders, employees and any other interested parties in connection with that takeover offer".

[43] Wisely, the Report distinguish from this situation that of companies fully digitalised since their establishment, where there are not impediments regarding possible dissenting shareholders, as the full digitalisation in communication is one of the conditions the shareholders agreed on as of their investment; see ICLEG Report, p. 31 *seq.*

[44] ICLEG Report, p. 25, Recommendation 15.

[45] ICLEG Report, p. 32.

[46] ICLEG Report, p. 33, Recommendation 24. This kind of protection could be an exit right, or less dramatically, the right to receive the information by traditional means.

Anyway, even if the company decides for a full digitalization, the shareholders should be free to opt-out for traditional communication *ad personam*;[47] and conversely, even where a company should decide for maintaining a traditional communication system, for instance for lack of the qualified majority in the general meeting on this issue, it "should be able to enter into an agreement with an individual shareholder as to how they will communicate".[48] In any case, the basic principles are two: on the one hand, all shareholders have to be treated equally; on the other hand, each shareholder must be free to change its mind regarding the preferred communication mean at any moment. Furthermore, as general principles for the entire system of electronic communication, the Report mentions the certainty regarding the identity of the parties involved, and the guarantee of the integrity of the communication.[49] As for the identification, it seems that the system of mutual acknowledgment established by the e-IDAS Regulation, we are going to analyse in next Chapter 5, is perfectly suitable to such purpose.

Moreover, the Report deals with a few additional issues: company's website, use of emails, general meetings.

As for the company's website,[50] the ICLEG again does not advocate for a general duty of creation for every company, but in the case a company has its own website, it should be used for supplying information to shareholders and third parties as well. To this end, the website should be recognisable by everyone as truly belonging to the company. The solution to this problem is, in the idea of the ICLEG, to offer the company the option[51] to file the "designated homepage" in the business register, so to make everyone aware of which one, among the many websites a big company could possibly have, is the relevant for official communications. This solution, together with the Business Register Interconnection System, ensures a widespread knowledge of the website, and consequently of the information there contained. As for the communication, the ICLEG suggest that the "designated homepage" could be used "to provide information that is mandated by law (whether national law or EU law)",[52] along

[47] ICLEG Report, p. 30.

[48] ICLEG Report, p. 30.

[49] In many *loca*; see for instance ICLEG Report, p. 24 *seq.*, Recommendation 14.

[50] ICLEG Report, p. 26 *seqq.*

[51] But the ICLEG states that "It would be worth considering whether there should be an obligation for certain companies with a homepage to register it as a designated homepage and, if so, whether this should apply to all companies or only to publicly traded companies" (p. 28). See also below, para. 5.4.3, regarding a possible joint use of the website and the information filed in the register.

[52] ICLEG Report, p. 28.

with – and thus not replacing to any extent – the filing in business register.[53] One of the proposals in this sense is to have some basic information[54] regarding the company and already filed in the national business register somehow "mirrored" in the website too,[55] so to facilitate the public knowledge of it, free of charge.[56]

Besides the pure public information, another meaningful role the company's website could be likely to play deals with the information supplied, on request, to shareholders and other entitled people. The ICLEG Report, founding its proposal on the provisions contained in e-IDAS Regulation, suggests that European institutions should explicitly allow companies to keep all their records in a digital secure format, with electronic seals, if they want. In order to make this provision effective also from shareholders' point of view, the ICLEG proposes that "those entitled to have access to the information should be able to request access electronically and whether companies should be able to, or required to, provide the information electronically", at least in publicly traded companies.[57] In this case, the most suitable and effective means for the exercise of this access right seems to be the company's website, even if this is not explicit in the Report, and in any case provided that the foreseeable European legal instrument for this purpose enacts a series of cautions.[58] More functions for the company's website can be linked to the general meeting's information, as we are going to see in a while.

[53] In the traditional way, or in the digital one the ICLEG advocates for, and that we are going to analyse in next Chapter 5.

[54] "15.11. The information to be set out on the website could include the information available at the national business registry, such as company's full name and registered number, where it is registered, its registered office, the names of the directors, who is authorised to enter into agreements on behalf of the company and to represent it in legal proceedings, the company's most recent ac-counts or if it is not required to prepare accounts, that fact, and whether the company is subject to insolvency or winding up or similar proceedings. We believe that this information should be availa-ble on the website in a standard format in addition to being available via the national business reg-istry and the e-justice portal so that it is readily available for free to someone using that website": ICLEG Report, p. 29.

[55] Or, at least, with a link to the relevant page in the business register.

[56] But at the same time with the risk to have diverging information in the register and the company's website.

[57] ICLEG Report, p. 33. See also below, para. 5.3.3.

[58] "Any such consideration should include: i. how the company would check that the request comes from someone entitled to access the in-formation; ii. what safeguards should be applied to ensure the information is used for the purpose for which it is intended and not for other purposes; and iii. whether there are cases where it would be inappropriate to provide information electronically": ICLEG Report, p. 34, Recommendation 25.

Regarding the use of email addresses, the Report simply proposes that, once that a company decides to adopt electronic means of communications, it should be required to disclose to the public at least one email address, filing it in the register, and mentioning it in its website.[59]

Finally, the ICLEG Report deals with the general meetings and the possibilities for an improvement of their digitalization.[60] On this subject, the ICLEG approach goes by far beyond the sole issue of digitalization. More precisely, starting from digitalization and the opportunities offered by its enhancement, the Report reaches really relevant systematic consequences; and this in spite of declaring that "[t]he possibilities of digitalization contemplated here do not in any way seek to influence the distribution of powers in national Company Law; it is solely intended as a reform of the practical forms of communication that are used in connection with the various national corporate governance models".[61] And, again, the proposed digital solutions are, in ICLEG's mind, to go along with traditional information structure, without replacing it, nor dispensing with the general meeting information, or with the idea of general meeting itself.[62]

The ICLEG's overall idea on the subject is that the traditional model is based on a "one-way" communication: the company supplies information to the members/shareholders, before, during and after the meeting; and, at least in some jurisdictions, the members are entitled to ask questions to the management, receiving replies during the meeting. It is, in other words, a soliloquy, while the entire company would instead benefit of a dialogue. Digital tools established by the company could be the means to achieve the goal of a more effective "two-ways" communication, or a dialogue.[63] A dialogue that could take place not only between members and management, but even between members themselves, being this way that sort of forum that already the 2011 Green Paper and the 2012 Action Plan advocated for.

This kind of dialogue would be extremely facilitated by the new digital structure; facilitated to that extent that the ICLEG proposes even to abandon the same concept of "extraordinary meeting", being it "simply a part of the ongoing communication between a company and its constituencies".[64] By this way, the Report suggests a reconsideration of the general distinction between the

[59] ICLEG Report, p. 29.

[60] As for proxies in publicly traded companies, see above, ref. 40.

[61] ICLEG Report, p. 34 *seq.*

[62] *Ibidem*.

[63] ICLEG Report, p. 35.

[64] *Ibidem*.

notice required for Annual General Meetings, and the remaining shareholders' communication facilities.[65]

Besides these insightful remarks, which however have not been transposed at all in the Proposal, the remaining ones deal with external digitalization in Company Law, and we are going to mention them when analyzing the April 2018 Proposal for a Directive.

3. THE EXISTING LEGAL PROVISIONS DEALING WITH DIGITALIZATION IN EUROPEAN COMPANY LAW

If we consider both of the facets of digitalization we have found in the ICLEG Report, and thus its internal and external dimensions, we can recover traces of them already in many pieces of legislation of the European Company Law already in force.

3.1 THE CODIFIED DIRECTIVE

In June 2017 the European Parliament resolved to codify in a single Directive many of the previous Directives regarding disclosure of company's (First Directive and later amendments[66]) and branches' (Eleventh Directive[67]) information, constitution and capital (Second Directive and its amendments[68]), domes-

[65] Finally, for publicly traded companies the Report states a proposal suggested by some companies "that it should be possible for them, with shareholder approval and subject to certain safeguards, to be able to dispense with any requirement for a physical meeting", having this way just virtual AGMs: ICLEG Report, p. 35 *seq*. And Recommendation 26.

[66] Being the last version available before the codified Directive the Directive 2009/101/EC of the European Parliament and the Council, of 16 September 2009, on coordination of safeguards which, for the protection of the interests of members and third parties, are required by Member States of companies within the meaning of the second paragraph of Article 48 of the Treaty, with a view to making such safeguards equivalent, (OJ L 258, 01/10/2009).

[67] Eleventh Council Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State, (OJ L 395, 30/12/1989.

[68] Last version available before the codification: Directive 2012/30/EU of the European Parliament and the Council, of 25 October 2012, 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 54 of the Treaty on the Functioning of the European Union, 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 315, 14/11/2012).

tic mergers (Third Directive and amendments[69]) and divisions (Sixth Directive and amendments[70]), and cross-border mergers.[71]

This work of codification[72] gave birth to a document rather similar to a basic "European Company Law Code", not yet uniformed as of its application, as some provisions apply to both public and private companies, and others to just some of them, nor in its overall structure, as only a few issue are actually regulated. In any case we can now rely on a codified and updated text dealing with many of the most relevant issues in European Company Law. This means that such text, the Directive 2017/1132, hereinafter also just "Codified Directive", is also perhaps the best place in order to appreciate the degree of digitalization the European Company Law reached before the April 2018 Proposal.

In many articles, we can find references to "*electronic means*", with a definition at article 16.2,[73] which is the fundamental article also with reference to disclosure – and Business Register Interconnection System – object of meaningful proposals of amendment by the April 2018 Proposal. In many others the citation of the company's website as an alternative mean of information even instead of the publication, in some cases.

More in detail, the External digitalization is at large present in the rules regarding the business register contained in articles 16 *seqq*., which lay down some obligations for Member States as for the electronic registration of documents and particulars required by article 14, converting in digital form those previously filed in hardcopy.

[69] Last version available before the codification: Directive 2011/35/EU of the European Parliament and the Council, of 5 April 2011, concerning mergers of public limited liability companies, (OJ L 110, 29/4/2011).

[70] Sixth Council Directive of 17 December 1982, based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies (82/891/EEC), (OJ L 378, 31/12/1982).

[71] Directive 2005/56/EC of the European Parliament and the Council, of 26 October 2005, on cross-border mergers of limited liability companies, (OJ L 310, 25/11/2005).

[72] From which the Directive (EU) 2017/1132 of the European Parliament and the Council of 14 June 2017, relating to certain aspects of company law, (OJ L 169, 30/06/2017) originated.

[73] "2. For the purposes of this Article, 'by electronic means' shall mean that the information is sent initially and received at its destination by means of electronic equipment for the processing (including digital compression) and storage of data, and entirely transmitted, conveyed and received in a manner to be determined by Member States by wire, by radio, by optical means or by other electromagnetic means". The definition at large recalls the notion given by Transparency Directive: see above ref. 25. For the suggestion of its repeal made by the Proposal, see below, para. 5.4.2.

Interested parties are free to apply for copies of disclosed information, even if, very curiously, while paper copies supplied to applicants are certified as "true copies" unless otherwise required by the applicant, the regime for electronic copies is exactly reverse, being them not certified as "true copies" unless the applicant "explicitly requests such certification".[74] The application for copies of the disclosed information can be made also for foreign registries, through the *system of interconnection of registers* (BRIS), according to article 18 of the Codified Directive. At least the information and particulars listed in article 14 are to be accessible through the BRIS, with a research system provided by the European Commission. More details regarding the BRIS are available at articles 22-25 of the Codified Directive; its momentous role for the development of an actually Single Market is to be as highlighted as possible. By means of this system, at least the basic business information is made really available throughout the Union, minimizing the linguistic issues, and increasing the unification of filing standards. In order to have no uncertainty regarding the searched company, it is necessary that each company has a "*unique identifier* allowing them to be unequivocally identified in communications between registers through the system of interconnection of central, commercial and companies registers"[75]; the same provision is established also for branches, for the same purposes.[76]

Besides the registers, which the Member States are owed to operate in a digital form, the Codified Directive establishes also an *option* for keeping in electronic form the *national gazette* where some basic information is to be published pursuant article 16.3. Another, even more radical option the Directive offers the Member States is to replace the publication in the national gazette, regardless of its paper or electronic form, with alternative means, provided that such means allow that the disclosed information "can be accessed in chronological order through a central electronic platform".[77]

Another key issue the Codified Directive deals with, in many articles and different subjects, is the company's *website*. Although for its own nature the website belongs, by itself, to the idea of internal digitalization, in the terms already discussed, the way it is used by the Codified Directive make of it some kind of a "bridge" between internal (as it is developed and issued by the companies) and external (due to its function of common information we are going to analyze in a while) digitalization.

[74] Codified Directive, article 16.4.

[75] Codified Directive, article 16.1.

[76] Codified Directive, article 29.4.

[77] Codified Directive, article 16.5.

Its importance is obviously paramount, but there is not a comprehensive regulation regarding the information it must contain, and this makes comprehensible the focus on it by the ICLEG Report. Furthermore, and above all, there is not a general duty for companies to have a website, and all the provisions laid down are thus applicable just to those companies that voluntarily decided to have a website. The first rule we can find lays down that Member States must ensure that the company's websites contain the same information to be supplied to the public in the letters and order forms (information on identification, comprising the relevant register and the unique identifier, and on company's legal form and seat), along with the mention of the capital subscribed and paid up.[78]

The mayor importance of websites is, nonetheless, when it comes to the mergers (domestic and cross-borders) and divisions of companies, where the norms explicitly state that some information can be published in the company's website *instead of the register*.[79]

As a general remark, we can say that, with reference to the issues here under discussion, the rules set down for domestic mergers are the same in force for cross-border mergers and, with the obvious replacement of the term "merger" with "division", for domestic divisions as well. What we are going to say applies, thus, to these three legal phenomena exactly in the same way.

The draft terms of mergers and divisions are to be disclosed, as it responds to a general interest, beside those of the members and shareholders of the merging or dividing companies to have knowledge of the terms of such operations. The general rule for disclosure is, obviously, that set down by article 16, with the filing of information – and draft terms are part of such information – in each register for each involved company, followed by publication in the national gazette, or the alternative equally effective electronic mean decided by the Member State. For the operation we are discussing about, nonetheless, besides this "traditional" way, there are two additional possibilities, the literature commonly sees as alternative to the disclosure through the filing in the national register.[80]

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[78] Codified Directive, article 26, with the penalties for failure in complying set down by article 28.

[79] This is, at least, the reading of the rule provided for by the leading textbooks in European Company Law: Grundmann, S.: *European Company Law*, Cambridge – Antwerp – Portland, 2012, p. 680; Dorresteijn A.F.M. *et al*, *European Corporate Law*, Alphen aan den Rijn, 2017, 72.

[80] See Codified Directive, articles 92 (domestic mergers), 123 (cross-border mergers), and 138 (divisions). Even if that in the text is the mainstream reading, it is my opinion that the alternatives laid down in the mentioned articles and described in the text are not to the whole system of disclosure, comprehensive also of the filing of the draft terms in the register, but just to the second part of it, *i.e.* the publication. In fact, the article 92 and its clones mention the exemption "from the publication requirements laid down in Article 16", where, article 16 mentions "pub-

On the one hand, it is possible to be exempted from publication when the draft term have been made available free of charge in the company's website "for a continuous period beginning at least one month before the date fixed for the general meeting which is to decide on the draft terms of merger and ending not earlier than the conclusion of that meeting".[81] By this way, the company's website serves as a public disclosure means, and the Member States only are entitled to set those proportionate restrictions required in order to "ensure the security of the website and the authenticity of the documents".

The second alternative passes through the same central electronic platform we already saw as an alternative to the publication in the national gazette, pursuant article 16.5, or other alternative websites, designated by the Member States and whose content is available free of charge. Even if in this case the platform or the website are not kept by the company itself, there is no doubt that we have here too an example of digitalization.

There is, then, a second set of rules where the company's website plays a meaningful role, in its internal dimension. We are referring to articles 97 and 143 laid down regarding the documents for inspection by shareholders in the case, respectively, of domestic mergers and divisions. Before the general meeting called for deciding on the merger or the divisions, the shareholders have the right to inspect a series of documents regarding the operation;[82] such inspection may oc-

lication" just in 16.5, referring to a *second* disclosure of the documents, the one to occur in the national gazette designated by each Member State. The derogation *SUP*plied by articles 92, 123 and 138 should thus be intended just to the part on the publication on the national gazette – that, by the way and as we saw, could be kept in electronic form as well – being in any case maintained the duty to disclose the document in the national register.

[81] And with the possibility of the Member Stats to extend the period of publication on the company's website, or the alternative eletronic platforms or sites mentioned by the norm: see for instance article 92, paragraph 6.

[82] Codified Directive, article 97.1: "1. All shareholders shall be entitled to inspect at least the following documents at the registered office at least one month before the date fixed for the general meeting which is to decide on the draft terms of merger:
(a) the draft terms of merger;
(b) the annual accounts and annual reports of the merging companies for the preceding three financial years;
(c) where applicable, an accounting statement drawn up on a date which shall not be earlier than the first day of the third month preceding the date of the draft terms of merger, if the latest annual accounts relate to a financial year which ended more than six months before that date;
(d) where applicable, the reports of the administrative or management bodies of the merging companies provided for in Article 95;
(e) where applicable, the report referred to in Article 96(1).
For the purposes of point (c) of the first subparagraph, an accounting statement shall not be required if the company publishes a half-yearly financial report in accordance with Article

cur at the company's registered office, or, as an alternative pursuant article 97.4 (and 143.4), by browsing the company's website. According to the cited rules, in fact, company is exempted from making the documents available at its registered office if they are present in its website, at least during one month before the meeting. In addition, the company has the right to refuse to provide copies of such documents if they are downloadable and printable from the website.[83]

3.2 THE REVISED SHAREHOLDERS' RIGHTS DIRECTIVE

Along with the Codified Directive, another piece of legislation currently in force contains many references to digital profiles, even if they are applicable only to "companies which are admitted to trading on a regulated market situated or operating within a Member State": the revised shareholders' right Directive (hereinafter RSRD).[84]

Already in the original version of the Directive, as of 2007, a few references to digital profiles were present; they have been increasingly enhanced in the revised version approved in 2017, with amendments dealing with the identification of the shareholders and their proxies. In these newer provisions, the main characters are the websites, and not just the company's one, as we are about to see. It seems that, even if there is not a specific obligation laid down in the black letter of the law, for the companies subject to the RSRD an implicit obligation to have and keep a website, for the purposes we are going to analyze in a while, still exists.

The leading principle of the RSRD is the urgency to provide shareholders with more tools for exercising their rights within the company, fighting by this way the so-called shareholders' apathy. From this point of view, the shareholders' participation may take place either directly, enabling the shareholders to take part into the company's meetings even without being physically present; or via representatives, by regulating the proxy voting and facilitating an aware appointment of proxy holders.

5 of Directive 2004/109/EC and makes it available to shareholders in accordance with this paragraph. Furthermore, Member States may provide that an accounting statement shall not be required if all the shareholders and the holders of other securities conferring the right to vote of each of the companies involved in the merger have so agreed".

[83] A final reference to digitalisation can be found in the Codified Directive at article 24(k) – and *Whereas* 37 of the Preamble, where online payments are considered in order to ensure that the BRIS can work if the applicants requiring information subject to a fee pays it by means of a foreign payment system. This provision, evidently part of the "external" digitalisation, is set down in order to preserve the actual function of the interconnection of the registers.

[84] Full references above, ref. 15 and 16.

In order to exercise their rights, a previous information regarding how to do that is needed; for this purpose, the company has the duty to inform shareholders and intermediaries regarding them, either directly, or indicating the part of the company's website where such information is available.[85]

The key corporate event for shareholders' participation is, of course, the general meeting. Before, during and after this event, digital tools play a relevant role for improving shareholders' information, mainly through the company's website.

As for pre-meeting information, the convocation – whose formalities can be different for the annual general meeting, and the other general meetings when the company allows its shareholders to vote by electronic means, being the requirements stricter for the former[86] – must contain some information, again on the shareholders' rights and their terms of exercise. It is possible for such communication simply to cross-reference the company's website if more detailed information is available there. The company's website has, or at least could have, this first function to supply information regarding shareholders' rights and ways of their exercise.[87]

Again, the convocation contains information on the proxy voting, comprehensive of the forms and information on electronic acceptance of the appointment by the company;[88] and on the exercise of the voting rights by correspondence or by electronic means. Finally, the convocation must report the company's website where additional information is to be made available by the company.

Pursuant to article 5.4, the informative function of the company's website includes:

- A copy of the convocations for the general meeting;
- The mention of the total number of shares issued by the company, the voting rights attached to them, and the distinction between classes of shares;

[85] RSRD, article 3b.1.

[86] The common means of convocation is the publication in the press; the RSRD allows that, in companies where the identification of shareholders it is possible, "provided that the company is under an obligation to send the convocation to each of its registered shareholders" (RSRD, article 5.2). In this case, even if it is not made explicit by the Directive, seems reasonable that the despatch of the convocation could take place by electronic means as well.

[87] Given the reading of the rule, it seems that this is not a compulsory content of the website, as the company could provide the same detailed information just in the convocation. In any case, as pursuant to RSRD article 5.4(a) the website must contain the convocation, this information will in any case be available in the company's website.

[88] This kind of acceptance is likely to occur, for instance, by accepting appointments via email, or having a dedicated section of the company's website where the appointing shareholders could upload the documents.

- The documents to be submitted to the general meeting, inclusive draft resolutions prepared by the company's management and tabled by the company's shareholders themselves, even electronically, pursuant to article 6.1;[89]
- Forms for the appointment of proxy holders.

Again with reference to pre-meeting information, the website is likely to serve as a means for not just one-way information from the company to its shareholders, but for a two-ways too, facilitating the exercise of shareholder's right to ask question. Clearly, each shareholder has the right to ask questions, and receive answers, during the general meeting; it is nonetheless possible that this right is made exercisable even before the meeting, allowing an exchange of information between shareholders and the company's management. Nevertheless, as sometimes the right to ask question could turn into an abuse by disturbing minority shareholders, it is possible that the company's website contains a FAQ section, and the answers there provided serve as a valid answer to relevant questions asked by shareholders, waiving by this way the management to provide *ad personam* replies.[90]

Finally, among the general information to be provided in the company's website there are also communications regarding the company's remuneration policy for their directors, and the remuneration report,[91] besides the detailed results of every vote that took place during the meeting.[92]

Moving to the moment of the general meeting, the general provision is that Member States must permit the shareholders' (and their representatives') participation by electronic means. The Directive highlights how these electronic means can be of three different types, which are not in alternative each other, but combinable:

- Real time one-way communication, where the subjects entitled to participate in the meeting only have the possibility to watch and listen the broadcasting, without interacting;
- Real time two-ways communication, with the possibility for the remotely present shareholders to interact with the meeting, *e.g.* by asking questions;

[89] Again, it shall be possible that such electronic means comprehend proposal via email, or uploading in a specific section of the itself.

[90] See RSRD, article 9.2.

[91] RSRD, articles 9a.7 and 9b.5, respectively.

[92] RSRD, article 14.2.

- "With a mechanism for casting votes, whether before or during the general meeting, without the need to appoint a proxy holder who is physically present at the meeting".[93]

As for the last point, such mechanism can obviously be also the vote by correspondence in advance of the general meeting, pursuant article 12. To our extent, however, it is much more interesting when the votes can be electronically cast,[94] by shareholders or by their representatives. In this case it is necessary that "an electronic confirmation of receipt of the votes is sent to the person that casts the vote".[95] Such confirmation must, thus, be sent to the voting person, whether the shareholder or a representative/proxy.

This remark leads us to consider the issue of proxy voting, that is central to the 2017 amendments to RSRD, with profiles of digitalization as well. There are two core principles on this issue:

- it should be possible for the shareholder to appoint the proxy in the quickest, safest, and most effective way;
- the shareholder must have the possibility to check whether the proxy holder followed the instructions, or not.

As for the first principle, we have already seen that instructions and forms are to be supplied to the shareholders along with the convocation for the meeting.[96] Regarding the certainty about how the representative voted, the confirmation to be sent to who cast the vote, pursuant article 3c.2 is to be sent, after the meeting, to the shareholder or to a third party nominated by the shareholder.[97] The second principle naturally deals with the reliability and the confidence the shareholder has towards the proxy.

There are some cases where the shareholder's voting policies should be public for the advantage of the market; this happens in particular when there are institutional investors and asset managers. In these cases, the RSRD lays down the rule that such subjects have to disclose their engagement and voting policies

[93] RSRD, article 8.1.

[94] Provision explicitly considered under RSRD, article 5.3(b)(iii), since the original version of the Directive.

[95] RSRD, article 3c.2, addedd with the 2017 amendments.

[96] Much more in detail, RSRD, article 11, also for the revocation of appointment. And, regarding the useful "permanent representative" proposal by the ICLEG, see above, in paragraph 2.5.

[97] And, even if here too there is no explicit mention of an electronic communication in this case, seems that there are no problems in having it sent by electronic means. Furthermore, this after-meeting information only is mandatory if it is not already available to the shareholder, or the third party designated by the shareholder.

in their websites, along with investment strategies.[98] Furthermore, a duty of transparency is laid down also on proxy advisors, regarding the application of a code of conduct, and other sensitive issues related to the vote.[99] They have to supply such information in their website as well.

3.3 THE ACCOUNTS DIRECTIVE

A couple of references to digital-related issues are, finally, available also in the Directive on annual and consolidated financial statements.[100] They are mainly technicalities,[101] but witness the progressive digitalization of the area of accounting as well.

This is clear since the statement in the Preamble that: "The Member States are strongly encouraged to *develop electronic publication systems* that allow undertakings to file accounting data, including statutory financial statements, only once and in a form that allows multiple users to access and use the data easily. With regard to the reporting of financial statements, the Commission is encouraged to explore means for a harmonized electronic format. Such systems should, however, not be burdensome to small and medium-sized undertakings"[102]. This principle finds its material declination in article 4.8 of the directive, with exemption from additional disclosure for SMEs publishing electronically their financial statements.

Furthermore, when a company prepares a separate non-financial statement, not enclosed to the management report, there is the mandatory provision to make it public on the company's website.[103] Equally on the company's website is to be published the corporate governance statement, if not enclosed in the management report.[104]

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[98] RSRD, articles 3g.2 and 3h.3. In the mentioned cases, we can argue that such websites are to be mandatorily held by those companies and subjects.

[99] RSRD, article 3j.

[100] 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, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, (OJ L 182, 29/6/2013), hereinafter also just Accounts Directive.

[101] For instance, see Accounts Directive, article 9,4 and *Whereas* 20 on the derogations in the layouts "if necessary for the electronic filing of financial statements".

[102] Accounts Directive, *Whereas* 39. Italicisation is mine.

[103] Accounts Directive, article 19a.4(b).

[104] Accounts Directive, article 20.2(b). As in the case above in ref. 98, here too it seems that the mentioned companies have the mandatory obligation to have a website.

4. THE ONCOMING LEGISLATION: THE SINGLE DIGITAL GATEWAY PROPOSAL

Before considering the April 2018 Proposal, whose destiny is still unclear mainly due to the forthcoming end of the European legislature, it is worth considering very briefly a Proposal for a Regulation issued by the Commission in May 2017 and currently with good possibilities to be adopted in short terms: the Single Digital Gateway Proposal (hereinafter SDGP).[105]

It is important to make it clear since the very beginning that the SDGP does not deal with Company Law in a direct way. The proposal has several profiles of interest for Company Law, but its scope of application is not that. Even more precisely, its – broad – scope of application covers many legal sectors and areas, but explicitly excludes Company Law.[106] This is due to two joint factors: on the one hand, the SDGP has been issued by the Commission's Internal Market directorate general, while Company Law issues are currently belonging to the competences of the Justice directorate. On the other hand, Company Law has many specificities that barely can be regulated by a "one size fits all" piece of legislation being more opportune to deal with such issues through a more tar-

[105] Proposal for a Regulation of the European Parliament and of the Council on establishing a single digital gateway to provide information, procedures, assistance and problem solving services and amending Regulation (EU) No 1024/2012, of COM (2017) 256 final, of 2 May 2017, [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017PC0256&from=EN], accessed on 13/08/2017.
The Proposal has been examined by the Council that on June 15th 2018 issued a final compromise text with a view to agreement, Council document 10069/18, available online [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CONSIL:ST_10069_2018_INIT&from=IT], accessed on 13/08/2018. As the just mentioned text is the most advanced version of the proposal, and the one with the most realistic expectation to be approved even in short terms, in this article we will cite this version.
According to a Commission's press release of July 12th, 2018, the formal approval by the Parliament and the Council is expected in September 2018, after that in July 2018 the Parliament's Internal Market and Consumer Protection Committee agreed on the text approved by the Council. Details: [https://ec.europa.eu/luxembourg/news/commission-welcomes-agreement-single-digital-gateway_fr], accessed on 13/08/2018.

[106] See SDGP, *Whereas* 23 of the Preamble: "In order to allow citizens and businesses to directly enjoy the benefits of the internal market without unnecessary additional administrative burden, this Regulation should require full digitalisation of the user interface of certain key procedures for cross-border users (…). *This Regulation should not cover the initial registration of a business activity nor the procedures leading to the constitution of companies or firms as legal entities or any subsequent filing by such companies or firms, as such procedures necessitate a comprehensive approach aimed at facilitating digital solutions throughout a company's lifecycle* (…)"; italicisation is mine.

geted document.[107] In any case, the Proposal on Digitalization in Company Law explicitly makes references to the SDGP, as we are going to observe in a while.

The goal of the SDGP is to establish a Single Digital Gateway – in the Proposal it is stated that it should be the existing website "Your Europe"[108] – in order to facilitate cross-border activities – not necessarily economic activities – for European citizens and enterprises. Such a purpose should be achieved through a system that guarantees to the beneficiaries low-cost and high-level verified information, the reduction of boundaries and fulfilments, and the possibility to get all the required information online. The areas interested by this proposals are listed in Annexes I (information to be supplied by the Gateway) and II (online procedures whose access must be possible via the Gateway), and deal with many profiles, from travel to work and retirement, to automobiles management, from residence to education, healthcare and family rights.

The SDGP is interesting for our purposes for two main reasons. We have the guiding principles for this Proposal, that are very much compatible, if not even inspiring for those contained in the later Proposal on digitalization in Company Law; and we can find there a set of rules that, even if are not directly applicable to companies in their large majority, are nevertheless a part of the overall business environment.

Looking at this latter profile first, we can see that it is present in both of the Annexes on information and digital procedures. This is very much consistent with the philosophy apparently underlying the Proposal: "First, Understand; Second, Act".

As for information that the Single Digital Gateway must provide for each Member State,[109] Annex I has a specific section dealing with business. Information are to be provided in a digital way with regard to starting, running and closing a business;[110] a firm's staff (employment law, social security, equal

[107] In addition, while the SDGP is a Regulation, the Proposal on Digitalisation in Company Law of April 2018 is on the contrary a Directive, which is, by the way, the most common legislative tool the European institutions use in the field.

[108] SDGP, *Whereas* 62 and articles 2.1, 18.1, 22.1

[109] Pursuant to SDGP, article 2.2(a): "The gateway shall give access to:
(a) information on rights, obligations and rules laid down in Union and national law, which are applicable to users exercising or intending to exercise their rights derived from Union law in the field of the internal market in areas listed in Annex I".

[110] Comprehensive of transformation and cross-border conversion; by this way, this area covers the issues dealt with by the Proposal on Digitalisation of April 2018, along with those contained in the accompanying proposal on cross-border conversions, mergers and divisions. This area includes also the information on intellectual property, commercial practices,

treatment, health and safety at work); taxes to be paid; goods and services (license, competition, certifications, production, disposal…); business' means of funding; public contracts. In other terms, the Single Digital Gateway should be a repository of information, provided by each Member State at least in two languages (the Member State's official one, and "an official language of the Union broadly understood by the largest possible number of cross-border users",[111] reasonably English), accurate and rather synthetic, allowing businessmen to better understand the legal environment of the Member States where they are interested in investing in.

Regarding the online procedures whose completion is to be entirely possible through the Single Digital Gateway,[112] the Annex II mentions in particular the possibility to notify the starting of a business activity or to request online via the Single Gateway the permission to start a business, if any. Here too, however, it is explicitly stated that the "initial registration of a business activity with the business register", the "constitution of or any subsequent filing by companies or firms within the meaning of the second paragraph of Article 54 TFEU", along with the termination of business activity involving insolvency or liquidation procedures are not regulated by the Proposal.[113] The Single Digital Gateway can thus be used in order to fulfil online some business-related requirements, but not to register a company, nor to record filings in the register; for these purposes, the digital tools provided for by the April 2018 Proposal on digitalization should be used.

cross-border online payments and e-commerce; insolvency, credit insurance, rights and obligations arising from contract law; civil liability of directors; processing of personal data.

[111] SDGP, *Whereas* 35.

[112] SDGP, article 6.1. In the original version, the rule was in article 5.2; the Council compromise, however, added to the text a part quite dangerous for the effectiveness of the provision, as Member States must ensure that "users can access and complete any of the procedures listed in Annex II fully online", but this only "where the relevant procedure is established in the Member State concerned". This naturally means that where these procedures are not established in a Member State, there is no obligation under the SDGP for such Member State to establish them.

[113] This means, however, that we have a grey area regarding, for instance, partnerships: as the derogation regarding initial registration and subsequent filing is motivated by the fact that such issues are dealt with by the April 2018 Proposal on digitalisation, we have to point out that this latter Proposal only deals with companies. On the other hand, the concept of partnership is within the notion of "company or firm" under article 54 TFEU, and thus out of scope of application of the SDGP, but also excluded from the scope of application of April 2018 Proposal on digitalisation. This means that no online procedure is available for this kind of firm; even if this is not a serious issue due to the very nature of partnerships, in most cases very much linked to the Member State where it is established and where its members are resident, from a systematic point of view this represent a gap in the overall system.

A few theoretical principles we can find in the SDGP are even more relevant for a better understanding of the Proposal on digitalization. They deal with:

- the basic information system, in order to spread detailed and qualified information regarding legal provisions currently in force in each Member State;
- the equivalency between domestic and foreign European citizens,[114] allowing the former and the latter to access to online procedures on the same basis, and this also thanks to the implementation of identification measures based on the e-IDAS Regulation;[115]
- the implementation of the "once-only" (*una tantum*) principle, meaning this, as for cross-border application, that "citizens and businesses should not have to supply the same data to public authorities more than once and that i[t] should also be possible to use this data at[ ]a the request of the user for the purposes of completing cross-border online proc[e]dures involving cross-border users".[116]

The mentioned principles are paramount as for a complete comprehension of the Proposal on digitalization, as it is to be intended as some kind of completion of the draw starting with the SDGP, namely regarding the profiles linked to Company Law. This being said, we are now ready to start the analysis of the Commission's Proposal on digital tools and processes in Company Law.

5. THE APRIL 2018 PROPOSAL ON DIGITALIZATION IN EUROPEAN COMPANY LAW.

As already several times reminded, on April 25th, 2018, the European Commission issued a series of initiatives, called "Company Law Package" aiming at the modernization of European Company Law.[117] One of them deals directly with the issue of digitalization, proposing amendments to the Codified Directive (EU) 2017/1132 in order to increase its level of recourse to digital processes;[118] such a proposal is the logic follow-up of the already described

[114] SDGP, *Whereas* 7, 8, 18 and article 13.

[115] SDGP, *Whereas* 21 and 70.

[116] SDGP, *Whereas* 44 (but also 12, 26, 42, 52, 72; and articles 1.1(b) and, in particular, 14).

[117] For full details see above reff. 1 and 13.

[118] Due to the fact that the Proposal has been released very recently, there are almost no commentaries on it, apart from Knaier, R.: *Digital first, Bedenken second?*, GmbH-Rundschau, 2018, 11, p. 560; Biermeyer, T. and Meyer, M.: *European Commission Proposal on Corporate Mobility and Digitalization: Between Enabling (Cross-Border Corporate) Freedom and*

ICLEG Report, even if not all the remarks contained in the Report have been actually transposed in the Commission's Proposal. In general, we can rather say that the Commission only implemented in the Proposal those suggestions regarding the "external digitalization", leaving almost no room to internal one.[119] Moreover, a part of the suggested amendments is not applicable to every company forms but only to some of them, namely those mentioned in the on-purpose added Annex IIA (private companies).

The Proposal has only five articles, and all the proposed amendments to the Codified Directive are in article 1; in order to make the referencing simpler and more understandable, we are going to refer to the proposed amendments as, e.g. "proposed" or "new article 13c", instead of the more correct and formal "article 1.3 *sub* article 13c".

5.1 THE STRUCTURE OF THE PROPOSALS

The Proposal deals with three main issues on digitalization in the strict sense; a couple of additional subjects are present, too, but they deal only partially with digitalization.

There is some kind of a "*General part*" on digital issues, the proposed articles 13a to 13e, dealing with definitions, identification means, fees and payments and information to be made available online by Member States.

These general provisions are followed by the core part of the document, providing for *new rules on a company's online registration and online filing* of particulars (proposed articles 13f to 13i); these rules are almost entirely applicable to the *company's branches* by virtue of new articles 28a to 28c, 30a and the new subparagraph added to article 31.

The provisions just partially related with digitalization are in particular those contained in the proposed article 13h on disqualified directors, whose application goes by far beyond the sole digitalization of companies;[120] and in the pro-

Fighting the 'Bad Guy', European Company Law, 2018, p. 110. As we are going to see in a few moment, in spite of not having yet literature on the Digitalisation Proposal, a large part of the commentaries on the *SUP* Proposal are still useful to our purposes.

[119] At the present day – August 2018 – it is still too early to say whether suggesions in the area of "internal digitalisation" are going to be added to the text at a later stage, for instance as a consequence of the analysis of the text by Parliament's Committees and the Council of the European Union, as on the issue there are not available documents by these subject yet.

[120] And with references also in the proposed article 13f.4(d), as we are going to point out in the next sub-paragraph.

posed article 162a, empowering the Commission to update the list of company forms in Annexes I, II and IIA.[121]

5.2 GENERAL PROVISIONS

The new articles 13a to 13e are a sort of a set of general rules on digitalization. Already here we can find hints of the principles we have already seen in the SDGP.

Starting from the equivalency between domestic citizens and European foreigners, we find it very clear already in the proposed article 13b, regarding recognition of identification means to be used in online procedures. In it, a clear reference to the e-IDAS Regulation is present too; all of this traces back to the already mentioned *SUP* Draft Proposal,[122] issued in April 2014 by the Commission in order to suggest the creation of a harmonized legal environment for the registration of single-member companies.[123] In its last available version

[121] Besides that, there are in the Proposal also a few "housekeeping issues" dealing with technical adjustments to the Codified Directive on:
- the business register interconnection system, allowing the creation of new optional access points by the Commission or the Member States in order to take full advantage of the system, and establishing new technical requirements and specifications (proposed amendments to articles 22 and 24);
- the repeal of the Contact Committee laid down by article 43, and currently without a legal basis;
- the simplification of provisions laid down in current version of article 16 by splitting it into a new article 16 and an article 16a.

[122] See above, ref. 7.

[123] In literature, there are many comments to the different versions of the proposal; we can mention here the most relevant to our purposes.
On the original version: Conac, P.H.: *The Societas Unius Personae (SUP): A "Passport" for Job Creation and Growth*, European Company and Financial Law Review, 2015, p. 139; Hansen, J.L.: *The SUP Proposal: Registration and Capital (Articles 13–17)*, European Company and Financial Law Review, 2015, p. 177; Malberti, C.: *The relationship between the Societas Unius Personae proposal and the acquis: Creeping Toward an Abrogation of EU Company Law?*, European Company and Financial Law Review, 2015, p. 238; Wuisman, I.: *The Societas Unius Personae (SUP)*, European Company Law, 2015, p. 40; Teichmann, C. and Fröhlich, A.: *Societas Unius Personae (SUP): Facilitating Cross-Border Establishment*, Maastricht journal of European and comparative law, 3, 2014, p. 536; Esteban Velasco, G.: *La propuesta de Directiva sobre la "Societas unius personae" (SUP): las cuestiones más polémicas*, El notario del siglo XXI: revista del Colegio Notarial de Madrid, 2015, p. 148; Id.: La propuesta de Directiva relativa a las sociedades unipersonales de responsabilidad limitada (en especial la Societas Unius Personae), in: Rojo Fernández-Río and Campuzano Laguillo (eds.): *Estudios jurídicos en memoria del profesor Emilio Beltrán*, Vol. 1, Valencia, 2015, p. 909; Lucini Mateo, A.: *En torno al Proyecto de Directiva europea sobre la Sociedad Limitada Unipersonal (SUP) presentado*

before the withdrawal by the Commission due to lack of political consensus,[124] the issue of the identification of the founding member was at large dealt with as it is now in the Proposal on digitalization.[125]

5.2.1 THE IDENTIFICATION OF EUROPEAN CITIZENS (E-IDAS REGULATION AND DIGITALIZATION PROPOSAL)

While in the *SUP* Draft Proposal the issue of identification was treated just with reference to the single funding member or his/her representatives, in the Digitalization Proposal it is applicable to all those subjects whose action could take place upon registration of the company and online filing. In spite of this, the underlying principles are the same in the two documents. The general idea is that the identification of a European Citizen should take place without the physical presence of such person before authorities of the same or another Member State, unless there is a "genuine suspicion of fraud based on reasonable grounds".[126]

por la Comisión Europea el 9 de abril de 2014, La Ley mercantil, 10 (enero), 2015, p. 24; Id.: *El proyecto de Directiva Europea acerca de la Sociedad Limitada Unipersonal*, El notario del siglo XXI: revista del Colegio Notarial de Madrid, 2015, 61, p. 54; Lecourt, B.: *La Societas Unius Personae: la nouvelle société unipersonnelle à responsabilité limitée proposée par la Commission européenne*, Revue des sociétés, 2014, p. 699; Serra, C.: *Societas Unius Personæ (SUP) – Um Golem na União Europeia?*, Direito das sociedades em revista, 2014, p. 127.
On the General Agreement version: Jung, S.: *Societas Unius Personae (SUP) – The New Corporate Element in Company Groups*, European Business Law Review, 2015, p. 645; Esteban Velasco, G.: *La Propuesta de Directiva sobre la "Societas Unius Personae" (SUP): el nuevo texto del Consejo de 28 de mayo de 2015*, Anales de la Academia Matritense del Notariado, 2015, p. 105; Bartolacelli, A.: *La Societas Unius Personae (SUP): verso un nuovo modello societario unipersonale europeo?*, Le nuove leggi civili commentate, 2016, p. 601; Fuentes Naharro, M.: *Una primera aproximación al test de solvencia recogido en la propuesta de directiva sobre la Societas Unius Personae (SUP)*, *working paper* [http://www.ucm.es/eprints], accessed on 13/08/2018; Teichmann, C. and Götz, A.: How to make a Molehill out of a Mountain: The Single-Member Company (*SUP*) Proposal after Negotiations in the Council, in: Viera González, A.J. and Teichmann, C. (eds.); *Private Companies in Europe: the Societas Unius Personae and the Recent Developments in the EU Member States*, Cizur Menor, 2016, p. 29. The entire just cited book contains many papers dealing with the issue here in discussion.

[124] Officially on July 4th, 2018 with document 2018/C 233/05; the withdrawal had already been anticipated by a Communication of the Commission of October 24th, 2017, COM (2017) 650 final, [https://ec.europa.eu/info/sites/info/files/cwp_2018_annex_iv_en.pdf], accessed on 13/08/2018, n. 10.

[125] And we are going to see in a while as the same core subject of the Proposal on digitalisation, the online registration of companies, comes directly from the *SUP* Draft Proposal.

[126] Digitalisation Proposal, article 13b.4. The provision recalls very closely the *SUP* Proposal, G.A. version, article 14b.3 and .4, which laid down that the Member State was exceptionally

In the normal case, *i.e.* when there is not a suspicion of fraud, the Member State's register shall identify the applicant. As the entire system designed by the Proposal is based on online procedures, such identification will not be carried out through analogic means of identification – for instance, a paper ID card, or a paper Passport issued by a Member State. More precisely, the mentioned means of identification are likely to be used, after their digitalization (*e.g.*: a scanned copy), if the Member State allows it.

Basically, identification means can belong to two categories: on the one hand, we have, traditional, paper identification means; on the other hand, electronic means. The choice between adopting paper or electronic identification means is made by each Member State; and even if electronic identification means are adopted, the citizen is in any case provided with a paper/hardcopy support of the identification document. The difference is that while traditional paper identification means cannot be read by electronic devices, and do not contain digitalized information, electronic identification means have these two basic features, and in most cases data written in the hardcopy support are available also in encrypted databases kept by Member States. Anyway, not all the electronic identification means are the same.

In order to understand this, it is necessary to introduce the notion of "electronic identification means" used by the Digitalization Proposal and that cross-references the e-IDAS Regulation.

e-IDAS Regulation[127] is a piece of European legislation issued in 2014 establishing, among the other, the key standards for the mutual recognition of foreign electronic identification means by the Member States.[128] Member States are free:

a) to adopt just paper-based means of identification;

b) to adopt (only or in addition) electronic means of identification, and in this case, such means of identification can be:

b.1) compliant with e-IDAS Regulation, if they follow the e-IDAS standards (and in this case there is the automatic mutual recognition of foreign means of identification);

free to require the presence of the person to be identified before its national authorities in case of a genuine suspicion of fraud. In the *SUP* Proposal this was the only case in which the registration could occur not fully online.
Besides this exception, another one can be established by Member States regarding the registration of companies where the shareholders have made in-kind contributions: see article 13f.4(f) and more in detail below, subparagraph 5.3.1.

[127] Details above, ref. 8.

[128] The entire subject is very technical, and perhaps for this reason there are not academic commentaries on the e-IDAS Regulation.

b.2) not compliant with e-IDAS Regulation (without automatic mutual recognition).

The basic principle is that the Member States are free to decide whether adopts e-IDAS standards, or not.[129] Thus, there is nothing preventing Member States from maintaining just the paper-based identification system, apart from the lower degree of competitiveness of such State (or, more correctly, of such State's national citizens) in a globalized and increasingly always more digitalized market. The enforcement to the creation of electronic identification schemes, their notification to the Commission, and consequently their compliance with e-IDAS Regulation is only indirect.[130] And, even if the European institutions provide for minimum technical standards to comply with regarding data security, not all the Member States are going to issue electronic identification means with the same level of assurance.[131] It is even possible that

[129] According to the e-IDAS Regulation, article 2, the "Regulation applies to electronic identification schemes that have been notified by a Member State, and to trust service providers that are established in the Union". This notification is dealt with by subsequent article 9. In general, this means that when a Member State establishes an electronic identification scheme – "a system for electronic identification under which electronic identification means are issued to natural or legal persons, or natural persons representing legal persons": article 3(4) – it is free either to notify it to the European Union, or not. In the latter case, the electronid identification means issued under such scheme won't be e-IDAS compliant.

[130] Each Member State can establish one or more identification schemes that not necessairly will be managed by public authorities.

[131] What is relevant to the purposes of the e-IDAS Regulation is that the electronic identification means issued under the notified identification scheme must have a certain degree of assurance. Such levels are described in detail by article 8.1 and .2: "1. An electronic identification scheme notified pursuant to Article 9(1) shall specify assurance levels low, substantial and/or high for electronic identification means issued under that scheme.
2. The assurance levels low, substantial and high shall meet respectively the following criteria:
(a) assurance level low shall refer to an electronic identification means in the context of an electronic identification scheme, which provides a limited degree of confidence in the claimed or asserted identity of a person, and is characterised with reference to technical specifications, standards and procedures related thereto, including technical controls, the purpose of which is to decrease the risk of misuse or alteration of the identity;
(b) assurance level substantial shall refer to an electronic identification means in the context of an electronic identification scheme, which provides a substantial degree of confidence in the claimed or asserted identity of a person, and is characterised with reference to technical specifications, standards and procedures related thereto, including technical controls, the purpose of which is to decrease substantially the risk of misuse or alteration of the identity;
(c) assurance level high shall refer to an electronic identification means in the context of an electronic identification scheme, which provides a higher degree of confidence in the claimed or asserted identity of a person than electronic identification means with the assurance level substantial, and is characterised with reference to technical specifications, standards and procedures related thereto, including technical controls, the purpose of which is to prevent misuse or alteration of the identity".

different electronic means issued by the same Member State, under the same identification scheme, have different levels of assurance; besides that, it will be possible that the identification means issued by different Member States have different levels of assurance. This could cause issues on the field of reliability of the information under a cross-border point of view.

Furthermore, cross-border mutual recognition of the electronic identification means needs a common interaction platform; this will be fully operative by September 29th, 2018.[132]

The mutual recognition system ensured by e-IDAS allows that the information regarding the identification data of the citizens detained by a Member State, and guaranteed in its reliability by the measures taken by the State upon the issue of the identification mean, can be exchanged with another Member State, provided that they are e-IDAS compliant.

The rules regarding such system are laid down in e-IDAS Regulation's article 6. The basic principle is that a Member State (Member State "A") shall automatically recognise the electronic identification means issued by another Member State (Member State "B") when A requires electronic identification for its own national citizens to access a service provided by A, and provided that:

- the electronic identification means issued by B is listed in the Commission's notification list; and
- B's electronic identification means level of assurance must be equal or higher than A's ones (that has to be no lower than substantial).

This is the general framework for mutual recognition in the e-IDAS Regulation. It is to be coordinated with Digitalization Proposal's article 13b, whose application purposes are both domestic and cross-border.

In order to allow online registration and filing of documents in the national registers, the Member State where the register is located (Member State "A") shall accept:

a) Electronic identification means issued by Member State A itself;

b) Electronic identification means issued by Member States different than A, but recognized by A in accordance with e-IDAS Regulation's article 6;

[132] As of August 2018, almost all European Member States have already implemented at least an electronic identification scheme. According to the Commission's official website on the issue, [https://ec.europa.eu/cefdigital/wiki/display/CEFDIGITAL/Country+Overview+-+eID], accessed on 14/08/2018, only Bulgaria, France, Romania, Poland are still in a phase of implementation, while the notification procedure has been completed by Germany, Croatia, Luxembourg, Estonia, Italy, Spain, Portugal, Belgium.

c) Other identification means, not necessarily electronic, issued by the Member State A, provided that the same type of identification means issued by other Member States are equally accepted.[133]

Exactly as it happened in the *SUP* Proposal, G.A. version,[134] we can see here two different levels of application. On the one hand, recognition of identification means under a) and b) is mandatory for all the Member States;[135] on the contrary, the recognition under c) is mandatory only with reference to the respect of the principle of equality of treatment of citizens of all the Member States.[136]

This system should allow to check fully online the identity of an applicant; there are nevertheless concerns regarding possible cases of identity fraud; for this reason, the already mentioned provision allowing Member States to require the physical presence of the applicant for the purposes of verifying the identity, "in cases of genuine suspicion of fraud based on reasonable grounds".[137] Examples of such "reasonable grounds" are offered in the Preamble,[138] specifying that the requirement of the physical presence is to be intended as exceptional, "not systematically but on a case-by-case basis", "on the basis of information available from the registers of beneficial owners, from criminal records or from indications of identity fraud or tax evasion".[139]

The point is that it is not impossible to imagine that Member States not extremely happy with a fully online procedure could use the mentioned exceptional provision as a "picklock" to "demolish" the entire system. From this

[133] For instance, a digital/scanned copy of a Passport or ID card is not an electronic identification means, but simply a digital copy of a traditional identification means. If a Member State, for instance, Italy, accepts a scanned copy of an Italian ID card for the purpose to register a company, the Italian register will not be able to refuse the registration to a Danish citizen willing to use for the same purpose a copy of a Danish ID card.

[134] Article 14b.

[135] Even if issues are likely to arise in case of different levels of assurance of the electronic identification means issued by a different Member State.

[136] About the issue of the use of e-IDAS Regulation in the first version of the *SUP* Directive, with proposals eventually transposed in the G.A. version, see Wuisman, I.: *op. cit.* in ref. 123, p. 40; Malberti, C.: *The Relationship*, cit. in ref. 123, p. 266 *seq.*; Esteban Velasco, G.: *La Propuesta de Directiva sobre la "Societas Unius Personae" (SUP): el nuevo texto*, cit. in ref. 123, p. 133.

[137] Article 13b.4.

[138] *Whereas* 14.

[139] These examples *SUP*plied by the *Whereas* 14 are very meaningful, in particular because the *SUP* Proposal, G.A. version did not require "reasonable grounds", and consequently did not *SUP*ply any kind of examples for such grounds, for the exceptional case of the required physical presence of the applicant.

point of view, it seems very relevant that the Preamble states examples of the "reasonable grounds". We must however note that the notion of "reasonable" is extremely subjective; for this reason, it seems that the Member States barely could find themselves bound by this kind of reasonableness.

Furthermore, the examples supplied in the Preamble do not actually seem to be a-systematic. On the contrary, they set some kind of supposition, which for its own nature is systematic, assuming that when an applicant had issues with identity fraud or tax evasion this would be enough to get rid of the online system, applying the traditional one. It seems that this issue should be carefully revised.[140]

5.2.2 INFORMATION

The second similarity we can find between the SDGP and the Digitalization Proposal deals with the information to supply regarding each Member State's Company Law system, according to proposed article 13e.[141] This is evidently in order to allow interested people to have an idea of Member State's Company Law, even if the belief that the information mentioned in article 13e is sufficient to have a conscious awareness regarding the basic structure of companies in the Country where one is intending to invest is more than naïve.

The spread of information is, as we have already seen, one of the key issues of the SDGP; for this reason, the interlocking between these two Proposals finds here its strong ring: Member States have to provide the information on Company Law on the same websites used to upload information to the Single Digital Gateway. This rule allows completing the information to be supplied by the Single Digital Gateway with the provisions on Company Law as well.

Nevertheless, the structure of article 13e clearly exposes the actual purposes of the information to provide. In fact, there are two different scopes of information: the first, with a narrower range of details, regarding all the company forms allowed under domestic law (those listed in Annex II of the Codified Directive);[142] and a second, whose application is limited to the companies list-

[140] Actually, the Impact Assessment, p. 45 *seqq.* informs that several options had been taken in consideration, and the one including the exceptional possibility described in the text was deemed as the preferred for its being "highly cost-effective for companies while offering the highest protection for stakeholders" (p. 49).

[141] A similar provision, dealing with the basic profiles on the functioning and registration of the company were present also in the *SUP* Proposal, G.A. version, article 12.

[142] Pursuant article 13, even according the proposed new text. The information to provide are, according to the proposed article 13e.1:

ed in the proposed new Annex IIA – *i.e.* private companies – that is by far more extended.[143] Furthermore, the latter is explicitly said to contain just the *minimum information*, leaving by this way the Member States free to provide additional information.

By reading the latter list of required information, it is very clear that the ultimate purpose of the Commission in drafting the rule is to provide possible investors in SMEs abroad with a sort of "certified vade mecum" of applicable rules.

5.2.3 REMAINING GENERAL PROVISIONS

The remaining provisions we can find in the General Part of the Proposal on Digitalization deal with not strictly digital issues, which are nevertheless useful to guarantee an actual implementation to the substantial rules. Articles

"(a) requirements concerning the registration and operation of companies and their branches, including online registration and online filing under national law;
(b) requirements relating to the use of templates, including information on national laws which govern the use and contents of such templates;
(c) requirements relating to the authentication of documents and information to be submitted as part of the online registration procedure;
(d) rules relating to the means of identification required as part of the online registration and filing."

[143] New article 13e.2: "(a) any formalities relating to online registration of and online filing by a company or branch, including procedures and time limits, together with details of all documents and information required and any applicable fees;
(b) any requirements concering the submission of documents drawn up in other languages, including the translation or certification of such documents;
(c) the means of identification, as referred to in Article 13b, required by the Member State;
(d) the powers and responsibilities of the administrative body, the managerial body and the *SUP*ervisory organ of the company or branch including the representation of a company or a branch towards third parties;
(e) the requirements for becoming a member of the administrative body, the managerial body and the *SUP*ervisory organ of the company or branch;
(f) details concerning the decision-making process of the administrative body, the managerial body and the *SUP*ervisory organ of the company or branch;
(g) details relating to the rights and obligations of the shareholders;
(h) details concerning the payment of dividends and other forms of distributions;
(i) information relating to legal reserves, where applicable;
(j) conditions affecting the validity of pre-incorporation contracts;
(k) any requirements relating to the operation and activities of a branch by a company, as well as any requirements relating to the opening and closure of a branch;
(l) any requirements relating to a change in the documents and information referred to in Articles 14 and 30".

13c and 13d, in fact, lay dawn the rules on, respectively, applicable fees for online registration and filing, and means of payment. In both of the cases, the underlying principle is the equal treatment of domestic and cross-border situations.[144]

Thus, there shall be no discrimination (for citizens of the Member State of registration and citizens of other Member States) in the fees applicable to the register and the filing, and the fees "shall not exceed the administrative costs of providing the service". And, as far as payments are concerned, if the procedure implies the payment, for instance, of a fee, such payment shall be possible "by means of a payment service widely available in cross-border payment services".[145]

5.3 ONLINE REGISTRATION AND FILING OF COMPANIES AND BRANCHES

The core part of the Digitalization Proposal deals with the online registration of companies, and with the online filing of documents; these issues cover the area of branches too, but certainly the "main course" of the proposal deals primarily with companies. It is not surprising, thus, that the rules on branches in practice simply reply those previously set down for the companies.

Again, the issue of online registration was the key feature of the *SUP* Proposal; and so evidently the key feature, to lead some commentators to argue that preparing a legal framework suitable for registering companies online was, in reality, the sole, hidden, purpose of that Proposal.[146] By requiring that the Member States had to ensure that the online registration of the *SUP* had to be possible, the Commission was, in fact, indirectly imposing them an extremely costly obligation, which would have been completely senseless to limit to the economically almost irrelevant *Societas Unius Personae*. As the system would have been prepared for the *SUP* – this was the unavowed belief of the

[144] As the ICLEG Report advocates for too, at p. 16 *seq*.

[145] The necessity of such last provision seems to be questionable; as we have already seen, provisions in the same sense are already present in the current version of the Codified Directive (namely at article 24(k)): see also above, ref. 83.

[146] Siems, M.: *The Societas Unius Personae (SUP): a Trojan Horse?*, [siemslegal.blogspot.it/2014/04/the-societas-unius-personae-*SUP*-trojan.htm], accessed on 13/08/2018; Hansen, J.L.: *The SUP Proposal*, cit. in ref. 123, pp. 178, 180 *seq*. and 189 *seq*.; Schmidt, J.: *Der Vorschlag für eine Societas Unius Personae (SUP) – SUPer oder suboptimal?*, GmbH-Rundschau, 2014, 9, p. 130; Esteban Velasco, G.: *La Propuesta de Directiva sobre la "Societas Unius Personae" (SUP): el nuevo texto*, cit. in ref. 123, p. 131, footnote 45; and Bartolacelli, A.: *La Societas Unius Personae*, cit. in ref. 123, p. 610 *seq*.

Commission – the Member States would eventually have it extended to all the company forms. Unfortunately, or fortunately, the *SUP* project did not succeed. Exactly at that point, the idea for a Proposal on Digitalization come out; by this way confirming that the real purpose of the *SUP* was what we can find now as the core issue of the Digitalization Proposal: the online registration of every company form.[147]

5.3.1 ONLINE REGISTRATION OF COMPANIES

The rules on online registration of a company are contained in proposed articles 13f and 13g.

The basic idea is that Member States have to ensure the fully online procedure of registration of a company for *at least* private companies. Honestly speaking, the wording of the rule is nonetheless questionable: the general rule is that a fully online registration must be available for (all of the) companies; however, "Member States may decide not to provide fully online registration procedures for those types of companies listed in Annex I".[148]

This means that once that a Member State decides to exclude the companies listed in in the Annex I from the possibility of being registered online, all the remaining company types present in Annex II, apart from those listed in Annex I, shall take advantage of the possibility of an online registration. Companies listed in Annex I are public companies, for instance Aktiegesellschaft in Germany, or Società per azioni in Italy, or Société anonyme in France. According to article 13, however, article 13f is applicable to all the company forms listed in Annex II; this means, using the same Member States just cited, Aktiengesellschaft, Kommanditgesellschaft auf Aktien, Gesellschaft mit beschränkter Haftung for Germany, società per azioni, società in accomandita per azioni e società a responsabilità limitata for Italy, and société anonyme, société en commandite par actions, société à responsabilité limitée, société par actions simplifiée for France. If we deduct the content of Annex I from Annex II, the result – *i.e.* the mandatory scope of application of the possibility for an online registration – is not limited to private companies (that are listed on the contrary in the proposed Annex IIA): there are the Kommandit, accomandita, commandite – limited partnerships by shares – for those Member States that have such company form. Due to the specificities of such company forms, it

[147] The same approach was adopted by the ICLEG Report, p. 17, with the proposal to extend the online formation to all the company types covered by the late Directive 2009/101, *i.e.* those currently listed in Annex II of the Codified Directive.

[148] Proposed article 13f.1.

makes no sense to have a mandatory online registration scheme for them too. Their inclusion in the scope of mandatory application of article 13f seems due to a slip of the pen, rather than a conscious choice.[149] On the contrary, it would be much better to allow Member States to limit the scope of application of article 13f just to company forms listed in the proposed Annex IIA.

The fact that the Member States have to ensure the possibility of a fully online registration of companies pursuant proposed article 13f does not mean that they must have it as the sole means of registration; on the contrary, the online registration is to be intended as an option. The founders will be free to choose between the traditional, paper-based registration, and the online registration, at least for those company forms for which the Member States have to ensure the implementation of such digital tool.

Again, the process of registration will be completed online only provided that the "genuine suspicion of fraud based on reasonable grounds" already analyzed under new article 13b.4 does not exist.

Due also to the nature of Directive of the proposed piece of legislation, besides the respect for "Member States' existing traditions of company law",[150] the Proposal does not set down rules for online registration directly; on the contrary, such duty belongs to the Member States. The Proposal, however, establishes the scope of such rules, prescribing that they must include details on the use of templates and "the documents and information required for registering a company".[151] Regarding this latter specification, the Member States have to ensure that information and documents can be submitted electronically and in particular that authenticated electronic copies issued by other Member States' registers and compliant with the e-IDAS Regulation are accepted.

Even if the Member States are theoretically free to set their own rules on companies' registration, the Proposal lays down provisions regarding the minimum

[149] This even more if we consider the reason for the possible derogation for the companies listed in Annex I: "due to the complexity of establishment and registration of such companies and in order to respect Member States' existing traditions of company law": *Whereas* 9. Now, the limited partnerships by shares have in common with public limited companies (Annex I) the same complexity of establishment and registration, even increased by the necessary presence of at least to categories of shareholders, one even with unlimited liability.
Besides the Member States mentioned in the text, the same issue is present in Belgium, Denmark, Spain, Poland, Portugal, Romania, and Slovenia.

[150] Again, *Whereas* 9 and 12. This specific provision deals in particular with the need, in many Member States, of the intervention of a notary in the process of registration; the subject will be analysed in a while.

[151] Proposed article 13f.2.

scope of such rules,[152] and further optional content.[153] This distinction is likely to create issues, though. In fact, if the Proposal states the minimum mandatory content ("The rules […] shall at least provide for the following…") first, and immediately after adds the optional one ("The rules […[may also provide for the following"), the question arises whether Member States are entitled to add further rules besides those listed in 13f.4, or not. If the answer is negative, the very nature of the Proposal as actually a Directive seems to be in peril.

Coming to the content of the rules on online registration that the Member States may or could implement, the *mandatory* ones deal with procedures to ensure:

- The legal capacity of the applicant and their authority to represent the company;
- That the person registering the company is actually the person that claims to be (verification of identity);
- How the applicant can use the trust services referred to in e-IDAS regulation, mainly for the purposes of authenticating documents.

The optional content, on the other hand, refers to:

- How to ensure the legality of the object of the company;
- How to ensure the legality of the company's name;
- How to ensure that the instrument of constitution – and/or the filling-in of the template, if used – is compliant with the law;
- How to verify the appointment of the directors, "taking into account the disqualification of directors by competent authorities of other Member States";
- How to ensure the presence of a notary or other person of body within the procedure of online registration, if so required by Member State's law;
- An additional case of impossibility to complete the online procedure of registration, due to the presence of shareholders' contributions in kind.

These rules are the starting point for a series of brief remarks.

With reference to the mandatory provision on the identity check, we must note that there is a meaningful step forward, if compared with the *SUP* Proposal, even in its G.A. version. In fact, in that Proposal the control on identification was simply optional: "the process of registration, including possible control of

[152] Proposed article 13f.3.

[153] Proposed article 13f.4.

legality *that may consist* of verification of identity and legal capacity (…)".[154] This development is likely to be due to the implementation of the e-IDAS Regulation, which had not been approved yet as of the first version of the *SUP* Proposal. Furthermore, the compulsory check of the applicant's legal capacity seems a good achievement too, as a good means to ensure the lawful constitution of the company also from the subjective perspective.[155]

As for the optional rules referred to in article 13f.4, their being not mandatory is due to the fact that they deal with issues not necessarily present every Company Law tradition. We have in fact cases in Europe where, for instance, company's object are not to be disclosed in a mandatory way; or a company's name is to be chosen from a pre-approved list; or, again, the notary or other public functionaries are not playing a role upon a company's registration.

The role of notaries is one of the Proposal's critic points. In order to understand the caution used by the Commission in dealing with such issue, we must remember that this subject caused the final deadlock in the *SUP* Proposal. We can deal with it along with the theme of templates.

Following some sort of a "tradition" in the last proposals in the area of Company Law,[156] the Proposal mentions templates for the registration of companies the Member States have to make available.[157] Regarding this issue too, Member States face on the one hand an obligation, and on the other hand are given an option. The obligation to make available templates for the registration is lim-

[154] *SUP* Proposal, G.A. version, article 14a.1. The italicisation is mine. In the same sense also the *Whereas* 18. The freedom regarding such verification was correctly criticised by Teichmann C. and Fröhlich A.: *Societas Unius Personae*, cit. in ref. 123, p. 542 *seq*.

[155] As it is useful remind that according to Codified Directive, article 11(b)(v) the incapacity of founding member is likely to lead to the nullity of the company, under many jurisdictions.

[156] Templates were present in the *SPE* Proposal of Regulation on a European Private Company: Proposal for a Council Regulation on the Statute for a European private company, of 25 June 2008, SEC (2008) 2098; SEC (2008) 2099, [https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2008:0396:FIN], accessed on 15/08/2018, now withdrawn (since 21 May 2014). The suggestion to use templates was present since the proposal of compromise of April 2009. Regarding the issue, in general, see: Guidotti, R.: *The European Private Company: The Current Situation*, German Law Journal, 2012, p. 331.
Eventually, templates have been one of the hallmarks of the *SUP* Proposal, with different attitudes regarding their source in the considered versions. At the very beginning, in the original version, the templates had to be prepared by the Commission itself (article 11.3); while in the G.A. version this duty was pending over the Member States (articles 11.4 and 13.3). This solution appears to be the most effective, due to the issue that a centralised drafting are likely to cause due to the diverging national provisions in the subject. Accordingly, on the *SUP* Proposal, Malberti, C.: *op. cit*. in ref. 123, p. 258, footnote 73.

[157] Such issue was faced also by the ICLEG Report, p. 18, advocating for standard articles to be prepared by the Member States.

ited to the company forms listed in Annex IIA; while for the other company types listed in Annex II (public companies and limited partnerships by shares) they simply "may also make templates available".[158] Such approach reassesses, once again, that the main recipient for the interventions the Digitalization Proposal deals with are SMEs established in form of a private company.

The content of the template is to be defined freely by each Member State;[159] and the Member States are to make available the templates – each one of them, both the mandatory and the optional ones, if any – on the Single Digital Gateway portal. Consistently with the SDGP's rules, the templates too are to be made available "at least (…) in an official Union language broadly understood by the largest possible number of cross-border users"[160]; this naturally besides the Member State's official language.

The templates may have two functions, according to the domestic applicable law. On the one hand, they can be used simply as forms for the registration in the online portal serving to that purpose; on the other hand, they can also be where domestic Company Law allows it, the very instrument of incorporation of the new-born company.[161]

The templates deal with the role of notaries upon a company's incorporation primarily because in the Member States with notarized incorporation of companies the notaries are usually in charge of drafting the company's instrument of incorporation, comprising their charters or articles. Naturally, the fact that templates are available for such a purpose is by itself perceived by notaries as some kind of a threat to their role in companies' incorporation: "if templates for articles are available, what are we supposed to do?" is the logic question.[162] As on this issue – among the others – the *SUP* Proposal was wrecked, the European Commission was much more careful in the drafting of the Digitalized Proposal regarding this specific subject.[163]

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[158] Proposed article 13g.1.

[159] Proposed article 13g.4. This is a meaningful change if compared with the system draft in the *SUP* proposal, even in its G.A. version, where the European lawmaker set down a *maximum* content for such document, with a provision rightly criticised by Esteban Velasco, G.: *La Propuesta de Directiva sobre la "Societas Unius Personae" (SUP): el nuevo texto*, cit. In ref. 123, p. 120.

[160] Proposed article 13g.3.

[161] Here we can find another divergence, if compared with the *SUP* Proposal's rules, where, at least in the original version, two separate templates were mentioned, one for the registration, and one for the instrument of incorporation (see: article 11.3, original version).

[162] And such question is present in the Impact Assessment as well, p. 17 *seq*.

[163] In the original *SUP* Proposal, there was no explicit mention of the role of notaries as of a company's registration (apart from the Impact Assessment annex to the Proposal), even if

The notaries, as in the withdrawn *SUP* project, as in the current Proposal, maintain in any case, where present according the applicable domestic law, the verification of the identity and the legal capacity of the people involved in the registration process, and of the legality of the instrument of constitution, "including verifying the correct use of the templates".[164]

Now, it is now clear why the (optional) provision on the role "of a notary or other person or body mandated by the Member State", *i.e.* proposed article 13f.4(e), is to be read together with the mandatory rules of proposed article 13f.3(a) and (b), and the optional ones of proposed article 13f.4(a), (b), (c), (f), and partly (d).[165] We can thus say that the latterly mentioned rules are held as optional by the Proposal because it deals with them from a general perspective; they have on the contrary to be intended as mandatory for those Member States where the notaries have a role in a company's registration. This should help notaries in being more in favor of the Proposal than they were in occasion of the discussion about the *SUP*. The notarial role, anyway, must find place in the fully online procedure, and this can be realized for instance by means of a video-conference system.[166]

Consistently with such reading of the proposed norm, thus, the provision stating that "Where those templates are used by the applicant in compliance with the rules referred to in point (c) of Article 13f(4), where applicable, the requirement to have the company instruments of constitution drawn up and certified in due legal form as laid down in Article 10 shall be deemed to be fulfilled"[167] is not

the domestic Company Law of many Member State recognises it. This fact comprehensibly provoked a certain degree of annoyance in Europe's notaries, which were afraid that the *SUP* Proposal was a measure to tone down, in an indirect way, their function in Company Law. For this reason, during the lifespan of such Proposal mentions to notaries' role were added (for instance, in the G.A. version see article 14b, and *Whereas* 13, 13a, 18 and 18a of the Preamble), even if according to some scholars the notarial role was in any case preserved already in the original version. See Hansen, J.L.: *op. citi* in ref. 123, p. 179; however, the majority of commentator was critical about that: Lucini Mateo, A.: *En torno al Proyecto*, cit. in ref. 123, p. 4; Ries, P.: *Societas Unius Persononae – cui bono?*, NZG – Neue Zeitschrift für Gesellschaftsrecht, 2014, p. 569. And see also the Impact Assessment to the Proposal on digitalisation (SWD(2018) 141 final, of 25.4.2018), p. 17 *seq*.

[164] Proposed article 13f.4(c).

[165] Just partly, as for the letter (d), as this provision seems to require additional rules in domestic law in order to be made applicable; see more in detail below, paragraph 5.4.1. In any case, there is no doubt that, where a notary is present, the verification of the lawful appointment of directors is a duty impending over him.

[166] As proposed in the Impact Assessment to the Proposal, p. 48, and admitted in general terms in the ICLEG Report, p. 19.

[167] Proposed article 13g.2.

surprising at all. The "due legal form" is in any case respected, also for the Member States where notarial role is required, by virtue of the just discussed rules.

A further common duty of notaries, in many domestic Company Laws, is to check that the part of the share capital required by national law to be paid down upon constitution has actually been paid. This leads to the type of contributions that the shareholders could provide the new company with. The rules on the issue are extremely different country by country, in particular as the Proposal is mainly addressed to private companies, where the boundaries set down by articles 46 *seqq*. of the Codified Directive are not applicable. For this reason, the Proposal on Digitalization only offers (scanty) provisions on cash and in-kind contributions.

As for cash, the Proposal reassesses the principle of the possibility to make the payment through online tools, having as a beneficiary a bank account in a bank operating generically in the Union. Furthermore, Member States shall have the duty to ensure that the proof of payment too can be provided online.[168]

Regarding in-kind contributions, the Proposal only mentions it in two passages, whose combination shows that the ultimate decision regarding the consent on allowing such kind of considerations even in presence of an online registration is left to Member States. We must consider, in fact, that in many jurisdictions in-kind contributions require experts' reports to assess the actual value of the consideration. Such a requirement is likely to complicate the online registration process, even if it is not by itself preventing it at all. Member States are thus offered two options.

The fact that one or more shareholders decide to make in-kind contributions, provided that they are allowed by company's article, could be a ground for the Member State to refuse the online registration, if a specific provision exists in national Company Law. Such a provision is explicitly held as lawful by the Proposal, as we have already pointed out.[169]

On the other hand, the equally lawful provision by a Member State allowing shareholders' in-kind contributions is confirmed not just by the wording of the just mentioned rule;[170] but also by subsequent paragraph 7 on the maximum time allowed for the completion of the online registration.

[168] Proposed article 13f.6, consistently with article 13d. Regarding this issue, it should be carefully examined the compatibility of such means of payment with those systems (for instance, the Italian and the Portuguese one for their private companies) that allow or prescribe the payment to be made directly in directors' hands.

[169] Proposed article 13f.4(f).

[170] "The circumstances in which online registration *may be excluded* where the share capital of a company is to be paid by way of contributions in kind"; italicisation is mine. This means

The entire issue of online registration, together with the rules on templates, is motivated on the grounds of the need to complete the registration process in a quicker, less expensive and cross-border available way.[171] For this reason, the key rule regarding the process of online registration is that Member States have to ensure that the registration process, where carried out online, is completed within five working days from either the receipt by the register of all the documents required for the registration, or the payment of fees or share capital according to national law, depending on the last performed.[172]

Especially the check regarding the fact that the share capital has been paid up has to be performed by a notary, if any, pursuant the national applicable law, along with the assessment that the prescribed licenses or authorizations for the registration of the company had been obtained.[173]

5.3.2 ONLINE REGISTRATION OF BRANCHES

While the online registration of a company was not completely new among the Commission's proposals in the field of Company Law, the document on Digitalization marks the first time that the issue is dealt with regarding branches.

Actually, the introduction of rules on online registration of branches in the analyzed Proposal makes perfectly sense. This not only because of the electronic nature of the registration; but also as the online registration of a company, supported by the side-provisions we have already at least in part analyzed, allows a cross-border creation of subsidiaries by already existing companies.[174]

that the Member State's provisions could even exclude the online registration just where some types of in-kind contributions are provided, allowing it in presence of other, different in-kind contribution. And, as specific rules about that are missing, work or service contributions seems to be considered as in-kind ones.

[171] That is properly the ultimate purpose declared by the Commission: see also the Impact Assessment, p. 16, and its Annex IX.

[172] Any "exceptional" derogation from the five days must be "immediately notified" to the applicant, along with the communication of the reasons for the delay: proposed article 13f.7.

[173] Such licenses or authorisations must in any case be exceptional, as the Member States are allowed to require the mas needed for the registration just where "it is indispensable for the proper control of certain activities laid down in national law": proposed article 13f.5. An analogous provision was set down in the *SUP* Proposal, G.A. version, article 14a.3, with the explicit distinction between authorisations needed *before* the registration, which can be required only exceptionally; and *after* the registration, before commencing the business. In the latter case, not provided for by the Digitalisation Proposal in an explicit way, but in my opinion plainly applicable to this case too, the Member States are free to ask for the requirements the judge appropriate.

[174] We can read accordingly the provision of proposed article 13f.2 where mentioning the electronic copies of documents and information referred to in article 16a.4, which comprehend

Having specific rules regarding branches as well, allows to have the traditional couple "branches and subsidiaries" reassembled, as far as online registration is concerned too.

The rules on online registration of branches are at large following those on online registration of companies, even if there is here a specific – and welcome – reprise of the last principle we found in the SDGP, the "once-only".

As it is for companies, for branches too Member States have to ensure the possibility of a fully online registration, with the only exception of the "genuine suspicion of fraud based on reasonable grounds".[175]

For the online registration of branches, there is no reference to templates and the article 28a.2 and .3 only lays down mandatory rules to be adopted by the Member States, avoiding the optional ones.[176] These rules must include norms on the documents and information to submit – including the reference to the electronic copies referred to by proposed article 16a.4, as present in the online registration of companies too – and adds a paramount provision. In fact, we can find here the statement that such rules must ensure that the registration of the branch may be carried out "by making use of the information or documents previously submitted to a register";[177] mentioning generically "a" register, this means not just the register of the Member State where the branch is about to be registered.[178] On the contrary, any European register could serve to such purpose, and in particular that where the company establishing the branch is registered. Such rule is the tangible outcome of the register interconnection system: it allows an effective flow of information between the register, with a full advantage of citizens and businesses, which will not be obliged to submit the same document to more than one register anymore.[179] This is the application of the once-only principle in Company Law, after its announcement in

the extracts of deeds of incorporation of companies registered in different Member States, necessary as means of identification of such companies as the shareholders of the new subsidiary. That was the (declared) purpose of the *SUP* Proposal, and in this sense we can say once more that the Digitalisation Proposal is some kind of a daughter of such project.

[175] Proposed article 28a.1.

[176] Such an approach is due to the fact that, as we have already seen, the optional rules for online registration of companies are to be used by Member States where there is the need to preserve the role of the notary. On the contrary, when establishing branches abroad, even if present, the role of the notary is by far less pervasive.

[177] Proposed article 28a.2.

[178] As in the case of a branch established by a company in its own Member State of registration.

[179] This works for the verification on the company establishing the branch as well, according to the proposed article 28a.4.

the SDGP. And an application of the same principle is also the provision laid down in paragraph 6, establishing an information flow between the register of the company and that of the branch, where different. In particular, the latter must inform the former of the registration of the branch, and the former must accept such information, acknowledging receipt of notification, and recording the information, immediately. In this case, again, this is possible by virtue of the business register interconnection system, and does not require any duplication of informative duties on the company.

Alike it happens with online registration of companies, the rules the Member States have to enact must include procedures for the verification of the identity and the legal capacity of the applicants,[180] and the prohibition to obstacle the registration of a branch by requiring licenses or authorizations unless it is indispensable for controlling certain activities. And, alike it happens for companies, the online process of registration of a branch must be completed within five days from the receipt by the register, or other subject mandated by the State, of all the required documents or information.

5.3.3 ONLINE FILING BY COMPANIES AND FOR BRANCHES

Apart from online registration, the Digitalization Proposal deals also with the subsequent filing a company or a branch must perform in the registers. Such issue was already present in the Codified Directive, namely in article 16.3, second subparagraph.[181] As the issue is of paramount importance for the digitalization in European companies, the original rule was somehow "exploded" in the more detailed regulation we are going to describe.

The basic structure of the provision is the same for companies and branches. The Member States must ensure the possibility of filing entirely online in the register company's and branch's documents and information,[182] with no need of physical presence of the applicant, apart from the already mentioned

[180] Proposed article 28a.3.

[181] "Member States shall ensure that the filing by companies, as well as by other persons and bodies required to make or assist in making notifications, of all documents and particulars which are required to be disclosed pursuant to Article 14 is possible by electronic means. In addition, Member States may require all, or certain categories of, companies to file all, or certain types of, such documents and particulars by electronic means"; the provision has now been deleted in the proposed version of the article 16. See below, paragraph 5.4.2.

[182] The Member States must ensure this possibility, which is only an option, at least in general. Nevertheless, according to proposed article 13i.2, Member States are free to require the online filing as an obligation for some or all the companies registered in their register.

exception for genuine suspicion of fraud.[183] In this case, as for the timing, no specific provision is present, apart from the mention of the fact that the online filing must be done "within the time limit/period provided by the laws of the Member State where the company/branch is [to be] registered/established".[184]

Only for the companies there is the additional explicit rule regarding the need that Member States ensure that origin and integrity of the filed documents may be verified by electronic means; it seems reasonable that the same rule is applicable to branches, too.[185]

Finally, it is worth mentioning that, with reference to companies, the proposed article 13i.1 mentions the filing of "documents and information, as referred to in article 14" of the Codified Directive. Article 14 in effect lists a series of documents and information to disclose, but leaves Member States free to add more;[186] the reference to article 14 seems to be interpreted as including in the possible object of online filing also the additional documents and information a Member State decided to add to the list of the Codified Directive. This is in order to prevent inequalities in the application of the rule.

5.3.4 ADDITIONAL PROVISIONS ON BRANCHES

Proposed articles 28c, 30a, and a new proposed subparagraph for article 31 provide for a few additional provisions on branches, consistent with some of the principles we already came across.

The first rule deals with the reverse of the online registration of a branch, *i.e*. the information flow between the register where the branch is filed to the register where the company is registered regarding the *closure* of the branch. This must take place through the system of interconnection of the registers, exactly alike it is as of the branch's registration, and alike in that case it is an expression of the "once-only" principle.[187]

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[183] Proposed articles 13i.1 and 28b.

[184] *Ibidem*. Just a short remark on two issues. On the one hand, the proposed article 13i mentions the laws of the State where the company is "to be" registered. As here we are dealing with subsequent filing, and the registration already took place, it seems that the "to be" is somehow a slip of the Commission's pen. And, again, article 28b refers to the laws of the State where the branchi s established, while it seems more correct to refer to the registration, instead of establishment.

[185] Even if this should be nevertheless guaranteed directly when the business registers interconnection system is used.

[186] "Member States shall take the measures required to ensure compulsory disclosure by companie of *at least* the followiong…": Codified Directive, article 14, italicisation is mine.

[187] See also the ICLEG Report's suggestions, p. 20 *seqq*., also with reference to the single point delivery principle and its impact on the financial markets law.

The second provision, again respectful of the "once-only" principle, deals with the changes that may occur regarding some of the information filed in the register by the company that established the branch. The idea is that, in case of cross-border branches,[188] the information or documents filed in the register where the company is registered must be communicated, through the register interconnection system, to the register where a branch of such a company is registered. According to proposed article 30a, such information must include changes in:

"(a) the company's name;

(b) the company's registered office;

(c) the company's registration number in the register;

(d) the company's legal form;

(e) the documents and information referred to in points (d) and (f) of Article 14".

This means that most of such information was included, as for initial disclosure, in the list provided by article 30.1 of the Codified Directive.

In this case too, as it happens with the online registration of the branch and with the information flow on the branch's closure, the recipient register must acknowledge the receipt of the information, and the information is to be filed in both of the registers. No further duty of information is pending on the company, the branch, directors or shareholders: the entire information is exchanged between the registers.

Finally, the proposed new subparagraph to article 31 is again a manifestation of the "once-only" principle, as it suggests to hold as disclosed the company's financial documents, according to Codified Directive's article 14(f), also with reference to such company's branches, again by virtue of the business register interconnection system.

5.4 FURTHER – "HOUSEKEEPING" - PROVISIONS

Apart from those analyzed so far, in the Proposal there are a few additional provisions that can be said for "housekeeping" purposes, as they are either intended to enhance the performance of existing rules, or to provide norms apparently not very much digital-related, or to repeal articles that were erroneously maintained in the Codified Directive as of its elaboration and publication.

[188] Actually, proposed article 28c does not mention the necessity that such a branch is abroad; nevertheless, the wording, besides common sense, suggests that this is the scope of application of such rule.

5.4.1 RULES ON DISQUALIFIED DIRECTORS

An unprecedented rule in the Proposal deals with the disqualified directors. We can say that this suggestion too is a rather logic follow-up of the importance gained by the business registers interconnection system; equally, we must note that such proposal has fallouts at large exceeding the issue of digitalization itself.

The core idea is that, as the business registers interconnection system allows accessing a series of information previously unimaginable, Member States might use such information also in order to prevent that a person disqualified as director in another Member State can serve as a director for companies registered in their own registers.[189]

The provision deals with disqualification of directors, but also with their ineligibility as directors.[190] Member States *may* "refuse the appointment of a person as a director of a company where this person is currently disqualified from acting as a director in another Member State". This is just a possibility for Member States, to be supported by an *optional* domestic implementation rule, and the knowledge of such "foreign disqualification" comes to the Member States properly through the business registers interconnection system: the information on disqualification must be filed in the register, "in respect of what period any disqualification is in force".[191] The notion of "director" to the extent of the provision cross-references that laid down in article 14(d) of the Codified Directive.

This proposal leaves some doubts, even if its purpose is clear and can be shared, as aims at an enhancement of the security and reliability throughout the Union.

In spite of being the fallout of what looks like a free option of each Member State, it is not clear at all the extent of obligation proper to the proposed provision. There are two rules that seem to be conflicting about this issue.

On the one hand, Member States are naturally free to provide for *domestic* grounds of disqualification,[192] as it usually happens. Such grounds can be – and usually are – rather different from one Member State to another, and the domestic bodies (administrative or judicial) entitled to declare the disqualifi-

[189] Proposed article 13h.3.

[190] Proposed article 13h.4.

[191] Proposed article 13h.2.

[192] *Ibidem*, and being the verb "may" to be intended as Member States could even avoid to set down causes of disqualification in their national law.

cation differ meaningfully on a Country basis. On the other hand, according to the Proposal, Member States may also provide, as of a company's registration, for "the procedures to verify the appointment of directors taking into account the disqualification of directors by competent authorities of other Member States".[193]

The point of the aforementioned provision lays in the meaning of "taking into account". First, it is clear that each Member State is free either to establish such procedure, or not. In the latter case, no issue arises, as this simply prevents such Member State from extending within their borders the consequences of foreign disqualifications: where lacking the provision, the directors of a company lawfully established in that Member State will be free to continue serving as directors even if they had been disqualifies in another Member State. The difficulties of interpretation arise in the former case, and deal with the extent of the "taking into account".

Basically, there are two different ways the Member States could adopt for "taking into account" the foreign disqualification, once that they freely decide to implement the rule in their domestic system. On the one hand, the "taking into account" could be intended as a mere knowledge of a possible foreign disqualification. This enables the use of the interconnection system, allowing it to be aware of the disqualification abroad of a person to be appointed as a director in a domestic company, but with no direct further consequence. However, this situation would not need a specific provision in domestic law: this could be equally achieved simply by mentioning the disqualification of directors in the information to be entered in the interconnected registers. The optional provision under proposed article 13f.4(d) simply would mean that there is an obligation to check the registers for discovering whether the chosen directors have been previously disqualified abroad, or not. This does not seem to be really useful, if the appointment of an "already abroad disqualified director" remains possible with no penalties.

The second interpretation, on the other hand, seems to be much more effective; perhaps too much. The "taking into account" (art. 13f.4(d)) would mean that the knowledge of a foreign disqualification is the necessary condition for the domestic application of the consequences of a foreign disqualification, forbidding the appointment of a director that has been previously disqualified abroad (art. 13h). This means that, once that a Member State adopts domestically both

[193] Proposed article 13f.4(d). The national rules shall certainly deal with the identification of who has the duty to check the disqualification of a proposed director, and the penalties for noncompliance. Furthermore, it is clear that, in those systems where a notary is present, such a duty will reasonably played by the notaries; it is not clear at all how such check may take place in the remaining Member States, perhaps leaving the entire issue to the automatized system.

of the provisions under arts. 13f.4(d) and 13h,[194] this would trigger the extension *not of the grounds, but of the consequences of the disqualification beyond national borders*. The disqualification occurred in Member State "B", according to the grounds for disqualification Member State "B" lays down, would have its effects in Member State "A" too, when Member State "A" implements arts. 13f.4(d) and 13h, even if the ground for disqualification occurred in "B" is not a legal ground for disqualification in "A".

Furthermore, the wording of art. 13f.4(d) is ambiguous: it is clear that each Member State is free to decide whether taking into account a foreign disqualification, or not. Meanwhile what is not clear is the extent of such "foreign": according to the wording, each Member State seems to be free to take into account what happens in one, more, or all of the other Member States. It is clear that there is not harmonization at all, by this way, as each Member State would be free to choose the foreign system(s) whose effects would be extended, as far as disqualification is concerned, in its own company law. The system could thus turn unequal: the same circumstance could be justified ground for disqualification in a Member State, but not in another; and vice versa.[195] Once that it occurs in a Member State where the situation is ground for disqualification, this disqualification shall be operative also in those Member States where the situation is not a ground for disqualification. We cannot say that there would be a "cross-border disqualification system": such rules are not material norms, and no system is built up directly by the European lawmakers. On the other hand, there could be a large spread of the effects of foreign disqualifications, even in asymmetric ways. This seems to lead to an even more chaotic system than the current one, and makes the proposed provision rather questionable, if not lacking at all a legal basis among those mentioned in the Proposal – the best suitable seems to be art. 50.2(b) of Treaty on the Functioning of the EU, even if at large forced.

Again, the proposed rule requires to be recorded in the register the persons "currently disqualified from acting as a director". It is not clear whether this list of disqualified people should include only those people disqualified while they were in charge as company's directors; or, as it seems more reasonable, the list includes all those people (Citizens? Residents? Foreigners too?) that

[194] From the reconstruction I operated, it should emerge quite clearly that there is no possibility for Member States to implement only art. 13h, without implementing art. 13f.4(d), unless the explicit implementation of the former implies an implicit implementation of the latter; while it is possible the implementation of art. 13.4(d) alone.

[195] We could thus have some Member States considering the foreign disqualification, and others refusing it; it should be investigated whether this situation, that is very likely to have an impact on the regulatory competition, could lead to a race to the top or to one to the bottom.

are in the subjective condition of being ineligible for the office of director of a company. This solution is likely to create a Europe-wide proscription list whose compatibility with Data Protection rules is to be carefully examined.

Finally, the wording of the proposed rules on disqualified directors gives the idea that the check regarding the personal status of the directors to be is to be performed upon registration;[196] and explicitly such rule is applicable also upon the appointment of a new director, whose possible disqualification abroad is to be verified.[197]

The grounds for a director's disqualification are nevertheless likely to happen, and be subsequently registered in the digital cross-border proscription list, even while the person is *already in charge* as a director of a company in another Member State than the one where the disqualification was decided. If so, the occurrence of a cause of disqualification for the company's director in Member State "A" would certainly lead to the end of his/her experience as a director of companies registered in Member State "A". It is nonetheless questionable whether the proposed rules allow the same to happen when he/she is a director of a company in Member State "B". The paradox would be that the cross-border disqualification could operate just from the beginning of the office as a director, and not later.

In any case, it should be rather clear that the proposed rule on the disqualification of directors has fallouts largely exceeding the very field of digitalization, and would heavily affect Member States' domestic laws. A "softer" approach based on an attempt of harmonization of grounds and effects or disqualification for a company's directors would perhaps be a more appropriate path.

5.4.2 DISCLOSURE IN THE REGISTER AND ACCESS TO INFORMATION

We have already seen that many of the provisions in the Proposal deal with the business registers interconnection system. The Proposal itself can be seen, at least as far as the "once-only" and free cross-border access principles, as a means to enhance the utility of such a tool. In order to do that, however, a few amendments to the norm on disclosure – article 16 of the Codified Directive – were needed; and the Digitalization Proposal suggests some changes accordingly.

[196] Explicitly the proposed article 13f.4(d) and also 13h.1: "the register where the company *is to be registered* (…) may request confirmation (…) whether or not the person who *is to be appointed* as a director (…) is currently disqualified"; italicisation is mine.

[197] Proposed article 13h.4.

The current content of article 16 would be split into the proposed articles 16 and 16a. A few of the older provisions would be repealed, and some new would be added, while the pre-existing structure would be substantially maintained, apart from the provisions on the access to disclosed information currently included in article 16.4, which would be translated in proposed article 16a.

Many of the proposed changes deal with terminology, and do not seem to be substantial; for instance, the term "particulars" would be replaced with "information", "whether… or" with "irrespective", and so on. On this basis, we can note that proposed article 16.1 is maintained the same as in the version currently in force, and new paragraphs 2 and 4 would replace, without meaningful amendments, current paragraphs 3 and 6.

The current paragraphs 2 and 7 are missing in the proposed new text, and so the second subparagraph of paragraph 3. In this last case, however, its lack is due to the already analyzed more detailed proposed rules on the online filing of companies and branches.[198] Finally, the proposed new paragraph 3 amends in a substantial way the current paragraph 5, regarding the means of disclosure; a new paragraph 5 is included in the proposal. As for article 16a, it is a restatement and update of current article 16's paragraph 4, just with a remarkable difference on the certification of electronic copies.

The proposed repeal of paragraph 2 is due[199] to the fact that a definition of "electronic means" was held as superfluous "since the new proposed rules on online procedures".[200] Such a conclusion seems to be questionable: it is true that the new article 13a supplies new definitions for many digital-related issues, but none of them deals specifically with "electronic means"; and this wording is nonetheless present many times in the proposed rules. For this reason, even if it is systematically correct to remove the definition from article 16, it seems in any case reasonable to maintain it in the proposal,[201] for instance integrating the content of article 13a.

The repeal of the current paragraph 7 is to be dealt with along with the amendments proposed to paragraph 5 – paragraph 3 in the proposed new article.

As it is well known, the disclosure and publication system currently in force has two basic pillars: the register for the disclosure itself and the national ga-

[198] See above, paragraph 5.3.3.

[199] According to the explanatory memorandum to the Digitalisation Proposal, p. 13.

[200] In the Impact Assessment, p. 14 it is stated that "the current definition […] is not specific enought and leads to a diverse implementation in the MS".

[201] Possibly changing its wording in order to overcome the differences in the implementations by the Member States the Impact Assessment mentions.

zette for the publication as a means of disclosure. We must highlight that, due to the Digitalization Proposal, but also by virtue of the implementation of the BRIS, the role of the registers in the disclosure procedure has been hugely enhanced. At the same time, in spite of the provisions of the Codified Directive suggesting a new digital role for national gazettes,[202] the publication in such official journals is perceived as largely outdated, and practically ineffective.[203]

For these reasons, the proposed new paragraph 3 aims at modifying the system, by using the registers also as a direct means of disclosure, leaving the Member States free to maintain the national gazette as an *additional* and *optional* means of disclosure. In any case, the disclosure is effected by registering documents and information in the register. As an application of the once-only principle, furthermore, even when the Member States choose to maintain the additional publication in the national gazette,[204] the duty to transmit the information to the gazette for the publication is not on the company's directors any longer, but belongs mandatorily to the national register. By this way, the company only has to register the information once; one more case of implementation of the "once-only" principle.

As the system of disclosure and publication would change so meaningfully, the current paragraph 7, on the possible discrepancies between what is recorded in the register and what is published in the gazette seemed useless to the lawmaker. Actually, while in the current system the public reliability of the system depends on what is published, and not filed in the register,[205] the proposed new system disregards at all the publication for the purposes of reliability against third parties, as this is affected by the public availability in the register.[206] Any possible discrepancy between what is registered and what is published, should a Member State maintain the optional publication in the national gazette, is by a matter of fact resolved in favor of what has been registered.[207]

The proposed rule is a welcome simplification of the disclosure procedure. It seems nevertheless that, in order to be effective, the rule should be coordinated

[202] See above, chapter 3 for more details.

[203] Regarding the different options considered in drafting the Proposal, see the Impact Assessment, p. 49 *seqq*.

[204] In the proposed new version, there is not the specification regarding the fact that the national gazettes may be kept in electronic form, but nothing seems to prevent such possibility even with the proposed text.

[205] Current article 16.7, second subparagraph, Codified Directive.

[206] In the same terms the Impact Assessment, p. 51.

[207] Besides that, the risk of discrepancies should be minimised by the fact that who sends the information for the publication to the gazette is the register itself.

with the many provisions in the Codified Directive at least dealing with the publication according to the current version of article 16, for instance those on drafts of merger and division.[208] And, again, for the sake of the overall system, similar steps should be taken for the Regulations on the EEIG, SE and SCE.[209]

To conclude with the proposed new article 16, the new paragraph 5 supplies a technical detail regarding the electronic format of the data recorded in the register due to a company's or a branch's registration, or subsequent filing. Such data must be stored "in a machine-readable and searchable format or as structured data". This requirement is laid down in order to allow the highest possible degree of automatization in the management of recorded data, taking the full benefit of the register system again with a view to its system of interconnection.[210]

Moving to the article 16a, as already anticipated it is at large a restatement of the current article 16.4, save for a couple of major discrepancies.

The most important one, from a systematic point of view, is the fact that, changing diametrically the current provision, the proposed paragraph 3 lays down the rule that the "Electronic copies supplied to an applicant shall be certified as 'true copies' unless the applicant dispenses with such certification".[211] This is what currently happens with copies supplied by paper means,[212] while for the electronic ones the certification is currently supplied upon explicit request. The revolution imagined by the Proposal finds a technical support in the proposed paragraph 4, laying down the rule that the authentication of the extracts coming from the registers must be ensured by means of the trust services the e-IDAS Regulation refers to. By this way, the integrity and certification of data is once again a matter depending on the e-IDAS.

[208] Regarding this issue in particular, see above, chapter 3. Moreover, with a strong register-centered system as that imagined by the Proposal, it should be reconsidered also the exemption from the publication laid down in articles 92, 123 and 138.

[209] For instance, for EEIG, the Council Regulation (EEC) No 2137/85 of 25 July 1985 on the European Economic Interest Grouping EEIG, (OJ L 199, 31/7/1985), art. 39.1, third sentence, leaves to the Member States the duty to "ensure that the documents and particulars referred to in Article 8 are published in the appropriate official gazette of the Member State in which the grouping has its official address". It is thus possible that in some Member States such obligation impends on directors, and in others on the register.

[210] This could also be useful for the purposes of the publication in the national gazette, if any.

[211] As also proposed by the ICLEG Report, p. 20.

[212] By the way, the proposed article 16a, unlike the current article 16.4, does not consider not-electronic copies at all; this could lead to issues with the certification of true copies of the paper copies – that should be held as anyway possible even in the absence of a specific provision – that would lack any default rule.

5.4.3 SCOPE OF DISCLOSURE AND FEES FOR INFORMATION

Along with those already examined, the Proposal introduces amendments in the article 18 of the Codified Directive, and a new wording for article 19.

As for article 18, the suggested provision is, once more, the fallout of the enhanced importance of the registers. The proposed additions aim at making available "documents and information referred to in Article 14 for types of companies other than those listed in Annex II". The meaning of such proposal is not perfectly clear. Perhaps, the goal of such extension is to make available – even for the BRIS purposes[213] – the information regarding other types of "business organizations", instead of companies, as the Annex II already considers the company type present in each jurisdiction.

As of the proposed article 19, its leading principle is that the cost for information throughout the Union should be reduced. For this reason, the proposed version of this article does not reduce the fees for getting information, which is not possible as they are already not exceeding the pure administrative costs, but widens the scope of information available free of charge – meaning, again, at a fee equal to just the administrative cost.[214]

Besides the information on the name, the legal form, the registered office and the unique registration number (EUID) of the company, it should be available free of charge at least[215] also the information on:

"(d) details of the company web-site, where applicable;

(e) the legal status of the company, such as when it is closed, struck off the register, wound up, dissolved, economically active or inactive as defined in national law and where available in the national registers;

(f) the object of the company, where it is recorded in the national register;

(g) the number of employees of the company, where this is available in the company's financial statements as required by national law;

(h) the name of any persons currently authorized by the company to represent it in dealing with third parties and in legal proceedings or to take part in the

[213] See the *Whereas* 20 of the Preamble.

[214] Again, according to the Impact Assessment, p. 51 *seqq*., the option of a full, free information was explored, but could not be pursued as it was likely to trigger an unbearable lack of resources for the registers.

[215] As according to the proposed article 19, last subparagraph, Member States are free to make further information and documents available free of charge. The same option is already present in the current text.

administration, supervision or control of the company, as referred to in Article 14(d);

(i) information on any branches opened by the company in another Member State including the name, registration number, EUID and the Member State where the branch is registered".

To the end of this paper, it is worth highlighting at least the proposed point (d), with reference to the details of company's website. The interpolated clause "where applicable", however, once again witnesses that there is no general obligation for companies to have a website, besides the few already seen above in Chapter 3.[216]

5.4.4 HOUSEKEEPING'S MEDLEY, IN PARTICULAR PROPOSED ANNEX IIA ON THE SCOPE OF APPLICATION

Finally, a few remarks on some provisions present in the Proposal and that do not suit with the categories examined so far.

Proposal's article 1.10 suggests amendments to Codified Directive's article 22, allowing that additional access points to the BRIS can be established not just by Member States, but also "by the Commission or other Union institutions, bodies, offices or agencies in order to perform their administrative functions or to comply with provisions of Union law". Once again, we can find in this proposed amendment a way to enhance the effectivity of the BRIS, for purposes going beyond the European Company Law strictly intended.

Subsequent paragraph 11 deals with technical specifications and procedures that are to be changed again in the BRIS.

Paragraph 16 provides for the repeal of the Codified Directive's article 43, due to an arisen lack of legal basis for such provision.

Paragraph 17 proposes an updated wording for Codified Directive's article 161 on Data Protection, due to the approval of Regulation (EU) 2016/679, replacing the Directive 95/46/EC.

Finally, a few words on Annexes.

As for Annexes I and II of the Codified Directive, the Proposal, in its article 1.20 and .21 simply introduces the difference between the private and the public companies established under Swedish Company Law, in order to allow there too the differential application already present in the remaining Member States.

[216] See ref. 98 and 104.

Furthermore, as we have already pointed out, the Proposal aims at introducing an additional Annex IIA, listing the Member States' domestic private company forms only, for the purposes of articles 13, 13e, 13g and 162a. The list the Annex IIA offers is rather curious. Dealing with Member States' national company forms, it should include solely company forms already listed in the Annex II of the Codified Directive, "cherry-picking" among them the private types; nevertheless, it does not work properly that way.

Even if in the majority of the cases the proposed Annex IIA provides for a specification where compared with the content of Annex II,[217] this does not happen always. This is possibly due to a partial overzealousness attitude of the Proposal.

In many cases, in fact, along with the private company types already listed in the Annex II, a few new ones are considered as well. In several cases, they are the simplified versions of the major company types;[218] in other ones, the single-member versions of the private companies.[219] In any case, such an approach is wrong from a theoretical point of view, incomplete from a practical one, should someone incorrectly agree on its theoretical foundations, and very much likely to generate issues even for the overall structure of the Codified Directive.

As for the theoretical foundations, both the single member and the simplified versions of the domestic private companies mentioned in the proposed Annex II do not seem to be autonomous company types in their national Company Laws, separated from the general private companies' one.[220] In spite of the denomination not including the word *société*, this is true also for the French

[217] This happens also as far as the Irish and UK's company forms are considered, where the Annex II simply lays down the application of the rules concerned to, generically, "companies incorporated with limited liablity", while the proposed Annex IIA specifies, respectively, "private company limited by shares or by guarantee/designated activity company" and "Private Limited by shares or guarantee". Such a normative tecnique had already been used in the current Annex I to the end to select public companies.

[218] This is the case of the Greek ιδιωτική κεφαλαιουχική εταιρεία, the Croatian jednostavno društvo s ograničenom odgovornošć, the Italian società a responsabilità limitata semplificata.

[219] So with Belgium (société privée à responsabilité limitée unipersonnelle/Eenpersoons besloten vennootschap met beperkte aansprakelijkheid), France (entreprise unipersonnelle à responsabilité limitée, société par actions simplifiée unipersonnelle), and if I well understand Bulgaria (еднолично дружество с ограничена отговорност).

[220] For instance, with reference to Italian società a responsabilità limitata semplificata, see Bartolacelli, A.: *The New Italian Almost Capital-less Private Companies: A Brand New Tile in the Mosaic*, European Company and Financial Law Review, 2016, p. 685 *seqq.*; Id.: *L'insostenibile leggerezza dell's.r.l.s.*, Rivista Orizzonti del diritto commerciale [www.rivistaodc.eu], accessed on 19/08/2018, 2014, 2, p. 4, footnote 7, where more references.

entreprise unipersonnelle à responsabilité limitée, which is to be intended as the single-member version, *ab initio*, of the *société à responsabilité limitée*.[221] For these reasons, it seems at least useless to mention explicitly these company versions, as the rules laid down for private company forms are directly applicable to them, too, for their being already included in the main company type.

Nevertheless, even if to the eyes of the European lawmaker such version should be treated as autonomous company types – an approach that, once again, we do not share at all – it cannot be understood why the Proposal cites some national cases, and "forgets" others, even much more meaningful. In particular, if the simplified forms are to be considered, it makes almost no sense citing Italian S.r.l.s., or the Greek I.K.E., and not the German UG, the Belgian s.à.r.l.-starter, the Danish IVS, or the very recent s.à.r.l.s. of Luxembourg, among the others.[222] And, as for the single-member companies, due to the former Twelfth Directive,[223] they are currently present in every Member State, and we cannot understand why only the Belgian, Bulgarian and French versions have been mentioned in the proposed Annex IIA.[224]

Even if these remarks should be already sufficient to question the content of the proposed Annex IIA, it is our belief that it could be even dangerous for the application of the remaining part of the Codified Directive, if approved in the current version. In fact, if we support the statement that the single-member and simplified versions of private limited companies listed in Annex IIA are autonomous company types, as they are not stated in the Annex II, all the provisions applicable to the companies listed in Annex II would not be binding for such company versions. This, at least, as far as the list of Annex II is not updated in order to include them too, even if the Proposal on Digitalization, which would be an appropriate mean as it suggests changes to the Swedish

[221] Bartolacelli, A.: *Almost Capital-less Companies in Europe: Trends, Variations, Competition*, European Company and Financial Law Review, 2017, p. 192 *seq.* and in particular footnote 25.

[222] A rather complete panorama can be found in Bartolacelli, A.: *Almost Capital-less*, cit. in the previous ref. 221.

[223] Now replaced by Directive 2009/102/EC of the European Parliament and of the Council of 16 September 2009, in the area of Company Law on single-member private limited-liability companies, (OJ L 258, 1/10/2009).

[224] Explicitly asked about such issue during the 2018 ECFR Conference in Madrid, on September 28th, 2018, a representative of the European Commission replied that it is up to the Member States to inform the European Institutions regarding the domestic legal forms to be included in annexes. Even if it is so, it seems that the Commission, also due to the fact that is currently dealing with issues strictly linked to the concept of company type – such as conversion in its cross-border dimension – should play a strong role in defining clearly the information the Member States are required to provide.

company forms, does not provide in this sense. Such conclusion is likely to create unjustified differences in the application of domestic private Company Laws, and seems to be avoided as much as possible.

6. CONCLUSIONS

The first conclusion we can reach regarding the digitalization in European Company Law is that, as it should be rather clear after the panorama supplied in this paper, it is an ongoing process with roots tracing back to sixteen years ago. Nevertheless, there is no doubt that at least the declared purpose of the Proposal on Digitalization of April 2018 is to be the first comprehensive document on such issue. This goal seems just partially achieved.

The Proposal on Digitalization can be seen as some kind of "finish line" for those provisions aiming at a more enhanced "external digitalization", as it involves the very start-up moment of the company, *i.e.* its registration. Nonetheless, this deals more with e-government issues than with Company Law strictly intended, and thus it is basically an Administrative Law subject. And that the very recipient of the Proposal are in particular Small and Medium Sized Enterprises, as it has been in all of the latest proposals issued by the Commission, as for instance the *SPE* and the *SUP*.

If even it is true that Company rather than Administrative Law are just labels, we must point out that the "private" part of Company Law, the one dealing with the internal structure and functioning of European companies, is not affected in an appreciable way by the Proposal. The Proposal on Digitalization in Company Law, in other words, does not increase by itself the degree of digitalization of the Companies, but just the digitalization of Member States' public sector with reference to Company Law issues.

Although a push towards actions in the field of internal digitalization, with a special focus on the communication between the shareholders and the company, came from the ICLEG Report, and even from the currently existing rules on shareholders' rights in publicly traded companies, the Commission's proposal decided not to deal with such issue at all, concentrating the efforts mainly on business registers. It is possible that Member States would have seen in it an undue intervention of the European institutions in their domestic affairs and therefore would have hardly accepted a strong intervention on that; nevertheless, the Commission did not show an irresistible courage on that. In addition, it is not said that such kind of proposal for internal digitalization should have been necessarily very strong. On the contrary, it even could be based just on the provision of enabling rules for all the companies regarding the use of digitalization tools in the company's day-by-day management and communication

towards the shareholders/members and third parties. Of course, a simple enabling rule would not have been enough, and should have been accompanied by rules for guaranteeing the right of equivalent information to dissenting subjects. However, this could have been a starting step for a real digitalization *of* companies throughout Europe.

The second issue is linked to the first one. The Commission's approach to this subject is – as it was in many other unfortunately unsuccessful occasions – very focused on the start-up phase of the company. We could say, even, too much focused on that. Clearly, the Commission is interested in the need to remove barriers to the Single Market, and such barriers are very much likely to occur when a company is established. In this sense, the Digitalization Proposal is just a little more than a revival of the *SUP* proposal, with a broader extent and paying more attention to the role of notaries as of a company's registration.

In any case, the start-up is not the only moment for restrictions to the Single Market. On the contrary, in an actually functioning Single Market, the free choice of the company form, expression of the regulatory competition between the Member States, implies that such a company established abroad for reasons of convenience, can also be managed in its internal corporate governance without needing the physical presence of its members and directors. Surely, the online filing system the Proposal enhances for both companies and branches serves this purpose from an external perspective; an enabling rule imposing the Member States to accept electronic means of participation for every kind of company type would be utmost useful as well. Unfortunately, it seems that the European institutions are much more driven by the "glamour" issue of short time and low cost for establishing a company, rather than the less "sexy" day-by-day management. Possibly, it is a matter of self-promotion of European institutions, along with the real necessity of an opener access to company forms abroad. However, if such facilitation to a company's birth does not evolve into a facilitation of a company's management and evolution, it risks being a kind of cathedral in the desert, whose practical advantage is rather questionable. Something has been moving in this sense with the Proposal on cross-border conversions, mergers and divisions presented in April 2018 too, but such operations are somehow extraordinary as well, while a more comprehensive action in the ordinary management of companies seems to be needed.

Again, the main feature of the Proposal and the cornerstone of the entire digitalization framework is the business register, and the system of interconnection of domestic registers. It is enhanced in its importance by the Proposal, as we have already seen. The Proposal even advocates for a general withdrawal of the double system of disclosure, currently based on the couple disclosure +

publication, leaving the business register disclosure alone, and abandoning the publication in the national gazettes.

Such an attitude seems to be praised, and is essentially a part of a broader cultural fight in act. On the one hand, the "once-only" principle the Proposal adopts can be mirrored, on the administrative side, by a "single point of information" idea, identifying a unique place the citizens can rely on for retrieving the information regarding the companies. Such a single point of information is, thus, the register, and the national gazette, where present, only has an optional and ancillary function. Furthermore, the national gazette in electronic form facilitates very much the receipt of information from the register, and possibly an automatic publication of the same information in both of the places, minimizing if not excluding at all the risk of discrepancies between the same information disclosed through different means. However, the key point is that the national gazette could even not play any role at all in the disclosure process, in the system the Proposal draws. This means that the Proposal imagines the business register as the only mandatory (and reliable) means of disclosure; the natural consequence of this is that the disclosed information is to be readily and easily accessible to the public. If we look at the experience of the national gazettes, in spite of being the most traditional means of disclosure, we cannot say that they were commonly read by citizens; their traditionally hardcopy structure, in addition, does not facilitate searches at all, nor the creation of a "single-company-archive" of information. The latter feature is, on the contrary, one of the key characters of the business register, once that it is kept in an electronic form. Naturally, the system of interconnection of business registers, together with the unique identifier of registered companies, enhances the possibilities of search, and enables a quick recognition of the entire information linked to a given company. This does not guarantee by itself an easy access to the information and for this reason the Commission decided to establish single portals for facilitating the searches. The idea, in the proposal, to create more access points, managed by European institutions as well, is from this point of view perfectly consistent with such an attitude, and a way to get the most proficiency from the registration system. The cultural fight is, thus, make the citizens to consult the registers much more than they have been doing with the national gazette; the proposed increase of the information available free of charge points right in that direction.

All of the remarks so far make it clear the importance the register acquired to the eyes of European institution, the Commission in particular. The registers' interconnection system is the cherry on the cake of such framework. It should nonetheless be questioned whether such system has not born somehow old. The domestic systems, although complying with similar criteria so to make the interconnection functioning, are nonetheless proprietary ones, and even

the BRIS is a net of centralized domestic registers: a "double level centralization". The most recent developments in the general field of registration are, on the other hand, focused on the possibility to use the blockchain technology, which would be even more secure, and would not imply the presence of central registers, while authentication authorities could in any case survive and play a role.[225] This seems to be an issue to look at very attentively in the next future.

Finally, just a word on the company's website. The Proposal does not enhance its role very much; nevertheless, it seems that the possible absence of the national gazette the Proposal advocates for could be replaced by making the information about the company present in the register automatically available in the company's website. From a technical point of view, this should be greatly facilitated by the requirement of having the filed information available "in a machine-readable and searchable format or as structured data", in the words of proposed article 16.5. The company's website could, thus, retrieve the relevant information directly from the register, making it available twice, in the best interest of the citizens, and thus of the market.

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FROM SHAREHOLDER RIGHTS TO SHAREHOLDER DUTIES – A TRANSFORMATION OF EU CORPORATE GOVERNANCE IN A SUSTAINABLE DIRECTION?

Hanne S. Birkmose *

ABSTRACT

Corporate governance discussions in Europe on shareholders' rights have increasingly been replaced by discussions on shareholders' duties. This trend is reflected in company and capital markets law, where shareholders increasingly are imposed duties towards investee companies. For example, the legalization of shareholders' duties was a key element in the EU Commission's amendment to the Shareholder Rights Directive in 2017 (Directive 2017/828). A key to this transformation is shareholder accountability, in particular in relation the share ownership of institutional investors. Thus, the transformation bodes a break with an embedded perception according to which the relationship between shareholders and the investee company reflects a private ordering at the center of the European corporate governance model. The increased focus on shareholder accountability emphasizes the societal aspect of share ownership and, more generally, the interest that society holds in public limited liability companies. On the basis of a discussion of the amended Shareholder Rights Directive and the possible implications of this transformation, the paper concludes is that it is questionable whether shareholders can serve as a reliable vehicle for transformation of company law towards a more sustainable framework.

KEYWORDS: *Shareholder rights, shareholder duties, Shareholder Rights Directive, corporate governance, EU company law, enforcement, sustainability, sustainable growth, principal-agency theory, externalities*

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1. INTRODUCTION

Corporate governance discussions in Europe on shareholder rights have increasingly been replaced by discussions of shareholder duties.[1] This trend is reflected in company law and capital markets law, where shareholders increasingly are imposed duties towards investee companies, other shareholders and market participants. Previous research has analyzed a variety of duties imposed on shareholders.[2] These duties show great variety as well as variance across Member States in the EU. The discussion of shareholder duties gained momentum after the financial crisis, and questions related to appropriate roles for shareholders in internal corporate governance received special scrutiny. The EU corporate governance framework has at all times emphasized the importance of shareholder engagement, and previous legislative initiatives have strengthened shareholder rights in order to spur shareholder involvement in corporate governance. However, weaknesses in the EU corporate governance framework became evident during the financial crisis,[3] and European as well as national legislators faced pressure to react to the financial markets' collapse.

Consequently, not only were the discussions about shareholder rights in corporate governance gradually supplemented with discussions about shareholder duties, but legislative action also reinforced shareholder duties in corporate governance through new provisions in company law. Probably the most prominent example of such shareholder oriented post-crisis regulation is the EU Commission's amendment to the Shareholder Rights Directive (SRD II), which was adopted in 2017 (Directive 2017/828), and shareholder duties was a novel element. This marks a break with the traditional perception in company law that shareholders have no duties when they invest in companies. Moreover, it also bodes a break with an embedded perception according to which the relationship between shareholders and the investee company is a private ordering. The provisions on shareholder engagement found in SRD II suggest

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[1] Shareholder duties is the topic of a research project based at Aarhus University from 2014–2018. This research project received financial support from the Danish Council for Independent Research. The author would like to thank the Council for their financial support. The work on this paper is also carried out as part of the research project 'Social Interest and Corporate Governance Balance: Shareholders' Duties and Managers' Duties', which is supported by the Spanish Ministry of Economy, Industry and Competitiveness.

[2] For a mapping of these duties, see Birkmose, H. S. and Möslein, F.: Introduction: Mapping shareholders' duties, in: Birkmose, H. S. (ed.): *Shareholders' Duties*, Alphen aan den Rijn, 2017, pp. 1–25.

[3] See Corporate Governance in Financial Institutions and Remuneration Policies, Green Paper, (COM(2010) 284 final), and EU Corporate Governance Framework, Green Paper, (COM(2011) 164 final).

that shareholders should be accountable to other company constituents when exercising their shareholder rights, thus emphasizing a societal aspect of share ownership that previously has not been dominant.

Therefore, SRD II can be seen as an indication of a transformation of company law. Status quo is not considered an option in a post-crisis perspective, and a transformation is needed to set a new direction for corporate governance practices. A transformation of company law involves an extensive and radical change that orients companies and their shareholders in a new direction.

One of the overarching objectives of SRD II is to contribute to the long-term sustainability of EU companies.[4] Sustainable development has become an integrated aim of the accomplishment of the internal market.[5] In relation to the Commission's Action Plan on Financing of Sustainable Growth, sustainable finance concerns 'improving the contribution of finance to sustainable and inclusive growth by funding society's long-term needs, and strengthening financial stability by incorporating environmental, social and governance (ESG) factors into investment decision-making.'[6] Even though SRD II does not define sustainability, the documents that preceded the Directive highlight the emphasis on short-term gains by some companies and shareholders as incompatible with sustainable development.[7] In relation to this article, it is sufficient to understand sustainability as a broad term that encompasses three dimensions, each of which is important to a company's activities: economic development, social development and environmental protection. Providing incentives for companies to take these dimensions seriously will also intensify their focus on long-term company practices, which is considered an inherent part of sustainability.

[4] Proposal for a Directive amending Directive 2007/36/EC as regards the encouragement of long term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (COM(2014) 213 final), Section 1.

[5] See for example the preamble of the consolidated version of the Treaty on European Union ('TEU'), 2016/C 202/01, Communication From the Commission, Europe 2020, A strategy for smart, sustainable and inclusive growth, COM(2010) 2020 final and 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) 97 final.

[6] 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, p. 1, COM(2018) 97 final.

[7] E.g. the 2010 Green Paper, Section 3.5 and the 2011 Green Paper, introduction and Sections 1.4 and 2.2.

The purpose of this article is to assess the extent to which shareholder duties can be an effective vehicle to ensure sustainable, long-term oriented corporate governance. In short, I am skeptical about the ability of SRD II, on its own, to provide sufficient momentum and for shareholder duties in general to be an appropriate vehicle for a transformation of corporate governance that is politically driven from above.

The article begins with a discussion of shareholder duties in Section 2, and explains why shareholders have become the center of regulatory attention even though shareholders are just one interest group among many in a company's sphere. Moreover, this section focuses on situations where we could expect duties to be imposed on shareholders. The rights shareholders are given in company law are closely integrated with the corporate governance duties we find in both company and capital market law. Section 2.1 explores this connection and unfolds some the most important governance duties. The amended Shareholder Rights Directive takes corporate governance duties to a new level, and the emerging engagement duties found in the directive are discussed in Section 3 in order to determine not only the content of the duties, but also their aim. The latter is important because the aim seems to go beyond the prevalent understanding of appropriate shareholder monitoring in corporate governance, which raises the question of whether SRD II requirements are likely to compel shareholders to embrace a more prominent role in corporate governance and, if so, if we can expect that role be used to promote a more sustainable, long-term corporate agenda. This discussion, the focus of Section 4, concludes that is questionable whether SRD II will be sufficient to induce the institutional investors to make significant changes to their engagement practices. Consequently, the effects realized may depend on how efficiently the provisions are enforced, and Section 5 takes up this important question. Finally, I sum up the discussions in Section 6 and point to some of the questions that legislators need to consider if shareholder duties are to become a reliable vehicle for transformation of corporate governance towards a more sustainable framework. Section 7 concludes.

2. WHY SHAREHOLDERS?

Shareholders, creditors and employees all have an intense and focused interest in corporate behavior. However, EU legislation has mandated the performance of specific, politically-oriented functions by shareholders and shareholders alone, and not by the other groups. It is therefore relevant to start out by considering, why shareholders have become the center of attention.

The simple answer is that shareholders have a unique position in company law and in corporate governance. Contrary to other groups of company constitu-

ents, company law across Member States grants shareholders a number of fundamental rights that are exclusive to this group.[8] Notable among these are the right to receive a dividend, the right to the return of surplus capital on winding up the company, and the right to vote at the general meeting.[9] Other rights include the right to speak at the general meeting, to table resolutions and to call an extraordinary meeting. These rights are protected by company law and resemble proprietary rights to some extent,[10] even though shareholders do not own the company or the company assets, but only the shares of the company.[11]

While share ownership carries certain rights, the general perception has been that share ownership, in itself, does not entail any duties for shareholders. Nor do we find that the proprietary rights derived from share ownership entail any duties in general.[12] Moreover, shareholders have been considered to be free to choose whether or not to exercise the rights they have been given,[13] and they are not obliged to do so.[14]

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[8] Pennington, R.: *Company Law*, London, 2001, pp. 160–1; Worthington, S.: *Shares and Shareholders: Property, Power and Entitlement: Part 1*, Company Lawyer, 22(9) 2001, p. 260 f.; Davies, P. L.: *Gower's Principles of Modern Company Law*, London, 2001, pp. 817 ff.; and Ireland, P.: *Company Law and the Myth of Shareholder Ownership*, Modern Law Review, 62(1) 1999, p. 46 f.

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[10] Chiu, I. H.-Y.: *The Meaning of Share Ownership and The Governance Role of Shareholder Activism in The United Kingdom*, Richmond Journal of Global Law & Business, vol. 8, 2008–2009, pp. 121 ff.

[11] Worthington, S.: *Shares and Shareholders* op cit note 8, p. 259; Demsetz, H.: *Toward a Theory of Property Rights*, American Economic Review 57(2) 1967, p. 359; Stein, P & Shand, J.: *Legal Values in Western Society*, New York, 1974, p. 220; Ireland, P.: *Company Law op. cit*. note 8.; Davies, P.L.: *Gower's Principles op. cit*. note 8, p. 815, which refers to Short v. Treasury Commissioners (1948) 1 K.B. 122, C.A.; and Deakin, S.: *The Corporation as Commons: Rethinking Property Rights, Governance and Sustainability in the Business Enterprise*, Queen's Law Journal, vol. 37, 2012, p. 355 f..

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[13] See among others Barker, R. M. & Chiu, I. H.-Y.: *Corporate Governance and Investment Management*, London, 2017, p. 165; and Birkmose, H. S.: *European Challenges for Institutional Investor Engagement – is mandatory disclosure the way forward?* European Company and Finance Law Review, vol. 11 2014, pp. 225 ff.

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Shareholder rights were at the core of the 2007 Shareholder Rights Directive.[15] The purpose of this directive was to enhance shareholder rights in listed companies, to facilitate and encourage shareholder engagement and to solve problems related to cross-border voting.[16]

The rights granted to shareholders in company law, and emphasized with the adoption of the Shareholder Rights Directive, are fundamental to the European corporate governance model. The Commission has increasingly emphasized the role of shareholders in corporate governance. In the 2012 Action Plan, the Commission stated that 'effective, sustainable shareholder engagement is one of the cornerstones of listed companies' corporate governance model'.[17] The Commission has also stated that the corporate governance framework is 'built on the assumption that shareholders engage with companies and hold the management to account for its performance'[18] and that shareholders have a crucial role to play in promoting better governance of companies. By doing this they act in both the interest of the company and their own interest.'[19] Consequently, by monitoring corporate decisions, shareholders play an important role in the checks and balances of company management. However, to understand the role of shareholders in corporate governance, we must look not only to company law, but also to the economic theories behind the European corporate governance framework – and in particular at the agency relationship between the shareholders and the board of directors.[20]

In a corporate governance perspective, principal-agent theory most commonly focuses on the relationship between the information-rich board of directors (the agent) and the company's shareholders (the principal), whose interests the board ostensibly serve.[21] Here, shareholder *rights* are important as part of a

[15] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

[16] See Recitals 1 and 3, Directive 2007/36/EC.

[17] European Company Law and Corporate Governance – A modern legal framework for more engaged shareholders and sustainable companies, (COM(2012) 740 final), section 3.

[18] The EU Corporate Governance Framework, Green Paper, (COM(2011) 164 final), introductory remarks.

[19] European Company Law and Corporate Governance – A modern legal framework for more engaged shareholders and sustainable companies, (COM(2012) 740 final), section 1.

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legal *governance* strategy to enable the *principal* to control the agent's behavior.[22] By contrast, in an agency relationship, *duties* are primarily relevant to legal *regulatory* strategies that aim to constrain the *agent* in ways that ensure protection of the interests of the principal. In the agency relationship between the shareholders and the board of directors, the shareholder is the principal. Consequently, agency theory explains the focus on shareholder *rights* in corporate governance, but it does not explain why *duties* are imposed on the shareholders, as they are the principals. However, shareholders can be understood as the principals in two other relationships: [23] those with company customers, creditors and employees and, importantly, with other shareholders.[24]

In all agency relationships, information asymmetries may lead to suboptimal outcomes, and disclosure can be an important means to offset an agent's potential information advantage. This is discussed further in Section 2.1, below. However, asymmetric information and conflicts of interest not only occur among company constituents. Such conflicts of interest, so-called externalities, sometimes rise between the company and non-contractual parties.[25] Shareholder duties may also be imposed to address externalities in situations where shareholders are in a position to cause market failure, as for example when they engage in market activities on the basis of private information

To sum up, shareholders have become the center of attention partly because of their unique position in company law and in internal corporate governance, due to the control rights they are granted in company law. Still, even though corporate governance theory stresses the importance of shareholder monitoring, the economic theories on which the corporate governance framework is built do not support the notion that shareholders have duties related to the companies in which they invest.[26] Nonetheless, if we look to other important

Approach, Oxford, 2017, p. 29 f., where three different agency problems in a company are defined.

[22] For a discussion on 'regulatory strategies' in relation to agency relationships, see Armour, J., Hansmann, H., & Kraakman, R.: Agency Problems, *op. cit*. note 21, pp. 31 ff. See also Birkmose, H. S.: Duties Imposed on Specific Shareholders Only, and Enforcement Implications, in: Birkmose, H. S. & Sergakis, K. (eds.): *Enforcing Shareholders' Duties*, London, 2018, (forthcoming).

[23] Armour, J., Hansmann, H., & Kraakman, R.: Agency Problems, *op. cit*. note 21, p. 30.

[24] See Birkmose, H. S.: Duties Imposed on Specific Shareholders, *op. cit*. note 22, p. (forthcoming).

[25] Externalities describe the cost or benefit that affects a party who did not choose to incur that cost or benefit. This might be the result of a market failure. See Armour, J., Hansmann, H., & Kraakman, R.: Agency Problems, *op. cit*. note 21, p. 30.

[26] Birkmose, H. S.: *Forcing Shareholder Engagement*, *op. cit*. note 12, pp. 616ff.

agency relationships in companies, where shareholders act as the agents of other company constituents, we can understand that shareholder duties might be best understood as being part of a legal strategy to deal with conflicts of interest and asymmetric information. Such an explanation, however, sidesteps the question of why SRD II has a particular focus on the duties of a specific subset of shareholders: institutional investors.[27] This puzzle is discussed in Section 3.

2.1. CORPORATE GOVERNANCE DUTIES

As discussed above, the European corporate governance model emphasizes the involvement of shareholders in the checks and balances of the board of directors. Here asymmetric information is an inherent problem because the board of directors may have an information advantage. But it is also possible that the majority shareholder, who might wish to influence the company, has an information advantage over minority shareholders. As discussed above, a legal strategy for controlling agency costs is to facilitate the principal's control over their agents' behavior.[28] The efficacy of such a strategy depends highly on the ability of the principal to exercise its control rights. In this respect, disclosure duties imposed on the agent are an important auxiliary mechanism, as it evens out the information advantage the agent may have and it allows the principal to assess the actions of the agent.[29] Thus, disclosure duties are also an important auxiliary mechanism to the governance strategies pursued by company law in which shareholder rights are at the core.[30] Outside the inherent agency relationships in companies, asymmetric information may be problematic in relation to externalities, which is why informing the market and market participants via mandated disclosures could be a key to ensuring an efficient capital market.[31]

Consequently, disclosure duties are found in company law as well as in capital market law. While it may not be surprising that corporate governance duties are found in company law, as ensuring good corporate governance is an essential part of the company law framework, it may be more surprising that corporate governance related duties are also found in capital market law.

[27] In broad terms, the provisions in SRD II only apply to undertakings carrying out activities of life assurance or institutions for occupational retirement provision and asset managers. See SRD II, Article 2.

[28] Armour, J., Hansmann, H., & Kraakman, R.: Agency Problems, *op. cit*. note 21, p. 31 f.

[29] *Ibid,* p. 32.

[30] *Ibid*, pp. 31 ff.

[31] Sørensen, K. E.: Shareholders' Duty to Disclose, in: Birkmose, H. S.: (ed.), *Shareholders' Duties*, p. 308.

Company law is intended to reduce the costs of transactions that take place within a business form with certain characteristics rather than within a market per se.[32] Organizing a business through the corporate form, involves a risk that company constituents[33] – including shareholders, the board of directors, creditors and employees – engage in opportunistic behavior, or that conflicts of interest occur. Therefore, the regulatory framework seeks to constrain value-reducing forms of opportunism and to control conflicts of interest.

The aims of capital market law are different from those of company law. The contractual relationship between market participants is of less importance here, as a primary aim is to ensure the existence of efficient capital markets. Moreover, capital market law also serves an important public interest function, in the sense that the state has a clear interest in the well-being of capital markets, an interest that goes beyond advancing the private interests of individual market participants. Thus, protecting against market failures, including those caused by asymmetric information, is a main focus in capital market law. However, the disclosure rules found in capital market law go beyond market efficiency; a number of these duties are also intended to enhance good corporate governance.[34]

The corporate governance duties found in the law serve several purposes, with most falling into one of two categories of disclosure duties.[35] They serve either to provide information about ownership or control structures of a company, or to ensure transparency about a shareholder's intentions. That is, the law seeks to make transparent the ways influence has been or will be exercised.

Because corporate governance duties aim to promote better corporate governance, most disclosure duties only apply to specific shareholders or groups of shareholders who have the potential to exercise significant (negative) influence on a company. For example, shareholders often must disclose holdings of a certain size, or certain defined relationships to the company, e.g. if the shareholder is also a director.[36] This is consistent with the discussion above, as these shareholders either have a majority holding (and thus act as agents of the minority), or may be able to cause a market failure due to the information their position in the company may provide access to.

While corporate governance issues concern all limited liability companies, some of the duties apply only to shareholders in listed companies. This is un-

[32] See Armour, J. *et al*., 'What Is Corporate Law?', in: Kraakman, R. *et al*. (eds.), *The Anatomy*, *op. cit*. note 21, p. 1 f...

[33] *Ibid*. p. 2 f.

[34] For a thorough discussion, see Sørensen, K. E.: Shareholders' Duty to Disclose, *op. cit*. note 31, p. 311–20.

[35] Sørensen, K. E.: Shareholders' Duty to Disclose, *op. cit*. note 31, pp. 311–20.

[36] See Birkmose, H. S.: Duties Imposed on Specific Shareholders, *op. cit*. note 22, (forthcoming).

surprising with regard to duties found in capital market law, but shareholders in listed companies are also subjected to duties in company law, in particular those found in SRD II.[37] While listed companies are more likely to have cross-border elements and therefore are more prone to EU regulation, also in the area of company law, it is more surprising that these duties apply only to some institutional investors, a scope that hardly can be explained by agency theory or fears of market failure.[38]

3. SHAREHOLDER ENGAGEMENT

The shareholder engagement provisions in SRD II take corporate governance a step further than previous attempts to encourage shareholders to take a more proactive role in investee companies. The question of appropriate shareholder engagement, an emerging corporate governance discussion, takes its starting point in the rights granted to holders of shares in limited liability companies. These control and governance rights are an inherent part of share ownership, as discussed above.[39] The EU Commission has for years emphasized the importance of shareholder rights, and the adoption of the Shareholder Rights Directive[40] in 2007 was an important measure to strengthen the rights of shareholders across Member States.

The strengthening of shareholders rights is important for shareholders who want to engage in the governance of investee companies. Traditionally, the corporate governance agenda has been regarded as optional for shareholders, and shareholders had been free to choose to exercise their given rights or to remain passive. However, a new agenda is emerging, whereby the traditional engagement agenda that relies primarily on shareholder rights is coupled with disclosure duties for institutional investors and asset managers that aim to increase long-term, sustainable shareholder engagement. This new agenda has materialized with SRD II, which was adopted in 2017.[41]

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[37] In broad terms, the provisions in SRD II only apply to undertakings carrying out activities of life assurance or institutions for occupational retirement provision and asset managers. See SRD II, Article 2.

[38] See Birkmose, H. S.: Duties Imposed on Specific Shareholders, *op. cit.* note 22, (forthcoming).

[39] 'What Is Corporate Law?' in: Kraakman, R. *et al.* (eds.), *The Anatomy*, *op. cit.* note 21, pp. 11 ff.

[40] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

[41] 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.

3.1. THE SHAREHOLDER RIGHTS DIRECTIVE

The amended Shareholder Rights Directive was born in the aftermath of the 2008 financial crisis, when national and supranational regulators were under pressure to react to the malpractices of market participants, including the shareholders, after the financial markets' collapse. In the 2010 and 2011 Green Papers, the EU Commission stressed that the lack of shareholder engagement might have contributed to the extensive consequences of the crisis.[42] Trust in shareholders had been shaken during the financial crisis, and the Commission argued that the observed passivity of shareholders raised 'questions about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders.'[43] Still, despite this criticism of a system that relied on the idea that a shareholder would engage and hold management to account for its performance, the Commission continued to rely on shareholder engagement as 'one of the cornerstones of listed companies' corporate governance model'.[44] Thus, the Commission stated in its 2012 Action Plan that it would propose an initiative on the disclosure of institutional investors' voting and engagement policies as well as their voting records, all in an effort to improve transparency on investor practices and improve corporate governance in listed companies.[45] The Commission put forward a proposal for an amendment of the Shareholder Rights Directive in April 2014[46] and, after some adjustments during the negotiations in the European Parliament, the SRD II was adopted three years later, in April 2017.

The SRD II includes a Chapter 1b on the transparency required of institutional investors, asset managers and proxy advisors. Of particular interest in this chapter is Article 3g, titled 'Engagement Policy'. Paragraph 1 states:

Member States shall ensure that institutional investors and asset managers either comply with the requirements set out in points (a) and (b) or publicly disclose a clear and reasoned explanation why they have chosen not to comply with one or more of those requirements.

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[42] See *Corporate Governance in Financial Institutions and Remuneration Policies*, (COM(2010) 284 final), section 3.5 (hereinafter the '2010 Green Paper'); and *The EU corporate governance framework* (COM(2011) 164 final), section 2 (hereinafter the '2011 Green Paper').

[43] The 2010 Green Paper, section 3.5.

[44] The 2012 Action Plan (COM(2012) 740 final), section 3.

[45] See the 2012 Action Plan (COM(2012) 740 final), section 2.4.

[46] Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement. COM(2014) 213 final.

Typesetter: please indent the following two quoted paragraphs, so that they are shown clearly as sub-paragraphs to the quoted paragraph immediately above

(a) 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, conduct dialogues with investee companies, exercise voting rights and other rights attached to shares, cooperate with other shareholders, communicate with relevant stakeholders of the investee companies and manage actual and potential conflicts of interests in relation to their engagement.

(b) Institutional investors and asset managers shall, on an annual basis, publicly disclose how their engagement policy has been implemented, including a general description of voting behavior, an explanation of the most significant votes and the use of the services of proxy advisors. They shall publicly disclose how they have cast votes in the general meetings of companies in which they hold shares. Such disclosure may exclude votes that are insignificant due to the subject matter of the vote or the size of the holding in the company.

3.2. AIM OF THE DIRECTIVE

From the text it is clear that the primary aim of Article 3g is to ensure public disclosure of institutional investors' and asset managers' investment strategies, their engagement policy and the implementation thereof.[47] Alternatively, institutional investors and asset managers may disclose an explanation as to why they have chosen not comply with the provisions (comply or explain). Engagement with investee companies is part of a legal governance strategy under which shareholders actively assert their control over the board of directors. However, as discussed above in Section 2, we would not expect any duties to be imposed on the shareholders in their role as principal vis-à-vis the board of directors, as governance strategies aim to facilitate the principal's ability to control the agent's behavior. It is thus more reasonable to understand disclosure duties like those found in Article 3g as mechanisms to assist efforts by an institutional investor's own principals to control their agent – the institutional

[47] See also Barker, R. M. & Chiu, I. H.-Y.: *Corporate Governance and Investment Management*, London, 2017, p. 182 f.

investor. Nothing in SRD II challenges this interpretation. However, a closer look at the preamble of the SRD II suggests that the aim goes beyond enhancing corporate governance as traditionally understood. Recital 16 states that

…. Public disclosure of such information could have a positive impact on investor awareness, enable ultimate beneficiaries such as future pensioners to optimize investment decisions, facilitate the dialogue between companies and their shareholders, encourage shareholder engagement and strengthen their accountability to stakeholders and to civil society.

Arguably, the purpose is not fully clear from the wording of this recital. From a corporate governance perspective, all shareholders have a financial interest in monitoring the board. However, the SRD II limits the disclosure duties to institutional investors and asset managers.[48] An argument that supports this emphasis on institutional investors and asset managers is that this type of shareholder has a long-term commitment to its own principals: their beneficiaries.[49] Since these beneficiaries, for example investors in pension schemes, are interested in the size of their return many years down the road, they expect their fund managers, for example pension fund managers, to use their shareholder power to encourage a similarly long-term focus by investee companies. Disclosure by the institutional investors would be consistent with a governance strategy that enables the principal (the beneficiaries) to control their agent (the institutional investor). While institutional investors undoubtedly are agents of their beneficiaries, this agency relationship has usually not been regulated in company law, though.

In addition to protecting the interests of these beneficiaries, the disclosure of the information in Article 3g seems to aim at ensuring the interests of a number of other company interest groups, including other investors and the investee companies themselves. If an institutional investor is the majority shareholder, then its actions can affect the interests of minority shareholders. But if such minority interests should be protected, then surely they should be protected with reference to all majority shareholders and not only institutional investors. Further, this argument does not take into consideration the range in size and investment strategies among members of the institutional investor 'group'. While it can be argued that duties should be imposed on institutional investors when they are in a position to cause market failure due to asymmetric

[48] Moreover, only a subset of the institutional investor population is covered by the provisions in Chapter 1b, supra n. 27.

[49] EU Corporate Governance Framework, Green Paper, (COM(2011) 164 final), section 2.1. See also Fairfax, L. M.: *Making the Corporation Safe for Shareholder Democracy*, Ohio State law Journal, vol. 69 2008, p. 83.

information, it can hardly be argued that institutional investors *per se* can be expected to be a unique cause of market failure.

While the disclosure duties in Article 3g cannot be seen strictly as an engagement duty, due to the flexible 'comply or explain' approach, the article contains some very detailed expectations for institutional investors' engagement with investee companies. These duties may be seen as implicit engagement duties.[50] Engagement expectations, built seem to go beyond the monitoring of the boards, which traditionally underlies the agency relationship between shareholders and the board of directors. This relationship builds on the premise that shareholders have a financial incentive to monitor the boards of directors to ensure that the value of their investment is maximized.[51] Emphasizing an expectation for institutional investors to include in their engagement policy how they monitor investee companies on issues such as 'strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance' and how they 'communicate with relevant stakeholders of the investee companies' suggests that institutional investors are expected to include interests that go beyond their own private interest. Looking at Recital 16 again, it mentions that disclosure of the required information should 'strengthen their accountability to stakeholders and to civil society.' It is not quite clear who 'their' refers to. However, in the 2012 Action Plan an almost identical wording is seen in Section 2.4. Here it is said that disclosure 'could strengthen companies' accountability to civil society.'[52] This might even suggest that institutional investors should be watchdogs on behalf of civil society's interests in listed companies.[53] Undoubtedly, civil society has an interest in the financial well-being of companies, but the extent of accountability owed by shareholders to civil society is arguable even after implantation of SDR II. The traditional division of power in limited liability companies limits the shareholders' role to controlling the board and leaves the board of directors as responsible for ensuring compliance of its company with any duties associated with the service of broader public interests. In addition,

[50] See also Chiu, I. H.-Y. & Katelouzou, D., who in their paper, From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe? argue that the SRD II is a tentative step towards a hardening of engagement duties. In: Birkmose, H. S.: (ed.), *Shareholders' Duties*, § 7.04.

[51] See among others Fama, E. & Jensen, M.: *Separation of Ownership and Control*, *op. cit*. note 20; Jensen, M. C. & Meckling, W. H.: *Theory of the Firm*, *op. cit*. note 20.

[52] European Company Law and Corporate Governance – A modern legal framework for more engaged shareholders and sustainable companies, (COM(2012) 740 final).

[53] The trend where the impact of listed companies on society and the overall economy becomes the focus of increased public attention has been labelled 'publicness'. See Fisch, J. E., *The Mess at Morgan: Risk, Incentives and Shareholder Empowerment*, University of Cincinnati Law Review, vol., 83, 2014, p. 653 with further references.

while institutional investors traditionally have been accountable to their beneficiaries, SDR II's provisions seem to hold this sub-group of investors accountable to a wider range of stakeholders, including society. Moreover, post-SRD II disclosure provides stakeholders with information, which they might use to hold institutions accountable.

This line of reasoning leads directly to the argument that the amendment to the Shareholder Rights Directive takes a stronger stand on the obligation of at least a subset of the institutional investor population to become more actively involved in corporate governance. The Directive has introduced a new type of shareholder duty. This duty falls outside the framework by which we are able to explain most shareholder duties in company law or capital market law, as discussed above in Section 2.[54] Rather, it could be argued that these duties are motivated by a post-crisis political agenda that includes increased transparency between companies and investors, increased shareholder engagement to improve corporate governance practices and an increased focus on sustainability and long-term commitment. Institutional investors have been identified as a group whose self-interest aligns closely with the latter two goals.[55] Compared with other investor groups, institutional investors are most likely to have engagement policies that further the political agenda that is embedded in SRD II. Nonetheless, as the discussion below suggests, much stands between an emerging engagement duty as specified in SDR II and a transformation of corporate governance.

4. ENGAGEMENT DUTIES – WHAT SHOULD WE EXPECT FROM INSTITUTIONAL INVESTORS?

It is hard to predict the effect of SRD II requirements on either institutional investors or the companies in which they invest. As discussed in Section 2, principal-agent theory predicts that duties will be imposed on shareholders either to constrain their behavior or to enable other company constituents to control shareholders who are the agents of these constituents. However, SRD II duties do not aim to constrain the behavior of institutional investors in specific ways, but rather to change their general behavior. As discussed in the previous section, the aim is somewhat unclear and the provisions in Article 3g do not specify clearly what the expectations are. Still, it is clear that the overall aim is to institutional investors, further in their engagement with investee companies

[54] See Birkmose, H. S.: Duties Imposed on Specific Shareholders, *op. cit.* note 22, (forthcoming).

[55] See the 2011 Green Paper, (COM(2011) 164 final) section 2.1.

in order to improve corporate governance practices.[56] This new approach allows us to consider the potential of shareholder duties to serve as a driver for a transformation of corporate governance in a more sustainable direction. Such a transformation, including corporate service of public interests, seems not to be far from the aim of the directive.

But what can we expect from shareholders, and especially from institutional investors? Are they going to embrace this more prominent role in corporate governance? Historically, shareholder engagement has been rather low in most Member States, which helps to explain why the Commission has taken a new approach with SRD II.[57]

The Commission has pointed out different reasons for the lack of engagement in the Green Papers preceding the Directive, such as conflicts of interest, costs of engagement and lack of sufficient shareholder rights.[58] While each of these may contribute to a better understanding of past engagement levels, part of the reason may also be that the general position in company law is that institutional investors have a duty of loyalty only towards their beneficiaries, and even the extent of even this is debated.[59] Traditionally, it seems, the European stand has been that this fiduciary duty does not oblige institutional investors to engage with investee companies.[60]

Without a duty to engage or a duty of loyalty, shareholders could be expected first and foremost to use the rights they are given to protect their private interests in the company. Share ownership is very often an investment, and shareholders can be expected to engage to protect the value of this investment. Even though other private interests, including social or public objectives, may

[56] This is also found in relation to the development of the UK stewardship code, see Jennifer G. Hill, Images of the shareholder – shareholder power and shareholder powerlessness, in Hill, J. G. & Thomas, R. S. (eds.): *Research Handbook on Shareholder Power*, London, 2015, p. 65 f.

[57] See the 2010 Green Paper, (COM(2010) 284 final), section 3.5, and the 2011 Green Paper, (COM(2011) 164 final) section 2.1. See also SRD II, recital 2.

[58] In particular, the 2010 Green Paper, (COM(2010) 284 final), section 3.5.

[59] See the contributions to Hawley, J. P. *et.al* (eds.): *Cambridge Handbook of Institutional Investment and Fiduciary Duty*, 2014.

[60] See among others Barker, R. M. & Chiu, I. H.-Y.: *Corporate Governance and Investment Management*, London, 2017, pp. 63 ff. and 163 f. and Birkmose, H. S.: *European Challenges op. cit*. note 13, pp. 229 ff. However, the duty to vote is understood to be a fiduciary duty owed by some institutional investors to their beneficiaries in the US. See Employee Retirement Income Security Act of 1974, 29 US Code Chapter 18, Sections 1101–14. See also See also Rock, E. B.: Institutional Investors in Corporate Governance, in Gordon, J. N. & Ringe, W.-G.: *The Oxford Handbook of Corporate Law and Governance,* 2018, p. 375 ff. and Youngdahl, J.: The basis of fiduciary duty in investment in the United States, in Hawley, J. P. *et.al* (eds.): *Cambridge Handbook of Institutional Investment and Fiduciary Duty*, 2014, p. 22 ff.

exist,[61] the predominant theories expect financial interests to prevail. Therefore, without legislation or other institutional incentives, we can expect shareholders to act as drivers for transformation only to the extent that doing so will protect their financial interest in the company. Moreover, whether or not shareholders will remain passive or engage will partly depend on a cost benefit analysis, and the extent of engagement can be expected to correlate with its expected impact on the return on investment.[62] The costs are primarily the cost of engagement,[63] and the expected benefits will primarily occur in the form of increased company value as reflected in the share price.

SRD II expects institutional investors to make use of the rights they are granted by company law to ensure better corporate governance – not just to further their own interests in the company, but to further the interests of non-shareholder groups as well. That is, SRD II intends to use institutional investors as a vehicle to promote corporate action on issues that are of concern to the wider public.[64] Even if we assume that SRD II provides shareholders with sufficient incentives to engage, however, the presumption that their interests are aligned with the interests of other stakeholders or society might not survive a closer inspection. This is why shareholders in general may be imperfect agents for other company constituents or the general public.[65] Moreover, because shareholders are able to diversify their investments, they may be more risk tolerant than other company constituents.[66] Finally, it is not at all clear that institutional

[61] Fairfax, L. M.: *Making the Corporation Safe for Shareholder Democracy*, *op. cit*. note 49, p. 82–85.

[62] Daniëlle Melis, Leen Paape & Mijntje Lückerath-Rovers warn against loading institutional investors with too many burdens in *Enforceability of institutional investors' responsibilities in corporate governance through the Dutch Corporate Governance Code: are regulators and practitioners on the same page (and to who are institutional investors accountable)?* Working Paper 2017, p. 22, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1975763. See also Rock, E. B.: Institutional Investors in Corporate Governance, in Gordon, J. N. & Ringe, W.-G.: *The Oxford Handbook of Corporate Law and Governance,* 2018, p. 373 f.

[63] See Birkmose, H. S.: The transformation of passive institutional investors to active owners – mission impossible? in: Birkmose, H. S.: *et al*. (eds.), *The European Financial Market in Transition*, 2011, pp. 117 ff.

[64] See also Fisch, J. E., *The Mess at Morgan*, *op. cit*. note 53, pp. 665 ff. See for a UK perspective Barker, R. M. & Chiu, I. H.-Y.: *Corporate Governance and Investment Management*, London, 2017, p 123 ff.

[65] Fisch, J. E., *The Mess at Morgan*, *op. cit*. note 53, p. 668. See also Gerald Hertig, who argues in: Governance by Institutional Investors in a Stakeholder World' that, of different groups of institutional investors, the interests of pension fund might be the closest to 'ordinary' other stakeholders' interests, in: Gordon, J. N. & Ringe, W-G: *The Oxford Handbook of Corporate Law and Governance*, Oxford, 2018, p. 836.

[66] Fisch, J. E., *The Mess at Morgan*, *op. cit*. note 53, p. 668.

investors have the capacity to serve wider purposes: shareholdings in hundreds or even thousands of companies dilute their interest in any single company; they may lack sufficient information to monitor for example the social and environmental impact of their companies; and they may lack the resources needed to gain such information, much less to include such factors meaningfully in their decision making. That is not to say, though, that shareholder interests are opposed to those of non-shareholders: if shareholders are too narrowly interested in short-term profit maximization and neglect a company's social responsibility, it might negatively affect the cost of capital and, consequently, the value of the company.[67]

It is therefore questionable whether the duties imposed by SRD II will be sufficient to induce institutional investors to make significant changes to their engagement practices, and even more questionable whether institutional investors will embrace a more prominent in role that includes non-shareholder interests.[68] All of this said that the impact of SRD II may be significantly greater if the emerging engagement duties can be enforced efficiently.

5. ENFORCEMENT OF SHAREHOLDER DUTIES

If we assume that neither shareholders in general nor institutional investors more specifically have strong incentives to take on a more prominent role in corporate governance and serve wider public interests, then a transformation of corporate governance in a more sustainable direction relies on whether or not the new disclosure duties can be efficiently enforced in a way that promotes the legislation's intentions.[69]

As cited above, Article 3g states that Member States must ensure that institutional investors and asset managers either disclose the information required by Article 3g paragraphs 2 and 3, or disclose why they have chosen not to comply with one or more of these requirements. In order to ensure not only the implementation of the provision but also its enforcement, Article 14b requires that Member States 'shall lay down the rules on measures and penalties applicable to infringements of national provisions adopted pursuant to this Directive and

[67] Ribstein, L. E.: *Accountability and Responsibility in Corporate Governance*, Notre Dame Law Review, vol. 81, 2006, pp. 1444–5.

[68] Others are less sceptical of the effect shareholders may have in relation to advancing stakeholder issues. See Fairfax, L. M.: *Making the Corporation Safe for Shareholder Democracy*, *op. cit*. note 49, p. 96.

[69] The discussions in this section are based on Section XX of Birkmose, H. S.: Duties Imposed on Specific Shareholders, *op. cit*. note 22.

shall take all measures necessary to ensure that they are implemented.'[70] This means that Member States must ensure that institutional investors and asset managers comply with Article 3g's comply or explain requirement. Public disclosure of institutional investors' and asset managers' investment strategies, their engagement policy and their implementation thereof might reduce the information advantage some shareholders have and could enable other company constituents to act upon the disclosed information to safeguard their own interests.[71] As such, here and in most agency contexts, disclosure is a means to an end: it allows principals to control their agents. Similarly, in relation to market failure, disclosure should enable the market to include the information in the assessment of the potential market impact of various shareholder actions, which ought to ensure a more efficient market.

While institutional investors are likely to comply with the formal disclosure requirements, this in itself might not lead to improved corporate governance in investee companies, or even to more shareholder engagement. Engagement by institutional investors can only have a positive impact on corporate governance if the individual institutional investor chooses to devote the resources needed to adopt and pursue a meaningful engagement policy.[72] That is, if shareholder engagement is to have an impact beyond private shareholder interests, the engagement policy and actual engagement should reflect the public dimension. None of this is required under SDR II, nor are Member States required to assess the quality of the institutional investors' engagement or the efficacy of the disclosed information. Thus, the disclosure might do nothing more than reflect status quo, which even could be: 'our engagement policy is that we do not engage.' The question then becomes: who can or should ensure that institutional investors deliver more than a box-ticking exercise? If they choose to present a non-engagement policy, who – if anyone – ought to have the authority to compel them both to engage in a meaningful way and disclose their engagement in an equally meaningful way?

In traditional corporate governance disclosure, the market is expected to incorporate the quality and the value of the disclosed corporate governance statements into the price of a listed company's shares: market disappointment

[70] However, see Konstantinos Sergakis, who warns that the broad working of Article 14b may raise concerns about its applicability across the EU. Legal vs. Social Enforcement of Shareholder Duties, in: Birkmose, H. S.: and Konstantinos Sergakis (eds.): *Enforcing Shareholders' Duties*, Edward Elgar, 2018, (forthcoming).

[71] Armour, J., Hansmann, H., & Kraakman, R.: Agency Problems, *op. cit*. note 21, p. 38 f.

[72] See also the G20/OECD Principles of Corporate Governance, introduction to section 3, 2015, where it is said that mandatory requirements to engage may be ineffective and could lead to a box-ticking approach.

with the disclosed reports is reflected in a lower market value. Thus, the board of a listed company has an incentive to ensure the quality of its corporate governance reporting.[73] Applied to SDR II mandated disclosures by institutional investors, it is doubtful that market pressure will sanction poor disclosure practices. First, it is not clear, who 'the market' is. Institutional investors need not be listed on a stock exchange, even though the SRD II preamble states that disclosure could have a positive impact on investor awareness. Moreover, it is not obvious that 'investor awareness' refers to those who invest their resources with institutional investors'. The phrase could equally well be meant to describe minority investors in the same companies. The latter have limited means to put pressure on the institutional investors beyond choosing to disinvest. Even that might not always be possible. Market pressure might also come from the institutional investors' beneficiaries, and the SRD II drafters might expect such pressure, as the preamble states that disclosure should enable ultimate beneficiaries such as future pensioners to optimize their investment decisions. And yet, even when beneficiaries pay attention to their pension fund, etc., they virtually never have the means to put pressure on their institutional agents,[74] because, as with minority shareholders, they face a massive collective action problem. Dialogue between institutional investors and investee companies is also mentioned in the preamble, and even though the boards in listed companies may have an interest in their investors' preferences, they lack means to put pressure on their institutional investors. Finally, accountability to society is mentioned, but society has been given no rights to sanction beyond the formal enforcement of disclosure. However, interest groups may be able to put some pressure on institutional investors, by 'naming and shaming' those whose engagement they consider inefficient or suboptimal.[75] The existence and effect of such strategies could be the subject of future empirical research. Relevant theoretical frameworks offer little insight regarding what we might expect.

In short, the enforcement provisions included in SRD II may ensure black-letter disclosure, but there no immediate mechanism for ensuring that legal disclosures advance the underlying aims of the engagement provisions. Howev-

[73] Evidence shows that the mechanism of comply or explain does not function perfectly. *See Risk Metrics, Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*, p. 13, 2009.

[74] See Melis, Paape & Lückerath-Rovers: *Enforceability of institutional investors' responsibilities*, *op. cit*. note 61.

[75] Informal enforcement strategies, such as 'naming and shaming', via the disclosure not only of the violations themselves (e.g. public warning) is also available to national authorities enforcing disclosure. See, Sergakis, K., Legal vs. Social Enforcement, *op. cit*., note 69, (forthcoming).

er, the absence of acceptable results might lead regulators to intervene later, which places investors in a conundrum familiar in a variety of contexts: a future choice between more engagement and more regulation.[76]

6. SHAREHOLDER DUTIES AS A DRIVER FOR A SUSTAINABLE TRANSFORMATION?

As discussed above, the shareholder duties found in SRD II can be seen as part of an emerging corporate governance agenda. Rather than limiting the actions of shareholders, the duties aim to extend shareholder actions, that is, to promote behavior that supports a political agenda. As we see it, shareholder duties can be part of a transformation of corporate governance practices in either of two ways: the transformation could be initiated by the company, whereby the board of directors proactively includes public interests even in situations where these are not aligned with the shareholder (short-term) interest in creating wealth; or it could be initiated by shareholders who use their shareholder rights to urge corporate behavior that is consistent with public interests, most especially as related to long-term sustainability.

Shareholders were not the only possible target of legislation intended to transform company practices in a more sustainable direction. It might have been more natural to look at the board of directors, which has the power to make most corporate decisions.[77] Looking forward, legislators might still do so. If, in the future, they impose duties on the board to include certain public interests in their decisions, then shareholders could use their rights to monitor the performance of the board of directors, in particular if management has to report on compliance. But unless new legislative initiatives clearly describe the board of directors' duties in that respect, it seems unlikely that shareholders will use their rights to push for a transformation that serves public interests which are not clearly aligned with their private interests.

Returning to Article 3, institutional investors' engagement policies are expected to explain 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'. However, the obligations the board of directors assumes regarding the social and

[76] Melis, Paape & Lückerath-Rovers: *Enforceability of institutional investors' responsibilities*, *op. cit*. note 61.

[77] The limits to managements' right to decide differ among individual Member States. See for instance Andenas, M. & Wooldridge, F.: *European Comparative Company Law*, Cambridge, 2009, Chapter 6; or Van Hulle, K. & Gesell, H. (eds.), *European Corporate Law*, Nomos, 2006.

environmental impact of the company they manage may depend on hard law as well as soft law, so a new duty of institutional investors to include such perspectives in their control practices might not result in improved practices on the matter,. Moreover, it has been shown in a US context, that even when duties are imposed on the board of directors, shareholder engagement might not be an efficient way to secure a change in practices.[78]

As an alternative to imposing duties on the board of directors, shareholders could take on a responsibility beyond the agency relationship between the board of directors and shareholders and include public interests in their own proactive agenda. However, the role of shareholders in corporate governance is formally limited to the general meeting, which may limit the shareholders' room for maneuver. Their authority at the general meeting depends primarily on the rights they are given in company law. Arguably, these rights first and foremost enable shareholders to monitor the board of directors and to protect their interests in the company. Whether or not shareholders are able to initiate any transformation of company practices depends on the rights given under national company law. In some Member States, shareholder rights are restricted to monitoring the board of directors, while in other jurisdictions shareholders may initiate transformations and obligate the board to carry out decisions taken at the general meeting.[79] But even if shareholders are able to initiate changes, shareholder-initiated transformations can be expected to take place in only a few situations. Shareholders can be expected to use the rights they are given primarily to protect their interests in the company, and a transformation is unlikely to take place unless the public aim is aligned with shareholder interests.

Finally, legislators may choose to impose duties on shareholders intended to transform company practices in a more sustainable direction. However, a process that is politically driven from above and crafted without adequate sensitivity to countervailing institutional incentives might not have the desired effect. Moreover, any legislative initiatives that require shareholders to be proactive should be within the limits of their authority at the general meetings, and the power to manage the company should remain with the board of directors.[80]

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[78] Fisch, J. E., *The Mess at Morgan*, *op. cit*. note 53, pp. 669 ff., in relation to the advisory shareholder vote on say-on-pay in the US, which was enacted with the Dodd-Frank Act.

[79] See Hansen, J. L.: The Role of Shareholders in Public Companies in the Nordic Countries, pp. 83 ff. and Kersting, C.: The Role of Shareholders in Public Companies in Germany, pp. 112 ff., both in: Fleischer, H., Hansen, J. L. & Ringe, W-G (eds.): *German and Nordic Perspectives on Company Law and Capital Markets Law*, Tübingen 2015. See also Lekvall, P. (ed.): *The Nordic Corporate Governance Model*, Stockholm, 2014, pp. 58 ff.

[80] See Lekvall, *ibid*, pp. 69 ff.

While legislators have the power to impose duties on shareholders to promote a desired practice by shareholders, the discussion above on the expected effect of the SRD II shows that the imposition of these new duties might not be sufficient to secure the desired transformation. Outside the agency relationships in companies, it is important that the model regulators choose is backed by efficient enforcement, as shareholders lack sufficient incentives to fulfill their engagement duties without proper enforcement. This feature is lacking in the SRD II disclosure model, as discussed above.

Consequently, if shareholder duties are to become an effective means to secure a desired transformation of corporate governance, we need to consider whether private or public enforcement is preferred. When we move outside the agency relationship, it is essential that legislators identify groups that already have an incentive to enforce shareholder duties, and provide these groups with appropriate means to do so. If we rely on private enforcement, then we have to consider who will benefit the most from compliance and is therefore willing to carry the costs connected with enforcement. Public enforcement may also be an option, giving for instance national financial supervisory authorities the power to enforce and sanction non-compliance.[81] While the sanctions may differ depending on whether the duties are to be enforced by private parties (for instance by taking the non-compliant shareholders to court) or public parties (using pecuniary or criminal sanctions), it is a fundamental prerequisite that the duties imposed on shareholders are clear and unambiguous, in order for the enforcing party to be able to assess whether or not the shareholders have complied. Moreover, it is essential that the shareholders know what to do to be in compliance with the given duties.

Besides the enforcement issue, the scope of any additional shareholder duties should be considered carefully. If new duties are imposed on shareholders in order to promote a political agenda that does not originate in agency relations or market failure concerns, a number of questions should be carefully considered. For one, as mentioned above in Section 4, it is questionable whether 'third party interests' are best protected by shareholder duties, as shareholder interests cannot be expected always to be aligned with the interests of other company constituents or the wider public. If legislators find that efficiently enforced duties can improve the alignment of shareholder interests with other parties' interests, then legislators need also to consider the costs that shareholders have to carry when such duties are imposed on them.[82] Furthermore, the costs need to be balanced against the interests the duties are intended to

[81] See Konstantinos Sergakis, who warns against legal sanctions of the emerging engagement duties in: Legal vs. Social Enforcement, *op. cit.*, note 69, (forthcoming).

[82] See Melis, Paape & Lückerath-Rovers: *Enforceability of institutional investors' responsibilities*, *op. cit.* note 61.

serve, and it must be assessed whether the duties are suited to protect the politically defined interests and whether the need to protect these interests are of greater value than the costs imposed on the shareholders. Legislators need also consider whether duties should be imposed on all shareholders, or a subset of shareholders. If the latter, legislators need to consider whether shareholders of certain types, such as institutional investors, should be imposed duties, or if a universal criterion like shareholding size should trigger the duties.[83] Finally, legislators need to consider whether duties should be imposed on shareholders in all types of companies or only on shareholders that invest in larger companies or in listed companies.

7. CONCLUSIONS

Imposing duties on shareholders can be seen as a transformative intervention in the private ordering of parties in a company. While such a legislative intervention might serve purposes traditionally seen as legitimate, such as protecting the interests of the principal in an agency relationship or ensuring market efficiency in case of concerns of market failure, duties can also serve other aims and SRD II explicitly does so. Duties like those mandated in SRD II are intended to be vehicles that support non-market-driven transformations of corporate governance. This is why legislators turn to other means to promote such transformations. Moreover, legislators may push for a transformation that is intended to serve a wider aim than to protect the interests of the shareholder, including public interests. SRD II has been discussed as an example of legislative attempts to promote a specific corporate governance agenda by the use of duties. In this article, I have argued that, in practice, SRD II duties might not bring about any significant changes to the institutional investors' engagement practices, partly due to an inefficient enforcement mechanism. If shareholder duties are to serve as a vehicle for a sustainable transformation of governance practices, legislators have to consider not only how to enforce the duties efficiently, but also whether this purpose truly justifies their intervention in companies' private ordering.

While shareholder duties can serve as a vehicle for transformation of company law and corporate governance in certain situations, the effect of shareholder duties arguably has clear limits. Therefore, should legislators decide to proceed down the path they started upon with SRD II, they should consider carefully in which situations shareholders duties will have the desired effect.

[83] A number of the corporate governance duties we find in company law and capital market law depend on size, as large shareholders have to potential to exercise influence over a company, see Sørensen, K. E.: Shareholders' Duty to Disclose, *op. cit.* note 31, pp. 311 ff.

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THE TRANSFER OF A COMPANY SEAT TO A DIFFERENT MEMBER STATE IN THE LIGHT OF THE RECENT „POLBUD“ DECISION

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ABSTRACT

This paper observes the transfer of a company seat to a different Member State as an expression of the EU freedom of establishment. The reason for such analysis is the recent and somewhat controversial "Polbud" decision. The Court decided that a company enjoys the freedom of establishment to transfer its registered seat to another Member State despite the fact that it will not perform any economic activity there. In addition, the Court held that the mandatory liquidation of a company goes beyond what is necessary to protect the legitimate interests of minority shareholders, creditors, and employees. The paper scrutinizes both findings. A special attention is devoted to the role of an actual economic activity for the notion of the freedom of establishment. The paper arrives to the conclusion that, along with the freedom to actually perform economic activity, the freedom of establishment includes the freedom to use all national legal forms suitable for performing of an economic activity. As to the second finding, although it is possible that the mandatory liquidation indeed goes beyond necessary, the Court failed to demonstrate that this was the case.

KEYWORDS: *registered seat, real seat, transfer of a seat, freedom of establishment, economic activity, freedom of legal form*

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1. INTRODUCTION

Functioning of the European Single Market presupposes, among other freedoms, the right of establishment in a territory of another Member State (Art. 49-55 TFEU[1]).[2] Having in mind that the establishment can take a form of a company (Art. 49 (2) TFEU) and that companies themselves enjoy the right of establishment (Art. 54 TFEU), it could be expected that the companies are free to change their seat from one Member State to another at their will. However, as expressly stated in Art. 54 TFEU, companies are primarily formed in accordance with the law of a specific Member State, and, consequently, they exist only by virtue of its national legislation.[3] This creates a tension between EU and national law – while EU law gives company a right to transfer its seat, both the Member State in which the company was initially incorporated (departure Member State) and the Member State in which the company wants to transfer its seat (destination Member State) set the requirements for the very existence of such company. Such tension cannot be solved by simply prioritizing either EU or national law. Instead, it is necessary to demarcate their competences as precisely as possible and to strike the right balance between conflicting interests.

This is further complicated by the fact that a seat of a company can be determined in multiple ways. Consequently, the seat can be a place where a company is registered, a place determined by company's articles of association, a place from which the company is managed or the place in which the company performs at least a part of its economic activity. Those places will, naturally, often coincide. This is especially true with the registered seat and the seat determined by company's articles of association, since the registration authority will carry out the registration on the basis of the articles of association. On the

[1] Consolidated version of the Treaty on the Functioning of the European Union, *OJ C 326, 26.10.2012, p. 47–390.*

[2] About the freedom of establishment in more detail see, e.g. Craig, P.; de Burca, G., EU Law, Text, Cases and Materials, Oxford University Press, 2015., p. 794; Goebel, R. J. et al., Cases and Materials on European Union Law, West Academic Publishing, 2015, p. 603; Barnard, C., The Substantive Law of the EU, The Four Freedoms, Oxford University Press, 2016, p. 381; Mathijsen, P. S. R. F., A Guide to European Union Law, Sweet & Maxwell, 2010, p. 266; Steiner, J.; Woods, L., EU Law, Oxford University Press, 2009, p. 491; Korte S. in: Calliess, C.; Ruffert, M. (ed.), EUV/AEUV, C. H. Beck, München, 2018, Art. 49 AEUV; Forsthoff, U. in Grabitz, E.; Hilf, M.; Nettesheim, M. (ed.), Das Recht der Europäischen Union, C. H. Beck; München, 2018, AEUV Art. 49; Müller-Graf, P-C. in Streinz, R. (ed.), EUV/AEUV, C. H. Beck, München, 2018, AEUV Art. 49; Tiedje, J. in: von der Groeben, H.; Schwartze, J., Hatje, A. (ed.), Europäische Unionsrecht, Nomos, 2015, AEUV Art. 49.

[3] Judgement of 27 September 1988, Daily Mail and General Trust PLC, C-81/87, ECLI:EU:C:1988:456, para. 19.

other hand, in contemporary globalized economy, especially within the EU, it is common that the place of company's management or the place of company's economic activity (so-called "real seat") diverge from its registered seat. It is, moreover, common that a company conducts its economic activity in several countries or even that it is managed in a decentralized way.

The fact that Member States regulate the incorporation of their companies' means that they are free to determine the connection those companies must have with their national territory[4] i.e. Member States are free to require the existence of a certain type of seat within their boundaries. In practice, they will at least require that the companies' registered seat is recorded by their registration authority or, otherwise, the system of the national company registration would become meaningless. Member States can also make registration of companies contingent upon a certain "real" connection with their territory, e.g. the location of company's management or performing of economic activity.

In addition to company law rules, Member States are generally free to designate private international law rules on how to determine the law applicable to companies (*lex sociatatis*). The connecting factor is usually either the place of company's registration, i.e. incorporation (incorporation theory), or the place of company's effective management (real seat theory).[5]

Consequently, the transfer of certain type of company seat depends on the role which that type of seat plays in the national company and private international law of the departure and the destination Member State. By registering itself in a Member State a company adopts a distinct legal form, specific for that legal system (e.g. LTD, SARL, GmbH). Therefore, a cross-border transfer of a registered seat almost always requires a conversion of transferring company in a legal form recognized in the destination Member State. Even if company forms from different Member States share the same name, due to the differences in national legislation they are rarely identical.[6] If the destination Member State requires that its companies also have a "real seat" in its territory, the transferring company will be forced to transfer its management and/or economic activity. On the other hand, the sole transfer of a "real seat" will rarely lead to a change of legal personality, although the departure Member State might refuse to recognize such company as its own.

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4 Müller-Graf, op. cit. in fn. 2., AEUV 54, para. 20.

5 Tiedje, op. cit. in fn. 2, AEUV 54, para. 35-40.

6 E.g. in both Germany and Austria private limited company is called *Gesellschaft mit beschränkter Haftung*, abbreviated GmbH. However, for German GmbH minimum share capital is 25.000 EUR (§ 5 German GmbHG), and for Austrian GmbH 35.000 EUR (§ 6 Austrian GmbHG).

National rules on the seat and its transfer, however, are not allowed to restrict the freedom of establishment as defined by the EU law. The scope of the freedom to transfer the company seat is primarily defined by the case law of the Court of Justice of the European Union (the Court). Unlike with some other types of cross-border transformation,[7] the existing EU secondary legislation does not regulate the cross-border transfer of the company seat or the cross-border conversion. Only recently, as a part of EU Company Mobility Package, European Commission issued a proposal for a directive that would comprehensively regulate cross-border conversions, mergers and divisions.[8] European Commission also started an initiative to codify the private international company, possibly in the form of a new Rome Regulation.[9]

Since the case law of the Court has already been extensively scrutinized, this introduction will provide only a brief overview. In Daily Mail case, the Court found that the companies exist only by virtue of national legislation, and as long as a company wants to remain incorporated in the United Kingdom, the freedom of establishment does not authorize it to move its central management to Netherlands before it complies with the requirements set by UK law.[10] Simply put, the departure Member State may prevent the sole transfer of a company's real seat.

In a series turn-of-the-century cases the Court held that the freedom of establishment precludes the destination Member State from restricting the transfer of a real seat, even if the transferring company does not exercise any economic activity in the departure Member State. To be more specific, in Centros case the Court found that Denmark cannot refuse to register a branch of a UK company even if the company was incorporated in UK only to avoid Danish requirements of a minimum share capital.[11] The transferring company could not have abused the right of establishment since its objective is precisely to

[7] Cross-border mergers which are regulated by the 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, Art. 118-134.

[8] Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions, COM/2018/241 final - 2018/0114 (COD).

[9] See Gerner-Beuerle, C.; Mucciarelli, F. M.; Schuster, E-P., Study on the Law Applicable to Companies, June 2016, p. 12. See also a proposal by the European Group for Private International Law (GEDIP), led by prof. Francisco Garcimartin, called The Law Applicable to Companies in the European Union, from October 2016.

[10] Daily Mail, op. cit. in fn. 3, especially para. 19-24.

[11] Judgement of 9 March 1999, Centros Ltd, C-212/97, ECLI:EU:C:1999:126.

enable companies to pursue economic activities in Member States other than the country of their incorporation.[12]

Similarly, in Überseering case the Court found that Germany is not allowed to use the real seat theory to deny the legal capacity of a company incorporated in Netherlands which transferred its central management to Germany.[13] In Inspire Art case the Court found that Netherlands could not impose the minimum share capital on a company incorporated in UK which wanted to conduct its economic activity exclusively in Netherlands.[14] Described cases are not contrary to the reasoning applied in Daily Mail. If a company derives its affiliation to a Member State from its registration,[15] only that Member State can impose certain requirements, while the other Member States have to respect its freedom of establishment.[16]

All three cases recognize that the freedom of establishment could be restricted in order to prevent fraud or abuse or if there are some other overriding reasons of public interest,[17] such as the protection of minority shareholders, creditors, employees (workers) or tax law objectives[18]. However, measures that restrict freedom of establishment have to be appropriate for attaining their objective and should not go beyond necessary.[19] The Court was generally very reluctant to recognize the fraud or abuse of the freedom of establishment, since its objective is exactly to enable companies to choose the most favorable combination of the registered and real seat.[20] The Court was also reluctant to recognize that a measure does not go beyond what is necessary to achieve a legitimate objective.[21] Nevertheless, in Cadbury Schweppes case the Court held that a Member State is allowed to restrict the freedom of establishment of wholly

[12] Centros op. cit. in fn. 11, para. 23-27.

[13] Judgement of 5 November 2002, Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC), C-208/00, ECLI:EU:C:2002:632.

[14] Judgement of 30 September 2003, Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd, Case C-167/01, ECLI:EU:C:2003:512.

[15] To be precise, Daily Mail does not equate the country of incorporation with the country of registration (Daily Mail, op. cit. in fn. 3, especially para. 23). However, at least as to the companies which need to be registered, the incorporation will be synonymous with registration.

[16] Inspire Art, op. cit. in fn. 14, para. 103.

[17] Centros op. cit. in fn. 11, para. 25, 34; **Überseering**, op. cit. in fn. 13, para. 92; Inspire Art, op. cit. in fn. 14, para. 105, 133.

[18] **Überseering,** op. cit. in fn. 13, para. 92; Judgement of 13 December 2005, SEVIC Systems AG, C-411/03, ECLI:EU:C:2005:762, para. 28.

[19] Centros, op. cit. in fn. 11, para. 34; Inspire Art, op. cit. in fn. 14, para. 133.

[20] Centros, op. cit. in fn. 11, para. 27; Inspire Art, op. cit. in fn. 14, para. 96, 138, 139.

[21] Centros, op. cit. in fn. 11, para. 36-38, Inspire Art, op. cit. in fn. 14, para. 135.

artificial arrangements which do not conduct any genuine economic activity, if their aim is to circumvent the application of Member State's legislation (in particular case – tax law).[22]

In none of the described cases, the Court decided on the transfer of a registered seat. This began to change with the SEVIC case, in which the Court held that the freedom of establishment precludes the destination Member State from restricting a transfer of the registered seat via merger. In particular, Germany was not allowed to refuse the registration of a merger in which a German company absorbed a Luxembourg company.[23]

In Cartesio, the Court decided on a case whose facts were similar to those of Daily Mail.[24] The Court found that the freedom of establishment did not compel Hungary to permit Hungarian company to transfer its real seat to Italy and to register such transfer in Hungarian company register. As long as a company wants to retain its status of a company governed by Hungarian law, Hungary is authorized to require the existence of the seat within its territory.[25] More interesting was an obiter dictum, according to which it would be different if a company completely detached itself from the departure Member State by converting itself into a company form of the destination Member State. In that case, the departure Member State would not be allowed to prevent such conversion by requiring winding up or liquidation of the company.[26]

That obiter dictum was soon tested in a Vale case, where an Italian company wanted to transfer both its registered and real seat to Hungary, converting itself into a company form of Hungarian law.[27] Hungarian courts refused to register such transfer, explaining that Hungarian law allows only domestic conversions, between company forms of Hungarian national law. The Court found that this constituted a restriction of the freedom of establishment. As long as the transfer is accompanied by an actual pursuit of economic activities,[28] in accordance with the principles of equivalence and effectiveness,[29] the transferring company can rely on the analogous application of the rules on

[22] Judgment of 12 September 2006, Cadbury Schweppes plc, Case C-196/04, ECLI:EU:C:2006:544, especially para. 51, 75

[23] SEVIC, op. cit. in fn. 18.

[24] Judgement of 16 December 2008, Cartesio Oktató és Szolgáltató bt, C-210/06, ECLI:EU:C:2008:723.

[25] Cartesio, op. cit. in fn. 24, para. 110.

[26] Cartesio, op. cit. in fn. 24, para. 111-112.

[27] Judgement of 12 July 2012, VALE Építési kft, C-378/10, ECLI:EU:C:2012:440.

[28] Vale, op. cit. in fn. 27, para. 34.

[29] Vale, op. cit. in fn. 27, para. 48

domestic conversions and, for that purpose, use the documents obtained by the authorities of the departure Member State[30].

In the most recent case, the Court decided on the transfer of a registered seat of a Polish company, called Polbud, to Luxembourg.[31] Those facts are similar to Vale case, however, with two notable differences. First, it was not the destination, but the departure Member State, Poland, which restricted the transfer by requiring mandatory liquidation of Polbud. Second, Polbud did not intend to transfer its head office or to conduct any economic activity in Luxembourg.[32] Contrary to the opinion of the Advocate General, Kokott,[33] The Court concluded that such transfer was covered by the freedom of establishment.[34] In addition, the Court found that Poland was not authorized to restrict that freedom by requiring liquidation of the company, since mandatory liquidation goes beyond what is necessary to protect the minority shareholders creditors and employees.[35]

Polbud decision, especially the conclusion that the freedom of establishment does not depend on the existence of any actual economic activity was both lauded[36] and criticized[37]. The aim of this paper is to examine both most im-

[30] Vale, op. cit. in fn. 27, para. 60.

[31] Judgement of 25 October 2017, Polbud – Wykonawstwo sp. z o.o., C-106/16, ECLI:EU:C:2017:351.

[32] Polbud, op. cit. in fn. 31, para. 8, 26.

[33] Opinion of the Advocate General Kokott, 4 May 2017, C-106/16, ECLI:EU:C:2017:351.

[34] Polbud, op. cit. in fn. 31, para. 43, 44.

[35] Polbud, op. cit. in fn. 31, para. 58, 59.

[36] Paefgen, W. G., „Polbud“: Niederlassungsfreiheit als Sitzspaltungsfreiheit, Teil I, WM 2018, p. 981-993; also Paefgen, W. G., „Polbud“: Niederlassungsfreiheit als Sitzspaltungsfreiheit, Teil II, WM 2018, p.1029-1041; Feldhaus, H., Das Erfordernis wirtschaftlicher Inlandstätigkeit beim grenzüberschreitenden (Herein-)Formwechsel nach „Polbud“, BB 2017, p. 2819-2825, especially p. 2823; Kovács, K., Der grenzüberschreitende (Herein-)Formwechsel in der Praxis nach dem Polbud-Urteil des EuGH, ZIP 2018, p 253-261, especially p. 255-256.

[37] Kindler, P., Unternehmensmobilität nach “Polbud”: Der grenzüberschreitende Formwechsel in Gestaltungspraxis und Rechtspolitik, NZG 2018, p. 1-7.; Mörsdorf, O., Nun also doch! – Die überraschende Umdeutung der Niederlassungsfreiheit zur Rechtswahlfreiheit durch den EuGH im Urteil Polbud, ZIP 2017, p. 2381-2389; Hushahn, J., Der isolierte grenzüberschreitende Formwechsel – Zugleich Anmerkung zum Urteil des EuGH v. 25.20.2017 in der Rechtssache Polbud, RNotZ 2018, p. 23-25; Kieninger, E.-M., Niederlassungsfreiheit als Freiheit der nachträglichen Rechtswahl, Die Polbud-Entscheidung des EuGH, NJW 2017, p. 3624-3627; Stelmaszczyk, P., Grenzüberschreitender Formwechsel durch isolierte Verlegung des Satzungssitzes, EuGH präzisiert den Anwendungsbereich der Niederlassungsfreiheit, EuZW 2017, p. 890-894. See also Horak, H.; Dumenčić, K., Cross-Border Transfer of the Company Seat: One Step Forward, Few Step Backward, US-China Law Review, Vol. 14, p. 722, which, although before Polbud decision was rendered, agree with the Opinion of Advocate General as to the requirement of the actual economic activity.

portant findings of the Court. First, it will be discussed whether a transferring company needs to conduct an actual economic activity in the destination Member State in order to be able to enjoy the freedom of establishment (2.). Second, it will be evaluated whether a mandatory liquidation goes beyond what is necessary to achieve legitimate objectives (3.).

2. DOES THE FREEDOM OF ESTABLISHMENT ALLOW A COMPANY TO TRANSFER ITS REGISTERED SEAT TO A MEMBER STATE IN WHICH IT DOES NOT CONDUCT ANY ECONOMIC ACTIVITY?

In allowing Polbud to transfer its registered seat to Luxembourg, the Court relied on the Art 49 (2) TFEU which states that the freedom of establishment includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms, under the conditions laid down by the law of the country where such establishment is effected for its own nationals.[38]

The Court also relied on its previous decisions, especially in Centros and Cartesio. In Centros it was held that a company with its seat registered in accordance with the laws of one Member State enjoys the freedom to transfer all of its activities to another Member State. Conversely, a company performing all of its activities in one Member State should be allowed to transfer its registered seat to another Member State.[39] In Cartesio it was held that the power of a Member State to impose requirements on companies incorporated within its legal system does not authorize that Member State to restrict the conversion of those companies to company forms of other Member States.[40] Consequently, a departure Member State should not be allowed to prevent the transfer of a registered seat to another Member State by demanding mandatory liquidation.

A number of scholars, however, consider that Polbud decision unduly widens the scope of the freedom of establishment from Art. 49 TFEU and that it misinterprets the previous case law.[41] After all, the Advocate General herself concluded that the transfer of Polbud's registered seat is not covered by the freedom of establishment.[42] Their main objection is that, as recognized in certain

[38] Polbud, op. cit. in fn. 31, para. 33.

[39] Polbud, op. cit. in fn. 31, para. 38.

[40] Polbud, op. cit. in fn. 31, para. 43.

[41] Especially Kindler, op. cit. in fn. 37, p. 3; Mörsdorf, op. cit. in fn. 37, p. 2382-2385; Stelmaszczyk, op. cit. in fn. 37, p. 893.

[42] Opinion of the Advocate General Kokott, op. cit. in fn. 33, para. 33-34.

previous cases, the purpose of the freedom of establishment is to protect an actual, genuine economic activity in a different Member State.[43] Consequently, the freedom of establishment does not imply a freedom to establish letterbox companies with no connection whatsoever with the destination Member State.

Opponents of Polbud decision believe that even Centros and Cartesio cases do not warrant a different interpretation. In Centros, the Court did not decide on the freedom of Danish citizens to register a company in the UK, but on the freedom of such, already established company to transfer its whole business to Denmark. In other words, the Court merely found that an already established company enjoys the freedom to conduct its actual economic activity in another Member State.[44] In Cartesio, the famous obiter dictum did not specify whether the right of a company to convert itself into a company form of a different Member State exists without the transfer of any economic activity. It is, however, possible that the Court omitted to clarify that issue only because the company in question wanted to transfer its real seat to Italy.[45]

If Polbud represents a rupture in the existing practice, the Court was at least supposed to provide an elaborate explanation. Instead, the Court failed to even mention the role of an actual economic activity for the definition of the freedom of establishment.[46] Consequently, the opponents of Polbud decision conclude that the Court's motivation was primarily political – to allow UK companies to circumvent the consequences of Brexit by an easy transfer of their registered seat to another Member State.[47] The Court, however, neglected the side effects of a precedent that gives a green light to the establishment of letterbox companies – race to the bottom between Member States as to the protection of creditors, minority shareholders and employees, and enabling of tax evasion as demonstrated by recent scandals of Panama Papers and Paradise Papers.[48]

Most of the criticism of Polbud decision, however, does not stand up to scrutiny. Erroneous is already the initial assumption that the transfer of Polbud's

[43] Mörsdorf, op. cit. in fn. 37, p. 2383-2384; Hushahn, op. cit. in fn. 37, p. 23; Kindler, op. cit. in fn. 37, p. 3.; Stelmaszczyk, op. cit. in fn. 37, p. 893. See Judgment of the Court of 25 July 1991, The Queen v Secretary of State for Transport, ex parte Factortame Ltd and others, C-221/89, ECLI:EU:C:1991:320, para. 20; Cadbury Schweppes, op. cit. in fn. 22, para. 54; Vale, op. cit. in fn. 27, para. 34, also Forsthoff, op. cit. in fn. 2, para. 16.

[44] Mörsdorf, op. cit. in fn. 37, p. 2383-2384; Kindler, op. cit. in fn. 37, p. 3.

[45] Cartesio, op. cit. in fn. 24, para., 23, 24, 100-102.

[46] About the lack of explanation, Mörsdorf, op. cit. in fn. 37, p. 2382, 2384.

[47] Mörsdorf, op. cit. in fn. 37, p. 2388; also Feldhaus, op. cit. in fn. 36, p. 2819 (although he welcomes such motivation).

[48] Kindler, op. cit. in fn. 37, p. 1.

registered seat did not represent an exercise of the freedom to actually perform economic activities (2.1.). Irrespective of that fact, a closer analysis shows that the freedom of establishment is not limited to the pursuit of an actual economic activity in another Member State. Although that is, indeed, its primary purpose, the freedom of establishment also encompasses the freedom to set up companies (and other legal forms) in another Member State under the same conditions as the nationals and companies of that Member State (2.2.). Thus defined, the freedom of establishment will be described both from the perspective of the departure Member State (2.3.) and the destination Member State (2.4.).

2.1. A COMPANY CAN EXERCISE ITS FREEDOM TO PERFORM ECONOMIC ACTIVITY IN A MEMBER STATE DIFFERENT FROM THE MEMBER STATE OF INCORPORATION EVEN BY A SOLE TRANSFER OF ITS REGISTERED SEAT

As already explained, the main criticism of Polbud decision was that it expanded the freedom of establishment to encompass the transfer of registered seat without the accompanying transfer of any actual economic activity.[49] Such opinion is based on the fact that Polbud transferred its registered seat to Luxembourg while leaving its management and business activities in Poland.

However, that represents a very reductive interpretation of the freedom of establishment. According to Art. 49 (2) TFEU the freedom of establishment includes a "right to take up and pursue activities as self employed persons and to set up and manage undertakings" in another Member State. In other words, the freedom of establishment encompasses not only the right to initiate economic activity but also the right to pursue or perform economic activity. Even further, it can be safely concluded that the right to initiate an economic activity exists only in order for that activity to be performed. In the context of the freedom of establishment of companies (Art. 54 TFEU), the companies have a fundamental right to perform economic activity in another Member State, and different ways to initiate that activity, e.g. by establishing a branch or a subsidiary, or by transferring its seat, are only means of exercising that right.

Having that in mind, Polbud's freedom of establishment did not consist in transferring of its registered seat to Luxembourg but in performing an actual economic activity in a Member State (Poland) different from the Member State of its registration (Luxembourg). The transfer of a registered seat to Lux-

[49] Kindler, op. cit. in fn. 37, p. 2; Mörsdorf, op. cit. in fn. 37, p. 2381; Stelmaszczyk, op. cit. in fn. 37, p. 892; Hushahn, op. cit. in fn. 37, p. 24.

embourg was only a way to exercise such fundamental freedom. Consequently, Poland was not allowed to restrict the performance of economic activity in its territory.

From the perspective of the freedom of establishment the situation in Polbud was not only similar, but identical to the situation in Centros. In both decisions the transferring company exercised its right to perform its activities in a Member State different from the Member State of incorporation. The only difference was reversal of the method through which such right was exercised – in Centros the company transferred its real seat from UK to Denmark, while in Polbud the company transferred its registered seat from Poland to Luxembourg. Consequently, it was only consistent of the Court to prevent the restrictions by the Member State in which transferring company intended to perform its actual economic activity (Denmark, Poland). Furthermore, both decisions confirm the Daily Mail doctrine which allows the Member State of incorporation to impose conditions for company incorporation and functioning. In both cases, the prerequisite for the freedom of establishment was that the state of registration (UK, Luxembourg) did not require a real seat in its territory.[50]

Opponents of the Polbud decision emphasize that the position of creditors, minority shareholders and employees (stakeholders) in Polbud is fundamentally different from the Centros case. In Centros Danish stakeholders would have been aware that they enter into a legal relationship with a newly arrived UK company.[51] In Polbud, on the other hand, Polish stakeholders could lose the already acquired level of protection after the company becomes subject to the law of Luxembourg.[52] Although such observation is entirely correct, a decision whether a company enjoys freedom of establishment cannot be influenced by the position of creditors, minority shareholders and employees. In accordance with the consistent practice of the Court, protection of minority shareholders, creditors, employees serves as a justification for the restrictions of the freedom of establishment.[53] The very fact that the freedom of establishment is being restricted confirms that it existed in the first place.

In addition, minority shareholders, creditors and employees would be equally endangered if Polbud transferred a part or its whole economic activity to Luxembourg. Consequently, their position cannot be used to criticize the transfer of the registered seat without an accompanying economic activity.

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[50] Centros, op. cit. in fn. 11, para. 27; Polbud, op. cit. in fn. 31, para. 43.

[51] Kindler, op. cit. in fn. 37, p. 3-4, see also Centros, op. cit. in fn. 11, para. 36.

[52] Kindler, op. cit. in fn. 37, p. 4.

[53] Überseering, op. cit. in fn. 13, para. 92; SEVIC op. cit. in fn. 18, para. 28; Vale, op. cit. in fn. 27, para. 39; Polbud, op. cit. in fn. 31, para. 54.

2.2. THE RELATIONSHIP BETWEEN THE FREEDOM OF ESTABLISHMENT AND THE ACTUAL ECONOMIC ACTIVITY

The previous chapter (2.1.) as well as the criticism of Polbud decision is based on the assumption that the freedom of establishment is limited to the freedom to pursue an actual economic activity. That statement, however, has to be closely examined. It is remarkable that TFEU does not give a comprehensive definition of the establishment.[54] Art. 49 (1) TFEU merely prohibits the restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State, including the restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. Art. 49 (2) TFEU, only as an example, states that the freedom of establishment "shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms".

The precise notion of establishment has, therefore, been left to the case law and jurisprudence. In Factortame II case the Court has given a definition of the establishment as an "actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period".[55] The need for an actual pursuit of economic activity was upheld in Cadbury Schweppes case,[56] and in one of the most recent cases on cross-border transfer of the seat, Vale[57]. Namely, the Court allowed the transfer of the registered seat from Italy to Hungary because there was nothing to suggest that the activities of the transferring company will be restricted to Italy.[58] The requirement of an actual pursuit of an economic activity has been widely accepted in legal scholarship.[59] Even further, a number of scholars consider that an actual economic activity within the EU, or even the departure Member State, is a prerequisite for the freedom of establishment.[60] In other words,

[54] Forsthoff, op. cit. in fn. 2, AEUV Art. 49, para. 16.

[55] Factortame II; op. cit. in fn. 43, para. 20.

[56] Cadbury Schweppes, op. cit. in fn. 22, para. 54.

[57] Vale, op. cit. in fn. 27, para. 34.

[58] Vale, op. cit. in fn. 27, para. 35.

[59] Barnard, op. cit. in fn. 2, p. 383; Craig; de Burca, op. cit. in fn. 2, p. 794-795; Forsthoff, op. cit. in fn. 2, AEUV Art. 49, para. 16.; Müller-Graf, op. cit. in fn. 2, AEUV Art. 49, para. 12, Korte, op. cit. in fn. 2, AEUV Art. 49, para. 25-28, 32; Tiedje, op. cit. in fn. 2, AEUV Art. 49, para. 12.

[60] Tiedje, op. cit. in fn. 2, AEUV Art. 54, para. 29.; Kindler, P., Der reale Niederlassungsbegriff nach dem VALE-Urteil des EuGH, EuZW 2012, p. 892: Böttcher, L.; Kraft, J., Grenzüberschreitender Formwechsel und tatsächliche Sitzverlegung – Die Entscheidung VALE des EuGH, NJW 2012, p. 2701; Roth, G., Das Ende der Briefkastengründung? – Vale contra Cen-

they treat the actual economic activity as an unwritten requirement from Art. 54 TFEU.[61]

The purpose of the freedom of establishment is indeed to enable an actual pursuit of a real economic activity. This is evident from the fact that it is located within Title IV of TFEU on free movement of persons, services and capital. After all the internal market (Art. 26 TFEU) presupposes an actual economic activity.[62] However, in order to achieve uniformity, publicity, and legal certainty, Member States usually provide that economic activities have to be performed through a certain, usually registered, legal form.[63] This can already be discerned from Art. 49 TFEU which mentions agencies, branches, subsidiaries, undertakings, companies and firms. The precise definition of those notions is left to individual Member States. This is most obvious for companies and firms which exist only in accordance with the laws of a Member State (Art. 54 (1) TFEU).

Naturally, national definitions of available legal forms should not hinder the freedom of establishment. This does not mean that a Member State cannot provide even for substantial requirements for a specific legal form. Member States are merely compelled to leave at least one legal form through which EU nationals and companies can perform economic activities without any substantial burden. Thus, a Member State may place significant requirements on the incorporation of its companies,[64] as long as it allows for another way of performing economic activities, e.g. by registration of a branch.

On the other hand, after a Member State institutes certain legal forms suitable for performing economic activities, in order to avoid discrimination (Art. 18 TFEU),[65] they have to be available under the same conditions to all EU nationals and companies.[66] It is, however, possible that a Member State does not require that those forms are indeed used for performing of actual economic activities. Even in that case, in order to avoid discrimination, those forms have

tros, ZIP 2012, p. 1745; Leible, S., EuGH: Eintragung der Zweigniederlassung einer in einem anderen Mitgliedstaat ansässigen und rechtmäßig gegründeten Gesellschaft, die dort keine Geschäftstätigkeit entfaltet; NZG 1999, p. 301; Mörsdorf, op. cit. in fn. 37, p. 2384.

[61] Tiedje, op. cit. in fn. 2, AEUV Art. 54, para. 29., see also Korte, op. cit. in fn. 2, AEUV Art. 54, para. 18-20.

[62] Mörsdorf**,** op. cit. in fn. 37, p. 2384.

[63] Daily Mail, op. cit. in fn. 3, para. 17; Centros, op. cit. in fn. 11, para. 20.

[64] Daily Mail, op. cit. in fn. 3, especially para. 20, 23.

[65] That the freedom of establishment retains a close connection to the general prohibition of discrimination from Art. 18 TFEU see Müller-Graf, op. cit. in fn. 2, Art. 49 AEUV, para. 111.

[66] Tiedje, op. cit. in fn. 2, AEUV Art. 49, para. 54.

to stay available for all EU nationals and companies. This is confirmed by Art. 49 (2) TFEU which states that the "freedom of establishment shall include the right … to set up and manage undertakings, in particular companies or firms … under the conditions laid down for its own nationals by the law of the country where such establishment is effected…". Art 49 (2) TFEU, thus, suggests that the mere establishing and managing of companies falls under the definition of establishment. This interpretation is supported by the existing case law. In Daily Mail the Court concluded that "a company may also exercise its right of establishment by taking part in the incorporation of a company in another Member State".[67] In Centros the Court held that "the right to form a company in accordance with the law of a Member State and to set up branches in other Member States in inherent in the exercise, in a single market, of the freedom of establishment".[68]

Opponents of such interpretation believe that, especially in regard to establishing of companies, an economic activity, a "real connection", is necessary to protect the departure Member State from letterbox companies, forum shopping, race to the bottom, tax fraud, abuse, and other similar evils.[69] However, the problem is how to determine the economic activity in the moment of applying for an establishment. EU nationals and companies obviously do not have to be economically active in a Member State which they are just trying to enter. Consequently, both departure and destination Member State often have to satisfy themselves with an intention to initiate an economic activity.[70] Such intention is notoriously difficult to prove, especially since the legal subject seeking establishment cannot be forced to make any investment in advance. This leads to a vicious circle – a Member State is not obliged to allow a legal subject to establish itself before it proves the seriousness of its intent, and a legal subject cannot be obliged to demonstrate its seriousness before it is granted an establishment. Moreover, even if a legal subject succeeds in proving that it intends to perform an economic activity, nothing can prevent it from subsequently changing its mind and ceasing with such activity.

Even if those problems are somehow solved, and a Member State is able to verify continuous economic activity of formally established legal subjects, this would not necessarily prevent abuse and "shopping" of the most favorable legal system. Namely, the performance of an economic activity does not ensure that a company is substantially connected to a legal system. Large enterprises

[67] Daily Mail, op. cit. in fn. 3, para. 17

[68] Centros, op. cit. in fn. 11, para. 27.

[69] Kindler, op. cit. in fn. 37, p. 1 and pass.

[70] Opinion of the Advocate General Kokott, op. cit. in fn. 33, para. 36.

could easily afford to perform a negligible amount of economic activity in a Member State which they deem as a legally desirable registered seat. This goes to the heart of the problem. Against the backdrop of a globalized economy and technological inventions a company can easily have a "real connection" with so many legal systems that the very reason for requiring a real connection is lost. Naturally, this does not mean that Member States should not fight tax fraud and abuse, but this should rather be done by converging legal standards through a political process on the EU level than by denying access to legal forms under the pretext that there is no economic activity.

To sum up, the freedom of establishment has two aspects. First, the freedom to actually perform economic activities, which compels the destination Member State to offer EU nationals and companies at least one legal form without any substantial requirements for performing of those activities (freedom of economic activity). Second, the freedom to use all legal forms of the destination Member State suitable for performing economic activities, under the conditions for its own nationals and companies, irrespective of the fact whether the economic activities are actually being performed (freedom of legal form). This second aspect corresponds to the general prohibition of discrimination from Art. 18 TFEU.

Such distinction was recognized in SEVIC case. The Court acknowledged that the right of establishment generally "covers all measures which permit or even facilitate access to another Member State and the pursuit on an economic activity in that State".[71] However, in regard to companies, the freedom of establishment "includes in particular the formation and management of those companies under the conditions defined by the legislation of the State of establishment for its own companies".[72] Thus, without any reference to an actual economic activity the Court concluded that cross-border merger operations "constitute particular methods of exercise of the freedom of establishment".[73]

Although independent, the freedom of legal form retains a certain connection to its original purpose – to allow the performance of an actual economic activity. Consequently, the restrictions of the freedom of legal form can be more easily justified if it is not exercised to actually perform an economic activity. This proves to be the exact context in which the above-mentioned decisions Cadbury Schweppes and Vale require an actual economic activity. In Cadbury Schweppes the Court did not deny that establishing of a company in Ireland

[71] SEVIC, op. cit. in fn. 18, para. 18.

[72] SEVIC, op. cit. in fn. 18, para. 17.

[73] SEVIC, op. cit. in fn. 18, para. 19.

was covered by the freedom of establishment of the UK company.[74] Only in a second step, when deliberating whether a restriction of such freedom was justified, the court stated that "the objective" pursued by the freedom of establishment is to participate in the economic life of another Member State.[75] Even if that objective is not met, the restriction of the freedom of establishment is not automatically justified, but only if there is an additional, "subjective element consisting in the intention to obtain a tax advantage".[76] In a relatively similar, although less clear fashion, the Court in Vale mentioned an actual pursuit of an economic activity only in the context of restrictions on the freedom of establishment and their justification, after it has already established that the national legislation which enables a conversion of national, but not foreign companies, falls under the scope of Articles 49 and 54 TFEU.[77]

It can be concluded that the lack of an actual economic activity can play a (not entirely clear) role in justifying the restrictions of freedom of legal form. However, the lack of an actual economic activity cannot automatically exclude the freedom to use legal forms under the conditions available for domestic legal subjects.

2.3. THE FREEDOM OF ESTABLISHMENT FROM THE PERSPECTIVE OF THE DEPARTURE MEMBER STATE

Art. 49 TFEU expressly prohibits only the restrictions of the freedom of establishment set by the destination Member State. Narrowly interpreted, this could mean that the departure Member State is free to restrict the freedom of establishment as much as it wants. Since this would practically render the freedom of establishment meaningless, it is universally accepted that the restrictions set by the departure Member State are equally prohibited.[78]

The departure Member State is, thus, in principle, prohibited to restrict either the freedom of economic activity or the freedom of legal form in the destination Member State. However, if those freedoms are exercised by a company, the departure Member State has the power to restrict them indirectly, by setting the requirements for the incorporation of a company. As already mentioned, a company can exercise its freedom of establishment only if it exists by virtue

[74] Cadbury Schweppes, op. cit. in fn. 22, para. 31, 37.

[75] Cadbury Schweppes, op. cit. in fn. 22, para. 53

[76] Cadbury Schweppes, op. cit. in fn. 22, para. 64.

[77] Vale, op. cit. in fn. 27, para. 34.

[78] Craig; de Burca, op. cit. in fn. 2, p. 807.

of a national legislation (Art. 54 TFEU).[79] The Member State of incorporation can, thus, require, that its company has a certain type of "real" connection to its territory, e.g. through its central management or its economic activity. The Member State of incorporation can also set other requirements, usually a minimum share capital. The power of the Member State is, however, not without its limits. The incorporation of a company is not only a prerequisite for the freedom of its establishment, but also an expression of the freedom of establishment of its founders (Art. 49 (2) TFEU). From that angle, the Member State of incorporation is a destination Member State, whose limitations will be explained in the corresponding chapter.[80]

The relationship between the national company law and the EU freedom of establishment gets more complicated after the company is incorporated. On one hand, the existence of such company and its affiliation remain dependent on the Member State of incorporation (the departure Member State).[81] On the other hand, such company acquires its own freedom of establishment that the Member State of incorporation should not restrict (Art. 54, 49 TFEU). Since the existence of a company remains a prerequisite for its freedom of establishment, certain priority has to be given to the national law. The Member State can still impose requirements on its company and even cease to recognize or wind-up a company that fails to meet them.[82] This was the situation in Daily Mail and Cartesio case, in which it was held that the departure Member State is allowed to require the existence of a certain real connection with its territory.[83]

The Member State of incorporation, however, has to take into account the company's freedom of establishment. Therefore, it has to refrain from imposing requirements whose primary goal is to prevent such freedom. The Member State of incorporation could not, in a general way, prohibit its companies from performing economic activities in another Member State. It is important to note the fine demarcation between the power of the Member States and the EU freedom of establishment. The Member State of incorporation could require that a company has its central management or that it performs economic activities in its territory, but it could not demand that all of company's economic activities are performed there.

[79] Daily Mail, op. cit. in fn. 3, para. 19.

[80] Section 2.2.2.

[81] Daily Mail, op. cit. in fn. 3, para. 19, 20, which state that the national law determines company "incorporation and functioning" and "whether a company incorporated under the legislation of a Member State may subsequently modify the connecting factor". Also Cartesio, op. cit. in fn. 24, para. 104, 105.

[82] Daily Mail, op. cit. in fn. 3, para. 18, 24; Cartesio, op. cit. in fn. 24, para. 110.

[83] Daily Mail, op. cit. in fn. 3, para. 24; Cartesio, op. cit. in fn. 24, para. 110

Similarly, the Member State of incorporation could not prohibit its companies from setting up legal forms intended for performing of an economic activity in another Member State, irrespective from the fact whether the economic activity is actually performed. Setting up legal forms without any economic activity could be prevented only by the destination Member State (see 2.4.).

Reached conclusions are equally applicable on the situation in which a company wishes to transfer its registered seat to another Member State (with or without the transfer of the real seat). By an analogy with EU nationals (Art. 49 TFEU), a company should be able to change its place of primary establishment, i.e. to transfer its registered seat.[84] Since companies are creatures of national law, they can transfer their registered seat only by converting their whole legal identity to a legal form of the destination Member State. By such conversion a company terminates its affiliation with the departure Member State. Considering that the departure Member State determines the functioning of its companies, it is generally authorized to set requirements for company termination. However, if a company does not cease to exist, but merely continues its existence in another Member State, the departure Member State has to respect such freedom. This was the situation in Polbud (and obiter dictum in Cartesio), where the Court found that the transferring company enjoys a freedom of establishment in respect to the departure Member State.[85] The departure Member State could only impose the restrictions which are justified on the basis of overriding public interests, appropriate for ensuring of the objectives pursued and do not go beyond what is necessary (see 3.).[86]

2.4. THE FREEDOM OF ESTABLISHMENT FROM THE PERSPECTIVE OF THE DESTINATION MEMBER STATE

The destination Member State is not allowed to prevent nationals and companies from other Member States from actually pursuing an economic activity within its boundaries. Literally, this means that the destination Member State has to let those nationals and companies to perform their activities directly, without any formal requirements. However, the destination Member State

[84] If the freedom of establishment encompasses the freedom of legal form, the place of registration is the place of primary establishment.

[85] Cartesio, op. cit. in fn. 24, para. 111-112; Polbud, op. cit. in fn. 31, para. 43.

[86] See Paefgen, Teil I, op. cit. in fn. 36, p. 986, who considers that this overrules Daily Mail principle of the autonomy of the Member State of incorporation. However, even Daily Mail decision hints that the Member State of incorporation would not be able to impose restrictions on the companies who do not retain their status as companies incorporated under the legislation of that Member State. (Daily Mail, op. cit. in fn. 3, para. 24).

has a legitimate public interest to have an overview of legal subjects which perform economic activities in its territory. Therefore, the destination Member State is allowed to require that the economic activity is exercised through certain legal forms, usually subject to some kind of registration. TFEU itself mentions branches, agencies, subsidiaries, companies and firms (Art. 49). An already existing company, which merely seeks a secondary establishment, performs its economic activity through branches, agencies or subsidiaries (Art. 49 (1) TFEU).

Since all mentioned legal forms are creatures of national law, the destination Member State is, in principle, authorized to set the requirements for their formation. Those, requirements, however, should not restrict the freedom to perform an actual economic activity. This leads to a conclusion that the destination Member State has to leave at least one legal form which can be used by the nationals and companies from other Member States without any significant obstacles. This was the basic problem in Centros and Inspire Art cases. In both decisions, the refusal of the registration authority to register a branch and the requirement of a minimum share capital for registering a branch would not represent a restriction of the freedom of establishment if the company in question could conduct economic activity in the destination Member State (Denmark, Netherlands) in some other way. However, since Denmark and Netherlands required that foreign companies perform their economic activity through a branch,[87] they were prohibited to place any significant restrictions on their formation.

The destination Member State is equally not allowed to prevent nationals and companies from other Member States from using all of its legal forms suitable for performing of economic activities under the conditions set for its own national and companies.[88] This follows already from the general prohibition of discrimination (At. 18 TFEU) and is explicitly confirmed by Art. 49 (2) TFEU. In other words, if an actual pursuit of an economic activity or a minimum share capital is not required from legal subjects of the destination Member State, it cannot be required from foreign legal subjects. Vice versa, if a destination Member State requires actual economic activity or a minimum share capital for its own nationals and companies, it can equally impose those requirements on foreign national and companies.

This was confirmed by SEVIC case, in which the Court found that a general refusal that companies from another Member State are merged with domestic

[87] Centros, op. cit. in fn. 11, para. 5.

[88] Tiedje, op. cit. in fn. 2, AEUV Art. 49, para. 54.

company forms is contrary to the freedom of establishment.[89] This was basically also the situation in Vale case, irrespective of the fact that the Court defined the freedom of establishment through the actual pursuit of an economic activity. The Court found that the destination Member State was allowed to set the requirements for domestic conversion, however, once those requirements are set, they have to be available to nationals and companies from other Member States.[90] Particularly, the rules on cross-border conversions cannot be less favorable than the rules on domestic conversions (principle of equivalence)[91] and the destination Member State has to accept documents obtained from the authorities of the departure Member State (principle of effectiveness).[92]

3. DOES A MANDATORY LIQUIDATION GO BEYOND WHAT IS NECESSARY TO PROTECT THE LEGITIMATE INTERESTS OF MINORITY SHAREHOLDERS, CREDITORS OR EMPLOYEES OF THE COMPANY?

After it is determined that transferring company enjoys a freedom of establishment and that such freedom was restricted, it remains to be determined whether such restriction may be justified in order to prevent fraud or abuse or because of some other overriding reason of public interest, most commonly the protection of minority shareholders, creditors, employees (workers) or tax law objectives.[93] The restriction may be justified only if it is appropriate for attaining of its objective and if it does not go beyond what is necessary to attain it.[94]

In Polbud, the Court allowed the possibility that Polish rules on mandatory liquidation of the transferring company have a legitimate objective of protecting minority shareholders, creditors and employees of the company.[95] However, the Court held that such measure goes beyond what is necessary to attain those objectives since the liquidation of the company is required generally, without the consideration of the actual risk of detriment to the interests of creditors and

[89] SEVIC, op. cit. in fn. 18, para. 30.

[90] Vale, op. cit. in fn. 27, para. 27-29, 32, 36.

[91] Vale, op. cit. in fn. 27, para. 54.

[92] Vale, op. cit. in fn. 27, para.58, 60.

[93] Centros op. cit. in fn. 11, para. 25, 34; **Überseering**, op. cit. in fn. 13, para. 92; Inspire Art, op. cit. in fn. 14, para. 105, 133; SEVIC, op. cit. in fn. 18, para. 28; Vale, op. cit. in fn. 27, para. 39; Polbud, op. cit. in fn. 31, para. 52.

[94] Centros op. cit. in fn. 11, para. 34; SEVIC, op. cit. in fn. 18, para. 29; Vale, op. cit. in fn. 27, para. 39; Polbud, op. cit. in fn. 31, para. 52.

[95] Implicitly, Polbud, op. cit. in fn. 31, para. 52-57 also Paefgen, Teil I, op. cit. in fn. 36, p. 987.

employees, and without the possibility of choosing a less restrictive measure.[96] In particular, the Court believes that the provision of bank guarantees or other equivalent guarantees could offer adequate amount of protection to the endangered interests.[97] Such opinion represents a continuation of the reasoning from obiter dictum in Cartesio, according to which the departure Member State is not justified in restricting the freedom of establishment by requiring the winding-up or liquidation of the company.[98]

Although such conclusion was less criticized that the finding that Polbud enjoys the freedom of establishment, it is not without its controversies. As already mentioned,[99] the existing creditors, minority shareholders and employees of a company which converts to a legal form of another Member State may find themselves in a dire position if the destination Member State provides for a lower level of their protection. This is fundamentally different from the Centros situation in which a company merely transfers its real seat while retaining its legal identity. Such considerations, which were deemed insufficient to generally exclude the freedom of establishment, are all the more important when assessing the justifications for restrictions of the freedom of establishment.

The brief explanation given by the Court can be described as superficial if not irresponsible. The fact that the Polish legislation prescribes mandatory liquidation generally does not mean that it does not take into account the actual risk of detriment to the interests of stakeholders. On the contrary, it seems that the very purpose of liquidation under Polish law is to determine who are the creditors of the company, to satisfy their claims and afterwards, to distribute the company assets among the shareholders.[100]

Similarly, it is not self-evident that the provision of bank guarantees or other equivalent guarantees would be less burdensome for the company than the liquidation procedure.[101] It is not likely that the bank will issue a guarantee unless it receives collateral of a corresponding value, and if the company is able to

[96] Polbud, op. cit. in fn. 31, para. 58-59.

[97] Polbud, op. cit. in fn. 31, para. 58.

[98] Cartesio, op. cit. in fn. 24, para. 112.

[99] Section 2.1.

[100] Polbud, op. cit. in fn. 31, para. 50, which states that the liquidation under Polish law includes the conclusion of current business, recovery of debts, fulfilment of obligations and sale of company assets, satisfaction or securing of creditors, submission of a financial statement on the conduct of those acts, and indication of the person to whom the books and documents are to be entrusted. As to the distribution of assets among shareholders see para. 5.

[101] It seems that the Court reflected an equally unsubstantiated statement from Centros, op. cit. in fn. 11, para. 37.

provide such collateral, the satisfaction of creditors in the course of liquidation would presumably also not be a problem.

A potential problem with liquidation could be that liquidation usually terminates the company, which could, at least from perspective of the departure Member State, prevent the continuation of company's legal personality in the destination Member State. However, it seems that this is not in case with the Polish law. In fact, the Court itself observed that the transfer of the registered office of a company incorporated under Polish law to another Member State does not entail the loss of legal personality.[102]

Another potential shortcoming of Polish liquidation procedure could be that it extinguishes, if not company itself, all of company's legal relationships.[103] This could especially be a problem in the case of long-lasting contractual relationships, where both the company and its contractual partners may have a legitimate expectation to continue the relationship in the future.[104] However, the Court failed to recognize that and to demonstrate that there was a less restrictive measure which would protect the interests of minority shareholders, creditors and employees.

Generally speaking, less restrictive measures for the protection of company stakeholders could be contained within the provisions of the departure Member State on domestic conversions. It can be presumed that those provisions would ensure a smoother transition of company personality and all of its legal relationships to a company form of the destination Member State. This would represent a solution similar to the solution from the Vale case, only from the perspective of the departure Member State. In Vale, the Court found that the destination Member State has to allow that companies from other Member States convert to its own company forms by an analogous application of the rules on domestic conversions. Similarly, the departure Member State would have to allow its companies to convert to a company form of another Member State in accordance with the rules on domestic conversions. In other words, as already announced in Vale, the conversion would be effected by a consecutive application of two national laws on company conversion.[105]

It seems that the Court in Polbud also suggested such solution. It held that the departure Member State is not authorized to prevent a company from cross-border conversion by imposing "conditions that are more restrictive than

[102] Polbud, op. cit. in fn. 31, para. 47.

[103] See fn. 100, especially the reference to the conclusion of current business.

[104] See Opinion of the Advocate General Kokott, op. cit. in fn. 33, para. 57, for employment contracts.

[105] Vale, op. cit. in fn. 27, para. 37.

those that apply to the conversion of a company within that Member State itself".[106] From such wording, it can be concluded that the departure Member State would be allowed to impose the national requirements for the conversion of its companies.

In any case, it is impossible to conclude on an abstract level which procedure for protecting company stakeholders is least restrictive. This can be determined only after a careful assessment of specific requirements for the company liquidation or its conversion under a national law. In particular case it is possible that both liquidation and conversion procedures go beyond what is necessary to attain legitimate objective. Also, although not very likely, it is theoretically possible that the conversion procedure is more restrictive than the liquidation procedure.

4. CONCLUSION

The analysis of Polbud has demonstrated that the most recent decision on the transfer of the company seat represents rather a continuation than a rupture with the previous case law of the Court. Therefore, it may seem surprising that the decision was widely criticized in jurisprudence. Most controversial was the fact that Polbud was granted the freedom of establishment to transfer its registered seat although it did not intend to perform any economic activity in the destination Member State. In that respect, the Advocate General and a number of scholars consider that, first, an actual economic activity is a prerequisite for the notion of establishment and, second, that Polbud could not rely on such freedom since it exclusively transferred its registered seat. However, neither of those conclusions is accurate.

It is true that the purpose of the freedom of establishment is to protect the pursuit of an actual economic activity and, thus, the internal market. In order to have an overview of the economic activity in their territory, Member States, however, usually grant the establishment through certain, usually registered, legal forms, such as branches, agencies and companies. The existence of those forms does not restrict the freedom of establishment as long as there is at least one legal form through which the nationals and companies from other Member States can perform an economic activity without any substantial requirements (freedom of economic activity).

On the other hand, a Member State may choose to set legal forms suitable for performing economic activity even without requiring any actual economic

[106] Polbud, op. cit. in fn. 31, para. 43

activity. Although such forms do not necessarily perform their original function, in order to prevent discrimination (Art. 18, 49 (2) TFEU), a destination Member State has to make them available under the same conditions to all EU nationals and companies (freedom of legal form).

A departure Member State might have an interest to prevent companies from circumventing its national law by transferring their registered company seat to a destination Member State which does not require an actual economic activity. Such interest, however, should not be given priority over the freedom of legal form. First, at the moment of giving permission to establish a legal form in the destination Member State it is very difficult to prove the company's intention to perform an economic activity. Even if that intention is somehow proven, the departure Member State cannot prevent the company from discontinuing such activity as soon as it is formally established. Finally, the underlying reason for insisting on an economic activity is becoming more and more obsolete. Insisting on an actual economic activity is based on the idea of a real existence of a company in a certain territory. However, with the globalization of economy and the technological innovation, instead of having a strong connection with one country, a company may easily have relatively weak connections with many countries. In that context, tying the company identity to some kind of "real seat" is often futile.

Moreover, the decision reached in Polbud would be correct even if an actual economic activity was a necessary prerequisite of the freedom of establishment. The true content of Polbud's freedom of establishment was not the transfer of the registered seat to Luxembourg, but the performance of an economic activity in a Member State (Poland) different from the Member State of registration (Luxembourg). In other words, the freedom of establishment should not be reduced to the freedom to initiate an economic activity or to move it to another Member State. On the contrary, the freedom to initiate or to move an economic activity is just a tool for the cross-border performance of that activity. In other words, from the perspective of the freedom of establishment, the situation in Polbud is identical to the situation in Centros.

Second conclusion of the Court in Polbud – that a mandatory liquidation goes beyond what is necessary to achieve the legitimate interests of protecting minority shareholders, creditors or employees of the company – is less justified. It is superficial to claim that the procedure whose aim is to determine the existence of creditors and their claims does not take into consideration the actual risk of detriment to their interests. This does not mean that the decision reached by the Court is necessarily incorrect. Generally speaking, the provisions of the departure Member State on the conversion of its own companies should be less restrictive than the provisions on company liquidation. However, that had to be determined and explained by the Court in more detail.

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THE RISK OF RE-CHARACTERIZATION OF TITLE TRANSFER FINANCIAL COLLATERAL ARRANGEMENTS

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ABSTRACT

In the European financial markets, the most common types of collateralised transactions are classic repos, sell/buy-backs and securities loans. In them all, financial collateral is provided under the title transfer method: in order to grant the collateral taker with a general right of disposal of collateral, the full legal title to financial collateral is transferred to the collateral taker. The title transfer financial collateral arrangements had prevailed in the European financial markets before the adoption of the Financial Collateral Directive ('FCD'), and they remained dominant after its transposition into the laws of EU Member States. One of the aims of the FCD is to eliminate the so-called recharacterisation of such arrangements as security interests. The FCD is not quite clear on whether its provisions on title transfer financial collateral arrangements are concerned only with the full outright transfers of title or should they also be applied to fiduciary transfers of title. As the fiduciary transfer of title is in substance a form of a security interest, it should not be covered under the notion of title transfer financial collateral arrangement. The ambiguity of the notion of title transfer financial collateral arrangement has spilled over into laws of a couple of Members States, as for instance in the Croatian law. This paper argues that Croatian law extends the scope for possible recharacterisation of title transfer financial collateral arrangements, instead of eliminating the risk of recharacterisation of such arrangements as arrangements creating a security interest in the collateral.

KEYWORDS: *financial collateral, title transfer financial collateral arrangement, repurchase agreement, repo, sell/buy-back, securities lending, recharacterisation, security interest, fiduciary transfer of title, Financial Collateral Directive*

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1. INTRODUCTION

In financial transactions which rely on the financial collateral arrangements, the financial assets which serve as a financial collateral are transferred by the collateral provider to the collateral taker at the opening leg of the transaction, when the agreed principal is transferred by the collateral taker to the collateral provider. At the closing leg of the transaction, when the financial obligations of the collateral provider to the collateral taker have been performed, the equivalent assets to the assets used as financial collateral are transferred by the collateral taker to the collateral provider. In these financial transactions the financial collateral, such as securities and credit claims, serves not only a recovery function but also a tradeability function.[1] For the collateral taker, it is a commercial imperative that he is allowed to deal freely with the financial collateral prior to the maturity of the obligation to transfer the equivalent assets to the collateral provider.[2] The traditional security legal structures (such as pledge, charge, and lien) in most jurisdictions are not suitable for realisation of the tradeability function of financial collateral, inasmuch as they commonly do not allow the collateral taker to use and to dispose of the collateral during the ordinary lifetime of the transaction. Hence, two methods of provision of financial collateral were developed in the financial markets: the 'security interest method' that combines a creation of a security interest in favor of the collateral taker with the right of use of financial collateral, and the 'title transfer method' that transfers the full legal title to financial collateral to the collateral taker.[3]

Prior to the adoption of the Financial Collateral Directive ('FCD'),[4] both of the market developed methods for the provision of financial collateral were

[1] The financial collateral is used both for recourse in the case of default of the collateral provider (recovery function), and for further trading in the financial market (tradeability function). For a more detailed explanation of the recovery and tradeability functions of financial collateral, see: Keijser, T. R. M. P.: *Financial Collateral Arrangements*: *The European Collateral Directive Considered from a Property and Insolvency Law Perspective*, Kluwer, Deventer, 2006, pp. 16-17; Haentjens, M. and de Gioia-Carabellese, P.: *European Banking and Financial Law*, Routledge, London/New York, 2015, p. 214.

[2] See: Murray, E.: Financial Collateral Arrangements and the Financial Markets, in: Dahan, F. (ed.), *Research Handbook on Secured Financing in Commercial Transactions*, Edward Elgar Publishing, Cheltenham/Northampton, 2015, p. 295; Tot, I.: *Financial Market lex mercatoria and its Influence on the Financial Collateral Directive*, InterEULawEast: Journal for the International and European Law, Economics and Market Integrations, 5 (1) 2018, [DOI: https://doi.org/10.22598/iele.2018.5.1.3], p. 41.

[3] See Keijser, *op. cit.* (fn. 1), pp. 15-16. See also: Haentjens and de Gioia-Carabellese, *op. cit.* (fn. 1), pp. 216-217.

[4] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L 168, 27/6/2002); hereinafter: FCD. The FCD was

faced with various legal restrictions in the non-harmonized national laws of the EU Member States.[5] While national laws were treating financial collateral arrangements that employ the security interest method in the same manner as traditional pledges, the arrangements that employ the title transfer method were met with the risk of recharacterisation of such arrangements as arrangements creating a security interest in the collateral. The legal impediments to the efficient use of the financial collateral were preventing collateral takers to deal freely with the financial collateral provided under both types of the financial collateral arrangements. With the objective to create an EU legal regime for the provision of financial collateral in bilateral financial collateral arrangements, FCD brought on a full harmonisation of substantive rules regarding the use of financial collateral in both the security financial collateral arrangements and the title transfer financial collateral arrangements.

The topics of this paper are the title transfer financial collateral arrangements ('TTFCAs'), the selected provisions of the FCD the purpose of which was to eliminate the risk of recharacterisation of TTFCAs, and the transposition of these provisions into Croatian law. The paper begins with a brief description of the peculiarities of a TTFCA, and of the typical features of the most common types of transactions in the European financial markets that rely on TTFCAs (Chapter 2). Next follows the explanation of the risk of recharacterisation of a TTFCA, and of the factors that can increase this risk (Chapter 3). The paper continues with the analysis of the provisions of FCD directed at the elimination of the risk of recharacterisation of TTFCAs (Chapter 4) and proceeds to the evaluation of the transposition of these provisions into Croatian law (Chapter 5). In the conclusion (Chapter 6), the results of the research are summarized, and the recommendations are given for appropriate amendments of the Croatian Financial Security Act ('FSA').[6]

amended by: (i) Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims (OJ L 146, 10/6/2009); (ii) Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12/6/2014).

[5] See Tot, *op. cit.* (fn. 2), pp. 55-57.

[6] Zakon o financijskom osiguranju [Financial Security Act] (NN no. 76/07, 59/12); hereinafter: FSA.

2. TTFCAS: LEGAL STRUCTURE

Before the adoption of the FCD, the use of the title transfer method in the European financial markets had prevailed over the security interest method of provision of financial collateral, and TTFCAs also remained dominant after the transposition of the FCD into the laws of EU Member States.[7] In contrast to the security financial collateral arrangement, in a TTFCA the title to the assets used as financial collateral is transferred 'outright' from one party to the other: the transfer of title is an unlimited transfer of all right, title and interest in respect of a financial collateral from the transferor to the transferee.[8] At the end of the transaction, the transferor discharges the principal debt, while the transferee is obliged to deliver to the transferor assets which are equivalent to the assets used as financial collateral, and not the particular assets which were originally used as financial collateral at the onset of the transaction. This obligation of the transferee is contractual and is owed by the transferee personally, and not proprietary.[9]

The main types of collateralised transactions relying on TTFCAs widespread in the European financial markets are repurchase transactions, sell/buy-back transactions, and securities lending transactions. As all these different types of transactions have similar features and effects, sometimes the term 'repos' is used to refer to all three transaction types together.[10] In the European market jargon, the term 'repo' is used as a generic term under which only the repurchase transactions and sell/buy-back transactions are covered,[11] whereas secu-

[7] See: Benjamin, J.: *Financial Law*, Oxford University Press, Oxford/New York, 2007, p. 306; Keijser, *op. cit.* (fn. 1), p. 100; Mäntysaari, P.: *The Law of Corporate Finance: General Principles and EU Law – Volume II: Contracts in General*, Springer, Berlin/Heidelberg, 2010, p. 345.

[8] See: Benjamin, *op. cit.* (fn. 7), pp. 306, 317; Keijser, *op. cit.* (fn. 1), p. 94.

[9] See: Benjamin, *op. cit.* (fn. 7), pp. 317; Bridge, M. and Braithwaite, J.: *Private Law and Financial Crises*, Journal of Corporate Law Studies, 13 (2) 2013, [DOI: https://doi.org/10.5235/14735970.13.2.361], p. 375; Gretton, G. L.: *Financial Collateral and the Fundamentals of Secured Transactions*, Edinburgh Law Review, 10 (2) 2008, [DOI: https://doi.org/10.3366/elr.2006.10.2.209], p. 213; Hudson, A.: *The Law on Financial Derivatives*, Sweet & Maxwell, London, 2006, p. 476; Murray, *op. cit.* (fn. 2), p. 316; Tarnanidou, C. I.: *EU Financial Collateral Arrangements and Re-Hypothecation in the Shadow of 'Shadow Banking': To Further Regulate or Not?*, Journal of Banking Regulation, 17 (3) 2016, [DOI: https://doi.org/10.1057/jbr.2014.22], p. 205.; Yeowart, G. and Parsons, R., with Murray, E. and Patrick, H.: *Yeowart and Parsons on the Law of Financial Collateral*, Edward Elgar Publishing, Cheltenham/Northampton, 2016, p. 145.

[10] See, e. g.: Stadler, V. and Lanoo, K.: *The EU Repo Markets: The Need for Full Integration*, Centre for European Policy Studies, Brussels, 2000, pp. 9-10.

[11] See: Comotto, R.: *A Guide to Best Practice in the European Repo Market – ICMA European Repo and Collateral Council – December 2017*, International Capital Market Association,

rities lending transactions are also referred to as 'securities loans'[12] and 'stock loans'.[13] To distinguish repurchase transactions from sell/buy-back transactions, in the European market jargon a repurchase transaction is frequently referred to as 'classic repo', and also as 'US-style repo' or 'all-in repo'.[14]

A repurchase transaction or a classic repo is legally structured as a combination of a spot sale and a forward purchase of securities, both of which are part of a single repurchase agreement: an agreement that the seller will sell securities to the buyer at a certain date at an agreed price, with a simultaneous commitment by the seller to buy equivalent securities from buyer at a future date or on demand at a different price.[15] Parties commonly enter into a master repurchase agreement under which individual repurchase transactions can be concluded and documented, while the terms and conditions contained in the master repurchase agreement apply to all individual repurchase transactions concluded between them. The standard master agreement most widely used in the European cross-border repo market to document repurchase transactions is the Global Master Repurchase Agreement ('GMRA').[16]

Zurich, 2017, p. 111. See also: Choudhry, M.: *The Repo Handbook*, Butterworth-Heinemann, Oxford, 2010, p. 115.

[12] See: Benjamin, *op. cit.* (fn. 7), p. 307; Faulkner, M. C.: An Introduction to Securities Lending, in: Fabozzi, F. J. and Mann, S. V. (eds.): *Securities Finance – Securities Lending and Repurchase Agreements*, John Wiley & Sons, Hoboken, 2005, p. 4; Stadler and Lanoo, *op. cit.* (fn. 10), p. 10.

[13] See: Choudhry, *op. cit.* (fn. 11), p. 127; Lomnicka, E.: Financing Devices Involving the Transfer or Retention of Title, in: Beale, H., Bridge, M., Gullifer, L. and Lomnicka, E.: *The Law of Security and Title-Based Financing*, Oxford University Press, Oxford, 2018, p. 302.

[14] See: Benjamin, *op. cit.* (fn. 7), p. 307; Choudhry, *op. cit.* (fn. 11), pp. 115-116; Comotto, *loc. cit.* (fn. 11); Schindler, C. and Hindelang, M.: *Praxishandbuch Repos und Wertpapierdarlehen*, Springer Gabler, Wiesbaden, 2016, p. 80.

[15] For definition of a repurchase transaction, see also: Benjamin, *op. cit.* (fn. 7), p. 308; Choudhry, *op. cit.* (fn. 11), pp. 115-116; Comotto, *loc. cit.* (fn. 11); Fabozzi, F. J. and Mann, S. V.: Repurchase and Reverse Repurchase Agreements, in: Fabozzi, F. J. and Mann, S. V. (eds.): *Securities Finance – Securities Lending and Repurchase Agreements*, John Wiley & Sons, Hoboken, 2005, p. 222; Faulkner, *op. cit.* (fn. 12), pp. 10-11; Haentjens and de Gioia-Carabellese, *op. cit.* (fn. 1), p. 211; Keijser, *op. cit.* (fn. 1), p. 11; Lomnicka, *op. cit.* (fn. 13), p. 299; Saguato, P.: *The Liquidity Dilemma and the Repo Market: A Two-Step Policy Option To Address the Regulatory Void*, Stanford Journal of Law, Business, and Finance, 22 (1) 2017, LSE Legal Studies Working Paper No. 21/2015, available at SSRN [https://ssrn.com/abstract=2812173], accessed on 15/09/2018, pp. 27-28; Schindler and Hindelang, *loc. cit.* (fn. 14); Stadler and Lanoo, *op. cit.* (fn. 10), p. 9; Tot, *op. cit.* (fn. 2), pp. 46-47.

[16] The current version of the GMRA is: Securities Industry and Financial Markets Association, and International Capital Market Association: *Global Market Repurchase Agreement – 2011 version*, Washington/Zurich, April 2011; hereinafter: GMRA.

In a sell/buy-back transaction parties enter simultaneously in a spot sale and a forward purchase as two separate agreements: the seller simultaneously agrees to sell securities to the buyer at a spot price and to buy equivalent securities from the buyer at a forward price.[17] The sell/buy-back transactions are not necessarily documented under a master agreement, but parties wishing to document their sell/buy-back transactions may do so by supplementing their master repurchase agreement with a separate annex, such as the standard Buy/Sell Back Annex to the GMRA.[18]

A securities lending transaction is legally structured as a combination of two loan transactions under a single agreement: an agreement that the lender will transfer securities to the borrower at a certain date against the transfer of collateral by borrower to lender, with a simultaneous commitment by the borrower to transfer to the lender equivalent securities at a future date or on demand against the transfer of assets equivalent to collateral to borrower by lender.[19] The securities lending transactions are typically documented and governed under a master agreement, while the standard master securities lending agreement is the Global Master Securities Lending Agreement ('GMSLA').[20]

The standard market agreements for all the mentioned types of collateralised transactions contain provisions from which it is evident that the intention of the parties is to transfer the title to the financial assets 'outright' from the transferor to the transferee. Under the GMRA, in a repurchase transaction 'all right, title and interest' in any securities 'shall pass to the party to which the

[17] For definition of a sell/buy-back transaction, see also: Benjamin, *op. cit.* (fn. 7), p. 309; Choudhry, *op. cit.* (fn. 11), pp. 121-122; Comotto, *op. cit.* (fn. 11), p. 113; Fabozzi and Mann, *op. cit.* (fn. 15), p. 237; Faulkner, *op. cit.* (fn. 12), pp. 11-12; Lomnicka, *op. cit.* (fn. 13), p. 300; Schindler and Hindelang, *op. cit.* (fn. 14), p. 95; Stadler and Lanoo, *loc. cit.* (fn. 10); Tot, *op. cit.* (fn. 2), p. 53.

[18] The current version of the Buy/Sell Back Annex to the GMRA is: Securities Industry and Financial Markets Association, and International Capital Market Association: *Global Market Repurchase Agreement (2011 version) – Buy/Sell Back Annex – Supplemental Terms and Conditions for Buy/Sell Back Transactions*, Washington/Zurich, March 2012; hereinafter: Buy/Sell Back Annex to the GMRA.

[19] For definition of a securities lending transaction, see also: Benjamin, *op. cit.* (fn. 7), p. 309; Choudhry, *op. cit.* (fn. 11), pp. 127-128; Comotto, *op. cit.* (fn. 11), p. 112; Faulkner, *op. cit.* (fn. 12), pp. 3-4; Haentjens and de Gioia-Carabellese, *op. cit.* (fn. 1), p. 212; Keijser, *op. cit.* (fn. 1), p. 12; Lomnicka, *loc. cit.* (fn. 13); Schindler and Hindelang, *op. cit.* (fn. 14), p. 33; Stadler and Lanoo, *op. cit.* (fn. 10), p. 10; Tot, *op. cit.* (fn. 2), p. 54.

[20] The current version of the GMSLA is: International Securities Lending Association: *Global Master Securities Lending Agreement – Version: January 2010 – Update: July 2012*, London, 2012; hereinafter: GMSLA.

transfer is being made'.[21] A full legal title to securities is transferred outright from the seller to the buyer at the opening leg of the repurchase transaction, while at the closing leg of the repurchase transaction the buyer is obliged to transfer 'equivalent securities', not to return the same securities that were initially transferred to him.[22] The provisions of the GMRA relating to the transfer of 'all right, title and interest' in securities are also to be applied to sell/buy-back transactions if they are documented under the Buy/Sell Back Annex to the GMRA.[23] The GMSLA also made clear that the transfer of both securities and collateral in a securities lending transaction is an outright transfer of the full legal title to securities and collateral: 'all right, title and interest' in any securities and collateral 'shall pass from one party to the other', while the party acquiring such right, title and interest 'shall have no obligation to return or deliver any of the assets so acquired' and 'shall be obliged […] to deliver Equivalent Securities or Equivalent Collateral as appropriate'.[24]

3. RECHARACTERISATION RISK: NOTION, FACTORS AND CONSEQUENCES

The risk of recharacterisation may be broadly defined as the risk that the court would reject the legal categorisation of a transaction chosen by the parties in their contract, and substitute another.[25] The recharacterisation of a TTFCA means the treatment under the national law of an outright transfer of title as a security interest in line with the 'actual' intention of the parties to a TTFCA.[26] In relation to collateralised transactions relying on TTFCAs, recharacterisation risk is particularly associated with repurchase transactions due to the disparity of their legal structure and underlying economics.

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[21] See GMRA, Paragraph 6 (e).

[22] See GMRA, Paragraph 1 (a) and 6 (f). Securities are 'equivalent' to the securities initially transferred if they are '(i) of the same issuer; (ii) part of the same issue; and (iii) of an identical type, nominal value, description and [...] amount' as those securities (see GMRA, Paragraph 2 (v)).

[23] See: GMRA, Paragraph 1 (b) and (c); Buy/ Sell Back Annex to the GMRA, Paragraph 1 (a) and (b).

[24] See GMSLA, Paragraph 4.2.

[25] See: Benjamin, *op. cit.* (fn. 7), p. 322; Gretton, *op. cit.* (fn. 9), p. 216.

[26] See: Choudhry, *op. cit.* (fn. 11), p. 341; Devos, D.: The Directive 2002/47/EC on Financial Collateral Arrangements of June 6, 2002, in: Vandersanden, G. and De Walsche, A. (eds.)*: Mélanges en hommage à Jean-Victor Louis - volume II*, Editions de l'Université de Bruxelles, Bruxelles, 2003, p. 261; Haentjens and de Gioia-Carabellese, *op. cit.* (fn. 1), p. 222; Keijser, *op. cit.* (fn. 1), p. 71; Schindler and Hindelang, *op. cit.* (fn. 14), p. 165; Stadler and Lanoo, *op. cit.* (fn. 10), p. 34.

Although the parties to a repurchase agreement agree on an outright transfer of the legal title to securities, the transaction usually functions as an alternative to a secured loan. Most repurchase transactions are for 'general collaterals' or 'GCs' and are cash-driven transactions as the parties are primarily motivated by the need to borrow and lend cash.[27] At the opening leg of the repurchase transaction, securities are transferred to the buyer against payment of a purchase price, while at the closing leg of the repurchase transaction equivalent securities are transferred to the seller against payment of a higher repurchase price, where the price differential in its economic substance represents an amount of interest.[28] Despite being legally structured on the basis of the agreement of sale of securities, the underlying economics of cash-driven repurchase transactions is that of a secured loan of cash.[29]

Prior to the adoption of the FCD, the discrepancy between the legal structure and underlying economics of a repurchase transaction had led to legal uncertainty regarding the enforceability of a TTFCA on which repurchase transaction relies. The risk of recharacterisation of a TTFCA as arrangement creating a security interest in collateral was present in several European jurisdictions. It was identified as a legal impediment to the enforceability of TTFCAs mainly in relation to the civil law jurisdictions,[30] while under the English law it appeared that the agreements made in conformity with the standard market documentation were not subject to recharacterisation risk.[31]

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[27] Repurchase transactions can also be securities-driven transactions, if specific securities, known as 'specials', are in high demand in the market. See: Choudhry, *op. cit.* (fn. 11), p. 147; Comotto, *op. cit.* (fn. 11), pp. 86-87; Schindler and Hindelang, *op. cit.* (fn. 14), p. 83.

[28] See: Benjamin, *op. cit.* (fn. 7), p. 308; Haentjens and de Gioia-Carabellese, *op. cit.* (fn. 1), p. 217; Keijser, *op. cit.* (fn. 1), p. 27; Tot, *op. cit.* (fn. 2), p. 41.

[29] See: Benjamin, *op. cit.* (fn. 7), p. 308; Choudhry, *op. cit.* (fn. 11), p. 7; Comotto, *op. cit.* (fn. 11), p. 75; Fabozzi and Mann, *op. cit.* (fn. 15), p. 222; Haentjens and de Gioia-Carabellese, *op. cit.* (fn. 1), p. 211; Lomnicka, *op. cit.* (fn. 13), pp. 301-302; Saguato, *op. cit.* (fn. 15), p. 30; Yeowart and Parsons, *op. cit.* (fn. 9), p. 147.

[30] 'Jurisdictions where there appears to be significant risk of recharacterisation of a title transfer collateral arrangements are Denmark, Finland, Greece, Italy, Netherlands and Spain. It is also not clear to what extent such arrangements may be recharacterised in Luxembourg. In Italy, however, a title transfer arrangement would normally be recharacterised as an irregular pledge (pegno irregolare), which has the effect in substance of transferring title to the pledgee. In Austria and Germany title transfer arrangements will not be recharacterised but certain provisions might mandatorily apply as they would for a security interest.' (International Swaps and Derivatives Association, Collateral Reform Group: *Collateral Arrangements in the European Financial Markets - The Need for National Law Reform*, International Swaps and Derivatives Association, London, 2000 (hereinafter: ISDA Report), p. 8).

[31] See: Benjamin, *op. cit.* (fn. 7), p. 323; ISDA Report, *op. cit.* (fn. 30), p. 7; Johansson, E.: *Property Rights in Investment Securities and the Doctrine of Specificity,* Springer, Berlin/Hei-

The recharacterisation risk was of special concern to the financial market participants, since the TTFCAs had been developed by the market in response to the perfection requirements and the restrictions on the use of collateral by the collateral taker under the traditional security legal structures, so the purpose of the TTFCA would be defeated if it was to be recharacterised as an arrangement creating a security interest in the collateral.[32] The intention of the parties of a TTFCA is not to create a limited property right in financial collateral, but to transfer the full legal title to the collateral outright on to the collateral taker. The collateral taker becomes the legal 'owner' of the collateral and may use it and dispose of it as he wishes. This tradeability function of the financial collateral which is of major significance to the financial market participants could not be achieved if TTFCAs were to be recharacterised as arrangements creating a security interest in the collateral.

The risk of recharacterisation of a TTFCA is increased by the fact that, although the legal title to the financial collateral is transferred to the collateral taker, the collateral provider retains the economic benefits and risks connected to the financial collateral. This is evidenced by the contractual rights and obligations of the parties to a repurchase agreement or a security lending agreement relating to income payments and margin maintenance. The collateral taker as the acquirer of the legal title to collateral is entitled to interest, dividends and any other earnings on the collateral, yet he is contractually obliged to pay to the collateral provider a so-called 'manufactured dividend': an amount equal to such income payment.[33] Margin maintenance methods are used in order to maintain the originally set balance between the market value of financial collateral and the value of counter-performance provided for financial collateral at the beginning of the transaction. Prime example of a margin maintenance method is a margin transfer: simplified, in the case of downward price fluctuations of the transferred collateral the collateral taker may require the collateral provider to deliver additional securities; while in the case of upward price fluctuations of the transferred collateral the collateral provider may require the collateral taker to deliver additional cash.[34] The party who has received the margin is obliged to transfer the equivalent margin at the end of the

delberg, 2009, p. 87; Keijser, *op. cit.* (fn. 1), p. 134; Lomnicka, *op. cit.* (fn. 13), p. 302.; Yeowart and Parsons, *op. cit.* (fn. 9), p. 150.

[32] See: Benjamin, *op. cit.* (fn. 7), p. 322; Choudhry, *op. cit.* (fn. 11), p. 346; ISDA Report, *op. cit.* (fn. 30), p. 7; Keijser, *op. cit.* (fn. 1), p. 71.

[33] For income payments under GMRA, see: GMRA, Paragraph 5 (a) - (b). For income payments under GMSLA, see: GMSLA, Paragraph 6.2 - 6.3.

[34] For margin maintenance methods under GMRA, see: GMRA, Paragraph 4 (a) - (l). For margin maintenance methods under GMSLA, see: GMSLA, Paragraph 5.4 - 5.8.

transaction, while both transfers of margin and equivalent margin are outright transfers of the full legal title to the margin,[35] thus serving both a security and a tradeability function.

Recharacterisation risk relating to TTFCAs is also increased by the language used by the financial market participants themselves since the market jargon employs terminology which is more associated with secured lending than with the true sales. For example, in the repo market jargon, the term 'collateral' is used to refer to the securities sold at the opening leg of the repurchase transaction, although these are not collateral in the traditional legal sense of the term as the full legal title to them is transferred outright to the buyer.[36] The standard market documentation relating to TTFCAs avoids phrases that would imply a secured loan. The term 'collateral' is not used in the GMRA, which clarifies that the expressions used in the GMRA which are commonly associated with secured loans are used only to reflect terminology used in the market, and that, notwithstanding the use of those expressions, 'all right, title and interest in and to' the transferred securities 'shall pass to the transferee'.[37] In the same manner, GMSLA provides that the expressions such as 'borrow', 'lend' and 'collateral' are used in the GMSLA to reflect the market terminology and that, notwithstanding the use of those expressions, the title to "borrowed" or "lent" securities and to collateral 'shall pass from one Party to another […], the Party obtaining such title being obliged to deliver Equivalent Securities or Equivalent Collateral as the case may be'.[38]

Thus a risk of recharacterisation of repurchase transactions, sell/buy-back transactions and securities lending transactions appear to be minimal if the parties to agreements governing those transactions do not deviate from the terms of the standard market documentation. The risk is increased if the parties amend the standard master agreement with the provisions which can make their repurchase agreement or securities lending agreement to be internally inconsistent. Examples for such provisions in a repurchase agreement are provisions which limit the buyer's right to deal freely in the securities during the term of the repurchase transaction, which require the buyer to deliver identical securities or which allow the seller to substitute the securities without the consent of the buyer.[39]

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35 See: GMRA, Paragraph 6 (e); GMSLA, Paragraph 4.2.

36 See: Comotto, *op. cit.* (fn. 11), pp. 75, 94; Keijser, *op. cit.* (fn. 1), pp. 19-20.

37 See GMRA, Paragraph 6 (f).

38 See GMSLA, Paragraph 2.3.

39 See: Benjamin, *op. cit.* (fn. 7), p. 323; Choudhry, *op. cit.* (fn. 11), p. 348; Johansson, *op. cit.* (fn. 31), p. 4; Keijser, *op. cit.* (fn. 1), p. 134.

4. THE FCD: ELIMINATING THE RISK OF RECHARACTERISATION OF TTFCAS

The objective of the FCD was to create an EU legal regime for the provision of financial collateral under bilateral financial collateral arrangements, including TTFCAs.[40] One of its explicit aims is to protect the validity of TTFCAs.[41] The FCD is to be applied to TTFCAs irrespective of whether or not they are governed by a master agreement.[42] The application of the FCD to TTFCAs is subject to the following requirements: (i) both parties must belong to one of the categories defined in the FCD;[43] (ii) financial collateral must consist of cash, financial instruments or credit claims;[44] (iii) financial collateral has to be provided to the collateral taker;[45] (iv) the provision of financial collateral has to be evidenced in writing or in a durable medium;[46] (v) TTFCA has to be evidenced in writing or in a legally equivalent manner.[47]

A TTFCA is defined in the FCD as 'an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of, or full entitlement to, financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations'.[48]

The definition of a TTFCA includes an explicit reference to the repurchase agreement, i.e. the agreement governing a repurchase transaction. This reference is probably made due to the disparity between legal structure and underlying economics which is more intrinsic to repurchase transactions than to the other types of financial transactions that rely on TTFCAs. Also, the peculiar feature of a repurchase transaction is that the securities which are sold to the buyer at the onset of the transaction are referred to as 'collateral' in the financial market practice, although they are in fact the main object of that sale agreement and not the additional collateral provided to secure the obligation relating to the main object of the agreement. Therefore, the clear

40 See: FCD, Recital (3), as well as Articles 1 (1), and 2 (1) (a).

41 See FCD, Recital (13).

42 See FCD, Article 2 (1) (a).

43 For the personal scope of application, see FCD, Article 1 (2) and (3).

44 See: FCD, Recital (18), as well as Articles 1 (4), and 2 (1) (d), (e), (o).

45 See FCD, Recital (10) and Article 1 (5), subparagraph 1.

46 See FCD, Recital (10) and Article 1 (5), subparagraphs 1-3.

47 See FCD, Recital (11) and Article 1 (5), subparagraph 4.

48 See FCD, Article 2 (1) (b).

mention of the repurchase agreement in the definition of a TTFCA is more than welcome.[49]

The notion of 'relevant financial obligations' contained in the definition of a TTFCA is also defined by the FCD. For the purpose of FCD, 'relevant financial obligations' are 'the obligations which are secured by a financial collateral arrangement and which give a right to cash settlement and/or delivery of financial instruments'.[50]

In the definition of a TTFCA, the FCD employs the term 'ownership', yet the use of this term is not entirely fitting, especially in relation to the book-entry securities.[51] The essential element of the definition of a TTFCA is the transfer of 'full ownership' of, or 'full entitlement' to, financial collateral. The words 'full ownership' and 'full entitlement' are used to indicate that the notion of a TTFCA covers an 'outright' transfer of title to financial collateral, i.e. the transfer of all right, title and interest in the financial collateral. This is particularly made clear in the German version of the FCD where a TTFCA is referred to as 'financial collateral in the form of full right transfer' (Ger. *Finanzsicherheit in Form der Vollrechtsübertragung*) and defined as 'the complete assignment of a financial asset or the transfer of all rights'.[52] Under a TTFCA there is no creation of a security interest in the financial collateral, and the collateral taker's 'ownership' of financial collateral is unlimited. Thus the tradeability function of financial collateral under a TTFCA is guaranteed by the FCD and the collateral taker may use and dispose of financial collateral as he wishes. In contrast to TTFCA, in a security financial collateral arrangement, the financial collateral is provided 'by way of security' and the 'full ownership of the financial collateral remains with the collateral provider'.[53] In order to ensure the tradeability function of financial collateral under a security financial collateral arrangement, the FCD requires the Member States to entitle the collateral taker with the controversial 'right of use' of financial collateral.[54]

[49] Due to several mentions of 'repurchase agreement' in the text of the FCD (see also Recitals (3), (13) and (14)), it was noted in the literature that a better name for the FCD 'might have been the "Repo Protection Directive"': Gretton, *op. cit.* (fn. 9), p. 210.

[50] See FCD, Article 2 (1) (f).

[51] See: Keijser, *op. cit.* (fn. 1), p. 96; Gretton, *op. cit.* (fn. 9), p. 214-215.

[52] Ger. *die vollständige Übereignung bzw. Zession eines Finanzaktivums oder die Übertragung aller Rechte*.

[53] See FCD, Article 2 (1) (c).

[54] See FCD, Article 5 (1). For a detailed analysis of the notion and purpose of a 'right of use' in relation to financial collateral in security financial collateral arrangements, see especially: Keijser, *op. cit.* (fn. 1), pp. 175-274.

It seems that the use of the words 'securing or otherwise covering' in the definition of a TTFCA in the FCD has misled several authors to the conclusion that the definition of a TTFCA also covers arrangements which create a security interest in the financial collateral.[55] However, the words 'securing or otherwise covering' are employed in the definition of a TTFCA to describe only the purpose of a TTFCA, not the method for provision of financial collateral under a TTFCA.[56] TTFCA's use the title transfer method of provision of financial collateral, not the security interest method. The word 'securing' is not used in the definition of a TTFCA in a technical legal sense and does not mean a creation of a security interest.[57] Since a TTFCA has a comparable economic effect to security but does not involve the creation of a *de jure* security interest, it is sometimes described in the literature as 'quasi-security'.[58]

The accuracy of the above analysis is confirmed in the Recital (13) of the FCD which establishes the elimination of recharacterisation risk relating to TTFCAs as one of the principal aims of the FCD. In the Recital (13) the FCD explicitly provides: 'This Directive seeks to protect the validity of financial collateral arrangements which are based upon the transfer of the full ownership of the financial collateral, such as by eliminating the so-called re-characterisation of such financial collateral arrangements (including repurchase agreements) as security interests.'

With the purpose to eliminate the recharacterisation risk of TTFCAs, the Article 6 (1) of the FCD requires the Member States to ensure that a TTFCA 'can take effect in accordance with its terms'.[59] This provision of the FCD requires the Member States to recognise the validity of TTFCAs and to ensure their enforceability. The Member States are required to give full effect to those contractual provisions of agreements governing the financial transactions which rely on TTFCAs that envisage the full unlimited title transfer of financial collateral.[60] Such provisions are, e.g., the provisions of Paragraph 6 (e) of the GMRA and of Paragraph 4.2 of the GMSLA. It would be contrary to the Article 6 (1) of the FCD if a Member State would treat a TTFCA in its national laws and regulations as arrangement creating a security interest, or if

[55] See, e. g., Gretton, *op. cit.* (fn. 9), p. 218.

[56] See: Murray, *op. cit.* (fn. 2), p. 286; Yeowart and Parsons, *op. cit.* (fn. 9), p. 152.

[57] See Yeowart and Parsons, *op. cit.* (fn. 9), p. 153.

[58] See: Benjamin, *op. cit.* (fn. 7), p. 307; Lomnicka, *op. cit.* (fn. 13), p. 301; Murray, *op. cit.* (fn. 2), p. 288

[59] See FCD, Article 6 (1).

[60] See: Devos, *op. cit.* (fn. 26), p. 268; Keijser, *op. cit.* (fn. 1), p. 160; Yeowart and Parsons, *op. cit.* (fn. 9), p. 147.

a national court would in the course of proceedings recharacterise the transfer of title to the financial collateral under a TTFCA as a creation of a security interest in the financial collateral.

With several other provisions of the FCD relating to the TTFCAs, the FCD seeks to ensure efficient creation, perfection, and enforcement of a TTFCA. The Article 3 (1) of the FCD imposes an obligation of the Member States to 'not require that the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement or the provision of financial collateral under a financial collateral arrangement be dependent on the performance of any formal act'. Article 6 (2) of the FCD seeks to protect the enforceability of bilateral close-out netting as a means of enforcement of TTFCAs. Moreover, FCD aims at ensuring that the TTFCAs, and the close-out netting provisions contained in them, remain valid and enforceable notwithstanding the opening of insolvency proceedings against the collateral taker or collateral provider.[61] Also, FCD calls for a disapplication of several provisions of national insolvency law, such as the 'zero hour' rules and the 'suspect period' rules, which were considered to be an obstacle for effective realisation of financial collateral.[62]

Due to the significant reception in the FCD of the terminology used in the financial markets and of the legal structures developed in the financial markets, the proper transposition of the FCD into national laws of the Member States was exceptionally challenging. As noted by a prominent legal scholar, the FCD 'is notoriously difficult to interpret'.[63] Therefore, it does not come as a surprise that in the several Member States the TTFCAs were, under national laws set forth in transposition of the FCD, considered as security interest arrangements, contrary to the Article 6 (1) of the FCD.[64]

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[61] See FCD, Articles 4 (5) and 7 (1).

[62] See FCD, Article 8 (1), (2) and (3). The 'zero-hour' rules give a declaration of insolvency the retroactive effect from the beginning of the day on which the insolvency is declared, while the 'suspect period' rules enable the liquidator to avoid transactions entered into during the 'suspect period' leading to the insolvency order. See, e. g., Keijser, T. R. M. P.: *A Need for a Change: The Undesirable Consequences of the Settlement Finality Directive and the Collateral Directive in the Field of Property and Insolvency Law, in Particular for Small- and Medium-Sized Enterprises*, Zeitschrift für Europäisches Privatrecht, 13 (2) 2006, [DOI: http://dx.doi.org/10.2139/ssrn.2859451], pp. 318-320.

[63] See: Beale, H.: *A View from England (Symposium: Reform of Security over Moveable Property)*, Edinburgh Law Review, 16 (2) 2012, [DOI: https://doi.org/10.3366/elr.2012.0106], p. 282.

[64] For instance, in Sweden, the assumption was made in the governmental reports that repos should be characterised as 'security transfers' (see: Johansson, *op.* cit. (fn. 31), p. 189).

Since the English version of the FCD employed the term 'transfer of the full ownership' in relation to TTFCAs, the FCD left room for possible interpretation of provisions of Article 2 (1) (b) and Article 6 (1) in a way that the notion of TTFCA under the FCD covers not only outright transfers of title but also fiduciary transfers of title. Fiduciary transfers of title are also transfers of the 'full ownership', but unlike the outright transfers of the title, they are not unlimited transfers of title. The view that the fiduciary transfers of title are covered under the notion of a TTFCA in the FCD is proposed by several authors in the legal literature who not only identify the TTFCA with the *fiducia cum creditore*, but moreover present the inclusion of fiduciary transfers of title in the FCD as an important novelty for those European property law systems that contain a general prohibition of *fiducia cum creditore*.[65]

The opposing view is that the notion of TTFCA under the FCD should cover only financial collateral arrangements that fulfill both the recovery and the tradeability function of financial collateral and not the arrangements that essentially entail the establishment of a security interest.[66] The tradeability function is what substantially distinguishes a TTFCA from traditional security legal structures, such as pledge and fiduciary transfer of title, under which the collateral taker would be able to dispose of the financial collateral only in the event of default of collateral provider.[67] Since on the basis of a fiduciary agreement the collateral taker does not have the right to dispose of the collateral under normal circumstances, where no default has taken place, the tradeability function of financial collateral is not present and the fiduciary transfer of title is actually a security interest.[68] Therefore, only outright transfers of the title should be covered by the notion of a TTFCA and protected under Article 6 (1) of the FCD, whereas the agreements employing a fiduciary transfer of title to collateral which are intended only for recovery purposes should be considered as security financial collateral agreements. This interpretation is compatible with the provisions of the standard market agreements which govern the main

[65] See, e. g.: Akkermans, B.: The European Union Development of European Property Law, in: Godt, C. (ed.), *Cross Border Research and Transnational Teaching under the Treaty of Lisbon - Hanse Law School in Perspective*, Wolf Legal Publishers, Oisterwijk, 2010, p. 44; Gretton, *op. cit.* (fn. 9), pp. 217, 222; Lefter, C. and Duagi, G.: *The Fiduciary Guarantee in the Romanian and European Legal Context*, Juridical Tribune, 6 (2) 2016, pp. 109-110; Moreno, H. S.: *Towards a European System of Property Law*, European Review of Private Law, 19 (5) 2011, p. 589; Sigman, H. C. and Kieninger, E.: The Law of Assignment of Receivables: in Flux, Still Uncertain, Still Non-Uniform, in: Sigman, H. C. and Kieninger, E.: *Cross-Border Security over Receivables*, Sellier, Munich, 2009, p. 5.

[66] See Keijser, *op. cit.* (fn. 1), p. 162.

[67] See *ibid*, p. 133.

[68] See *ibid*, p. 161.

types of financial transactions that rely on TTFCAs [69] and is in line with the economic, liquidity-enhancing function that financial collateral fulfills.[70]

The view that the notion of a TTFCA under the FCD covers outright transfers of title and not the fiduciary transfers of title to financial collateral is supported with the Article 6 (2) of the FCD which refers to the obligation of the collateral taker to transfer 'equivalent collateral', not the identical financial collateral originally provided by the collateral provider at the beginning of the transaction. The collateral taker's right of use and dispose of financial collateral provided under a TTFCA is inherent to the outright transfer of title to financial collateral. The protection of the collateral providers in transactions that rely on TTFCAs is ensured with the provisions of Securities Financing Transactions Regulation ('SFTR')[71] which provides that the collateral taker's right to reuse of financial collateral is subject to the two conditions: (i) that the collateral provider has been duly informed in writing by the collateral taker of the risks and consequences of concluding a TTFCA, at least those that may arise in the event of the default of the collateral taker; (ii) that the collateral provider has expressly agreed to provide collateral by way of a TTFCA.[72]

5. CROATIAN FSA: EXTENDING THE SCOPE FOR RECHARACTERISATION OF TTFCAS

Repurchase transactions, sell/buy-back transactions and securities lending transactions are types of securities financing transactions ('SFT's) regularly entered into by the participants in the Croatian financial market. In the SFT segment of the Croatian financial market, the repo market is considered to be particularly developed.[73] Domestic repurchase transactions are commonly governed under the Standard Master Repo Agreement (Cro. *Okvirni repo ugovor*; 'ORU'), prepared and published by the two national financial market associations.[74] The ORU was heavily influenced by the provisions of the

[69] See *supra*, Chapter 2.

[70] See Keijser, *op. cit.* (fn. 1), p. 162.

[71] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 (OJ L 337, 23/12/2015); hereinafter: SFTR.

[72] See SFTR, Article 15 (1).

[73] For the size and the structure of the Croatian repo market, see: Mihalina, E.: Ekonomski aspekti repo posla, in: Slakoper, Z. (red.), Bukovac Puvača, M. and Mihelčić, G. (eds.): *Bankovni i financijski ugovori*, Narodne novine, Zagreb, 2017, pp. 1288-1291.

[74] ACI Croatia/Hrvatska udruga banaka: *Okvirni ugovor o reotkupu financijskih instrumenata (okvirni repo ugovor) – verzija 2014*, ACI Croatia/Hrvatska udruga banaka, Zagreb, 2014; hereinafter: ORU.

GMRA and represents almost a letter-by-letter translation of the GMRA into the Croatian language. In a similar manner as the GMRA, the ORU provides that the transfer of financial instruments in a repurchase transaction governed by the ORU is the transfer of 'all rights' to financial instruments and that the transferee is obliged to deliver the 'equivalent' financial instruments at the end of the transaction.[75] Sell/buy-back transactions may be documented by supplementing the ORU with a separate annex,[76] which is similar to the Buy/Sell Back Annex to the GMRA. There is no specific standard market agreement for securities lending which would be comparable to the GMSLA, but a standard market agreement for derivatives transactions may be used to document the securities lending transactions.[77]

The repurchase agreement, the sell/buy-back agreement and the securities lending agreement are not regulated as specific types of contract in the Croatian Obligation Act ('COA').[78] From the contract law point of view, a repurchase agreement under Croatian law is a mixed contract consisting of elements of two sale agreements, one of which is a spot sale of securities, and the other being a forward purchase of securities.[79] In a sell/buy-back transaction, parties simultaneously enter in a spot sale and a forward purchase of securities as two separate agreements of sale.[80] Securities lending agreement is a combination of two loan agreements, one being the loan of the principal securities, while the other is the loan of collateral securities or cash.[81]

Under Croatian law, the provision of securities on the basis of a valid repurchase agreement, if the parties do not deviate from the provisions of ORU, will lead to an outright transfer of title to provided securities.[82] An outright transfer of title is also the result of the provision of principal securities and of the collateral on the basis of a valid securities lending agreement since in

[75] See ORU, Paragraphs 11.1., and 11.2.

[76] ACI Croatia/Hrvatska udruga banaka: *Dodatak I Okvirnog ugovora o reotkupu financijskih instrumenata (okvirnog repo ugovora) – verzija 2014*, ACI Croatia/Hrvatska udruga banaka, Zagreb, 2014.

[77] See: ACI Croatia/Hrvatska udruga banaka: *Okvirni ugovor za transakcije izvedenim financijskim instrumentima – verzija 2008*, ACI Croatia/Hrvatska udruga banaka, Zagreb, 2008.

[78] Zakon o obveznim odnosima [Obligations Act] (NN no. 35/05, 41/08, 125/11, 78/15, 29/18); hereinafter: COA.

[79] See Tot, I.: Repo ugovor, in: Slakoper, Z. (red.), Bukovac Puvača, M. and Mihelčić, G. (eds.): *Bankovni i financijski ugovori*, Narodne novine, Zagreb, 2017, pp. 1254-1255.

[80] See *ibid*, pp. 1248-1249.

[81] See *ibid*, p. 1251.

[82] See COA, Article 376 (1) and (2).

the course of a securities lending transaction the principal securities and the collateral are transferred on the basis of a loan of fungibles.[83] The securities used in repurchase transactions and securities lending transactions are commonly fixed-income instruments, such as bonds, and equity securities, such as ordinary shares. They are typically non-materialized securities, the title to which is normally acquired in the moment of the book-entry into the acquirer's account in the central securities depository.[84]

As well as in the European cross-border financial market, in the Croatian financial market repurchase transactions, sell/buy-back transactions and securities lending transaction employ a title transfer method for provision of financial collateral and are types of transactions which rely on TTFCAs within the meaning employed in the FCD. Transposition of the FCD into Croatian law was made through provisions of FSA which is marked by clumsy translations of the market originated terminology and by several inconsistencies and contradictions.

Croatian FSA employs the term 'financial security' (Cro. *financijsko osiguranje*) to refer to the method of provision of a financial collateral, whereas the financial collateral is referred to as a 'financial security instrument' (Cro. *instrument financijskog osiguranja*).[85] Financial security is defined as 'a transfer of, or an establishment of a special right of pledge in, financial security instruments for the purpose of securing a financial obligation'.[86] A financial collateral agreement is referred to as 'financial security agreement' and is defined in Article 2, pt. 2 of the FSA which represents an unsuccessful attempt to describe both the TTFCAs and the security financial collateral arrangements in a single definition. In relation to the TTFCAs, the relevant elements of this definition of 'financial security agreement' are that the financial security agreement is an agreement under which: (i) the provider of a financial security instrument is obliged to transfer a financial security instrument to the taker of a financial security instrument, (ii) for the purpose of securing the performance of own financial obligation or financial obligation of another, (iii) under conditions set

[83] See COA, Article 499 (2). For transfer of title on the basis of loan of fungibles in Croatian law, see: Slakoper, Z.: Ugovor o zajmu, in: Slakoper, Z. (red.), Bukovac Puvača, M. and Mihelčić, G. (eds.): *Bankovni i financijski ugovori*, Narodne novine, Zagreb, 2017, pp. 531-532.

[84] See Zakon o tržištu kapitala [Capital Market Act] (NN no. 65/18), Article 530 (1). For a detailed analysis of the acquisition of non-materialised securities under Croatian law, see: Markovinović, H. and Tepeš, N.: Posebno o pripadnosti nematerijaliziranih vrijednosnih papira povjerenih u skrbništvo, in: Slakoper, Z. (red.), Bukovac Puvača, M. and Mihelčić, G. (eds.): *Bankovni i financijski ugovori*, Narodne novine, Zagreb, 2017, pp. 985-989.

[85] See FSA, Articles 1 and 2, pt. 1.

[86] See FSA, Article 2, pt. 1.

out in the agreement, master agreement or a general terms and conditions, (iv) while the taker of that financial security instrument is obliged, in accordance with the contractual terms and provision of FSA and other laws, to return to the provider 'the same or equivalent' financial security instrument.

An attempt to describe a TTFCA is also made in Article 2, pt. 7 of the FSA. The problem with this provision is that it refers to a 'security by transfer of financial security instrument' (Cro. *osiguranje prijenosom instrumenta financijskog osiguranja*), which is a method of provision of financial collateral, and not the agreement which employs a method of provision of financial collateral. Yet the method of provision of financial collateral is here defined as 'financial collateral agreement under which the rights in financial security instrument are transferred from the provider to the taker of a financial security instrument, including a repurchase agreement and a reverse repurchase agreement'.[87]

Article 6 (1) of the FCD, which sanctions the enforceability of TTFCAs and intends to eliminate the recharacterisation risk, is transposed in the FSA with the provision which reads as follows: 'If not stipulated otherwise in the financial security agreement under which the financial security instrument is transferred, the taker of a financial security instrument is entitled to unlimited use and dispose of the cash and financial instruments which are financial security instruments, including to a right to sell them.'[88]

The use of words 'unlimited use and dispose of' (Cro. *koristiti se i raspolagati*) in the Article 6 (1) of the FSA indicates that the transfer of title in a TTFCA under Croatian law is an outright transfer of title, i.e., that all right, title and interest to financial collateral is transferred to the collateral taker. Thus, the tradeability function of financial collateral in a TTFCA is in Croatian law guaranteed and clearly highlighted. However, by its legal nature, the provision of Article 6 (1) is a non-mandatory provision. Therefore, the parties to a TTFCA may agree that the collateral taker will not be entitled to unlimited use and dispose of financial collateral, or that his rights to use and dispose of financial collateral will be limited and subject to conditions laid down in the agreement. Such contractual provisions would be in contradiction with the dual purpose of financial collateral under a TTFCA and would indicate that the parties intended the financial collateral to serve only a recovery purpose.[89]

[87] For a justly criticism of this provision see: Radin, D.: Hrvatski pravni okvir financijskog osiguranja, in: Miladin, P. and Jakšić, T. (eds.): *Prilagodba hrvatskog prava i ekonomije europskom tržištu kapitala*, Pravni fakultet Sveučilišta u Zagrebu, Zagreb, 2013, pp. 344-345; Tot, *op. cit.* (fn. 79), p. 1253.

[88] See FSA, Article 6 (1).

[89] See: Radin, *op. cit.* (fn. 87), pp. 345-346; Tot, *op. cit.* (fn. 79), p. 1258.

The non-mandatory nature of Article 6 (1) of the FSA is of a special concern when this provision is considered in connection with Article 2, pt. 2 of the FSA. In contrast to the definition of TTFCA set out in the Article 2 (1) (b) of the FCD, in relation to the purpose of a TTFCA the Article 2, pt. 2 of the FSA provides that the title to financial collateral is transferred for the purpose of 'securing' financial obligations, while the words 'or otherwise covering' are omitted from the FSA. Moreover, instead of referring to the obligation of collateral taker to provide only the 'equivalent' financial collateral to the collateral provider at the end of the transaction, the Article 2, pt. 2 of the FSA opts for a solution according to which the collateral taker may also be obliged to return to the collateral provider the 'same' financial collateral that was originally provided to him at the beginning of the transaction.[90] The contractual provision which would require the collateral taker to provide the collateral provider with the same financial collateral that was previously delivered to the collateral taker is a prime example of a provision that indicates that the actual intention of the parties might have been a creation of a security interest in the financial collateral. The consequence of the gold-plating of the FCD, made through the insertion of the possible collateral taker's contractual obligation to return the 'same' financial collateral in the provision of Article 2, pt. 2 of the FSA, is that under Croatian law the definition of TTFCA covers not only a 'true' TTFCA, but also a financial collateral arrangement in which the tradeability function of financial collateral is virtually non-existent.

It is argued that the definition of a TTFCA under Croatian FSA covers not only outright transfer of title, which is the method of provision of financial collateral in TTFCAs under which the collateral taker is obliged to provide equivalent financial collateral to collateral provider at the end of the transaction, but also fiduciary transfer of title,[91] which would be the method of provision of financial collateral in TTFCAs under which the collateral taker is obliged to provide to the collateral provider the same financial collateral that was previously provided to collateral taker at the beginning of the transaction. In relation to the latter TTFCAs, it should be noted that TTFCAs that rely on such transfer of title are not covered by a security legal structure known in Croatian law as a court and notary public security of claims by transfer of right (Cro. *sudsko i javnobilježničko osiguranje tražbina prijenosom prava*), which is regulated by the enforcement law rules.[92] This is evident from the provision of Article

[90] See: Radin, *op. cit.* (fn. 87), p. 346; Tot, *op. cit.* (fn. 79), p. 1259.

[91] See: Radin, *op. cit.* (fn. 87), p. 346; Tot, *op. cit.* (fn. 79), p. 1259.

[92] For this type of security legal structure see, e.g., Mihelčić, G.: Sudsko i javnobilježničko osiguranje tražbina prijenosom prava vlasništva na nekretninama i pokretninama i prijenosom prava, in: Slakoper, Z. (red.), Bukovac Puvača, M. and Mihelčić, G. (eds.): *Bankovni i financijski ugovori*, Narodne novine, Zagreb, 2017, pp. 411-412.

4 (1) of FSA, which serves the transposition of the Article 3 (1) of the FCD, under which 'the validity of financial security agreement is not dependent on the performance of any formal act', such as the conclusion of the agreement in the form of a court record or a notary public act and the entry in the appropriate registry, which are the *titulus* and the *modus aquirendi* of the transfer of right under the enforcement law rules governing the court and notary public security of claims by transfer of right. Also, taking into account that the collateral taker is entitled under the FSA to 'unlimited use and dispose of' financial collateral unless stipulated otherwise in the agreement, it should be concluded that if a 'fiduciary transfer of title' is protected under the FSA, such transfer of title is definitely not the fiduciary transfer of title on the basis of the property law rules, as the right to the unlimited use and disposal of financial collateral is not compatible with fiduciary transfer of title under the property law. Rather, transfer of title in a TTFCA, under which the collateral taker is obliged to return the same financial collateral to the collateral provider, should be treated as an outright transfer of title with the establishment of a fiduciary relationship under the general rules of obligations law.[93] The main features of this 'fiduciary assignment' of title to financial collateral are that: (i) the collateral provider transfers unlimited title to financial collateral to the collateral taker; (ii) the collateral taker is entitled to use financial collateral for the purpose and under the conditions agreed with the collateral provider; (iii) the collateral taker is obliged with contractual fiduciary duties to the collateral provider which are owed personally, not proprietary; (iv) the collateral taker is obliged to retransfer the financial collateral to the collateral provider.[94]

The effect of inclusion of fiduciary assignment of title to financial collateral in the definition of the TTFCA under the FSA is that the FSA affords the same level of protection of validity and enforceability of TTFCAs which employ a fiduciary assignment of title, as it does in relation to the TTFCAs which employ the method of an outright transfer of title. This approach unfairly favours the economic interests of collateral providers. Financial collateral agreements under which the financial collateral is provided on the basis of a fiduciary transfer of title should be treated as security financial collateral arrangements within the meaning of Article 2 (1) (c) of the FCD, and not as TTFCAs. Paradoxically, under the FSA, the collateral taker in a financial collateral arrange-

[93] For transfers of title with the establishment of a fiduciary relationship under rules of the law of obligations, see, e.g., Gavella, N.: Fiducijarni prijenos i neke daljnje mogućnosti stvarnopravnog osiguranja tražbina, in: Gavella, N. (red.): *Stvarno pravo – Svezak drugi*, Narodne novine, Zagreb, 2007, pp. 474-475.

[94] For the main features of a fiduciary assignment see, especially: Miladin, P. and Markovinović, H.: *Založno pravo na pravu*, Pravo u gospodarstvu, 46 (4) 2007, pp. 105-106.

ment which employs the method of a fiduciary assignment of title has fewer rights to financial collateral than the collateral taker in a security financial collateral arrangement, as in the latter the collateral taker is entitled to a right of use and dispose of financial collateral under the provisions of Article 5 of the FSA.

Due to the ambiguity of the notion of a TTFCA under the FSA, the scope for unjustified recharacterisation of a TTFCA under Croatian law is undoubtedly extended. This is, *inter alia*, indicated by one interpretation of the provisions of FSA made in Croatian legal literature: the TTFCA was named a 'fiduciary financial security' and the title transfer method employed in a TTFCA was identified with the fiduciary transfer of title, while it was neglected that the outright transfer of title is covered with the definition of TTFCA in the Croatian law.[95] As the Croatian legal literature on the topic of financial collateral arrangements is significantly scarce, the labeling of all TTFCAs as fiduciary transfers of title, in connection with the analyzed deficiencies of the notion of a TTFCA under the FSA and with the non-mandatory legal nature of provision of Article 6 (1) of the FSA, could mislead the national courts: the possibility exists that the national courts could mistakenly recharacterise even the true outright transfers of title to financial collateral as fiduciary transfers of title. Such recharacterisation would have calamitous consequences for the collateral takers, as they would be deprived of the right to use and dispose of financial collateral. It should be noted that the risk for unjustified recharacterisation of a TTFCA is yet unrealised in the Croatian court practice, as there are still no court decisions rendered relating to the application of FSA, or at least such decisions have not yet been made available to the public. However, in one published court decision relating to fiduciary transfers of title in general, the court has made a reference to the FSA as one of the laws that governs the fiduciary transfers of title under the Croatian law.[96]

6. CONCLUSION

The title transfer method for the provision of financial collateral which is employed in the TTFCAs was developed in the financial market practice with an aim to ensure the tradeability function of financial collateral. In TTFCAs this function is guaranteed only if the financial collateral is transferred to the

[95] See: Ernst, H. and Matanovac Vučković, R.: *Prijenos prava radi osiguranja – nedorečenosti i nedovršenosti*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, 33 (1) 2012, p. 161.

[96] See: Županijski sud u Splitu [County Court in Split], 16 Gž Zk-509/17-2, 28/9/2017, p. 6, available at: Vrhovni sud Republike Hrvatske, Portal sudske prakse [https://sudskapraksa.csp.vsrh.hr/], accessed on 30/10/2018.

collateral taker on the basis of an outright transfer of title, i.e. transfer of all right, title and interest in financial collateral to the collateral taker. The most common types of securities financing transactions entered in the European cross-border and domestic financial markets rely on a TTFCA, as evidenced by the provisions of the standard market agreements governing those transactions.

The validity and enforceability of TTFCAs and of the legal solutions developed in financial market practice and employed in the standard market agreements are protected by the FCD, the provisions of which are significantly influenced by the financial market practice. The recharacterisation of TTFCAs by the national courts as arrangements creating a security interest in financial collateral would deprive the financial collateral provided under a TTFCA of its important function: tradeability in the financial market. Therefore, the aim of the FCD is to eliminate the recharacterisation risk of TTFCAs as security interests.

Generally, the risk of recharacterisation of a TTFCA is minimal if participants to the securities financing transactions which rely on TTFCAs do not deviate significantly from the terms of the standard market documentation when concluding agreements that govern those transactions. The parties may increase the re-characterization risk if they insert to their agreements contractual provisions which make their agreement internally inconsistent, such as provisions which limit the collateral taker's right to freely use and dispose of financial collateral and provision which require the collateral taker to return to the collateral provider at the closing leg of the transaction the same financial collateral that was previously transferred to him at the opening leg of the transactions. In these cases, the recharacterisation by the national court of a TTFCA might be justified as such provisions indicate that the true intent of the parties was to create a security interest in financial collateral, and not to transfer the title to financial collateral outright to the collateral taker.

In view of the tradeability function of financial collateral, the provisions of the FCD relating to TTFCA should be interpreted in a manner that under the notion of a TTFCA only an outright transfer of title is covered, and not a fiduciary transfer of title. The financial collateral arrangements which rely on fiduciary transfers of title are essentially security interests and should be considered as security financial collateral arrangements under the FCD.

Unfortunately, the notion of a TTFCA contained in the Croatian FSA covers not only outright transfers of title to financial collateral but also fiduciary assignments of title to financial collateral. Due to the analysed shortcomings of the regulation of TTFCAs in the Croatian law, the risk of recharacterisation of TTFCAs is not eliminated but is moreover increased. Improper transposition

of the FCD into Croatian law and the complexity of the financial collateral law as highly specialised field of law might mislead the national courts to an unwarranted recharacterisation of an outright transfer of title to financial collateral under a TTFCA as a fiduciary transfer of title, thereby ruling out the tradeability function of financial collateral and depriving the collateral taker of his right to use and dispose of financial collateral during the ordinary lifetime of the transaction.

Therefore, the provisions of the Croatian FSA should be amended in order to eliminate the present inconsistencies and the negative effects of the currently employed legal solutions for collateral takers, and in order to transpose the FCD properly into Croatian law. The future amendments to the FSA should include at least a deletion of a part of the provision of Article 2, pt. 2 of the FSA which provides that the collateral taker may be obliged to transfer to the collateral provider financial collateral *in specie*, i.e. the 'same' financial collateral that was originally provided to him at the beginning of the transaction. However, due to numerous deficiencies of the FSA, many of which were not topics of this paper, a better approach would be to adopt a new FSA which would be made from scratch.

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RECENT DEVELOPMENTS IN EUROPEAN COMPANY LAW: A WAY FORWARD TO MORE SOCIAL EUROPE?

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ABSTRACT

Developments in EU Company Law show how EU Company Law has become more than just a set of market-driven rules focusing on overcoming legal barriers in cross-border investment. Non-binding guidelines on methodology for reporting non-financial information, combating discrimination on the grounds of gender by implementing the principle of equal treatment of men and women in matters of employment, proposal for a new legislation aiming at attaining a 40% objective of the under-represented sex in non-executive board-member positions in publicly listed companies are some of those initiatives. Several EU reports have stressed the positive impact of employee participation on companies' economic results, motivation and retention of employees. It is encouraging for stakeholders and the future of 'Social Europe' to see that the present European Company Mobility Package – tackling cross border conversions, mergers and divisions - takes an approach in favor of shareholders, employees and creditors. According to the European Economic and Social Committee, the new company law rules should make it easier for companies to merge, divide or move within the Single Market. New rules should ensure better protection of employees' rights and prevention of tax abuse. One may pose a question should the EU implement its social policies through EU Company Law. If so, which areas of EU Company Law should preserve (and enhance) social values? Could too much care for sustainability of social values eventually lead to non - sustainability of traditional company law?

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KEYWORDS: *EU Company Law, European Company Mobility Package, 'Social Europe', sustainability*

1. INTRODUCTION

The last financial crisis has shown that one can no longer see companies as pure economic entities, de-contextualized from their social surrounding. Hegemonic "shareholder model" had passed through crisis.[1] The time has come to look for an alternative model to the shareholder value model.[2] Alternative model means, the one which will take into consideration the existence of internal stakeholders (shareholders and employees) and external stakeholders (creditors, clients, local community, state, etc.).[3]

If a company not pure economic entity, then one cannot see company law as purely internally oriented either. Namely, in many jurisdictions company law is seen as "supporting shareholder primacy drive" since it regulates the relationship between shareholders, the board and management.[4] New age company law should refer to social objectives as well and open itself to broader social context. It calls for adoption of stakeholder model.[5]

The stakeholder model is the guiding principle of modern progress of corporate governance, which manifests itself in the model of so-called "sustainable company".[6] As opposite to shareholder model, it takes into concern sustainability, involvement of stakeholders (in particular employees) into decision making

[1] Vitols, S.; Kluge, N.: Introduction, in: Vitols, S.; Kluge, N. (eds.), *The Sustainable Company: a new approach to corporate governance*, Vol. I, Brussels, ETUI, 2012, p. 7.

[2] Shareholder value model presupposes that social relations are set of contractual obligations and mechanisms to resolve conflicts and reduce uncertainty. Shareholders are key factor among different factors of production. This model was firm in the 1980's and the beginning of 2000s. Vitols, S., What is the Sustainable Company, in: Vitols, S.; Kluge, N. (eds.), *The Sustainable Company: a new approach to corporate governance*, Vol. I, Brussels, ETUI, 2012, pp. 15-16. The shareholder concept gives priority to the shareholders in corporate governance and increasing of shareholders' wealth is considered to be the primary function of a company. See Vitols, S.; Heuschmid, J., Introduction, in Vitols, S., Heuschmid, J. (eds.), *European Company Law and the Sustainable Company: a stakeholder approach*, Vol. II, Brussels, ETUI, 2013, p. 9.

[3] *Ibid*., p. 13.

[4] Sjåfjell, B., Regulating companies as if the world matters, in Vitols, S., Heuschmid, J. (eds.), *European Company Law and the Sustainable Company: a stakeholder approach*, Vol. II, Brussels, ETUI, 2013, p. 270.

[5] Stakeholder theory recognizes that a company is a social organization dependent on different groups: employees, suppliers, investors, community etc. Vitols, *op. cit.* (ref. 2), p. 15.

[6] *Ibid*., p. 24.

process,[7] transparency in reporting financial and non-financial information, dependence of executive remuneration to achievement of sustainability goals and long term "socially conscious" investments. As will be elaborated below, these principles comply well with previous and recent EU legal initiatives.[8]

A good example of conceptual shift from isolated company law to "socially engaged" company law has its traces in the field of labor law. Board - level employee representation has been a common element of major EU company law initiatives. [9] Any legal initiative in the field of company law calls for implementation of holistic approach that takes into concern both labor law elements and company law elements. I.e. company law should not be isolated from other legal fields.[10] Although labor law and company law are different legal areas by their subject matter and aims,[11] two fields intertwine since social sphere impacts economic sphere and *vice versa*.[12] Holistic, socio-economic approach to company law requires that law making processes embed company law, tax law, capital markets law and labor law as mutually intertwined elements of a company law framework.[13]

Empirical proof of positive effects of such approach one can notice in initiatives regarding European company law. Those legal initiatives, which have integrated company law and labor law elements, have shown successful. On the other hand, those initiatives that have drawn a clear (or formalistic?) line between two legal fields simply failed.[14]

Indeed, employee participation is an example of how social policy issues have eventually become EU company law issues. Employee share ownership (ESO), in particular its individual share ownership as part of employee financial ownership (EFO) in the nineties had been predominantly regarded as related so-

[7] E.g. board level employee participation, European Works Council, collective bargaining. *Ibid*.

[8] Such change of paradigm reflects its twin brother Anglo-American concept of "progressive corporate law". Conchon, A., Regulating company law: the need for a holistic approach, in: Vitols, S., Heuschmid, J. (eds.) *European Company Law and the Sustainable Company: a stakeholder approach*, Vol. II, Brussels, ETUI, 2013, p. 75, note 8.

[9] *Ibid*., p.71.

[10] *Ibid*., p.72.

[11] Labor law traditionally focuses on social aims (protection of *a priori* economically weaker party) and company law is traditionally business-oriented, dealing with relations between a company, managers and shareholders.

[12] Conchon, *op. cit*. (ref. 8), p.74. E.g., Statute on *Societas Europea* took into concern employee participation, as well as legislation on *Societas Cooperative Europea*.

[13] Conchon, *op. cit*. (ref. 8), p.75.

[14] *Ibid*., p.80.

cial policy.[15] New way of thinking about ESO/EFO has begun with Action Plan to Reform EU Company Law and Corporate Governance in 2012. The ESO stands for the "element that ought to be considered in the design of any well-functioning governance framework. "[16]

When speaking of fundamental social values of the European Union[17] we mean not only those embedded in EU primary law - European Union Treaties[18] and the Charter of Fundamental Rights of the EU.[19] We mean also the European Convention on Human Rights.[20] Namely, fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms, as they result from the constitutional traditions common to the Member States, constitute general principles of EU law.[21] Analysis of these documents has shown how "social" and "economic" are often mentioned together in EU fundamental documents.[22] One can feel the idea of balance between "social" and "economic" behind.

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[15] The Promotion of Employee Ownership and Participation, Study prepared by the Inter-University Centre for European Commission's DG Markt (Contract MARKT/2013/0191F2/ST/OP), Final report October 2014, p. 17. [http://ec.europa.eu/internal_market/company/docs/modern/141028-study-for-dg-markt_en.pdf], accessed on 9/5/2018.

[16] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies, COM/2012/0740 final. Hereinafter as: Action Plan…

[17] Hereinafter as: EU.

[18] See e.g. Preamble of the Treaty on European Union, consolidated version, (OJ C 202, 7/6/2016), p. 13–388 (hereinafter as TEU). See also Art. 3 (3) TEU; Protocol No. 28 attached to TEU; Art. 21 (2)(d) TEU. See Preamble of the Treaty on the Functioning of the EU, consolidated version, (OJ C 202, 7/6/2016), p. 1–388 (hereinafter as TFEU). See also Art. 4 TFEU, Art. 5 TFEU; Art. 9 TFEU; Art. 21 TFEU; Art 107 TFEU, Title X TFEU *etc*.

[19] See Preamble of the Charter of Fundamental Rights of the EU, (OJ C 202, 7/6/2016), p. 389–405 (hereinafter as CFREU). See also Art. 34 CFREU; Art. 36 CFREU.

[20] The Convention for the Protection of Human Rights and Fundamental Freedoms, as amended by Protocols Nos. 11 and 14 supplemented by Protocols Nos. 1, 4, 6, 7, 12 and 13, [http://www.echr.coe.int/Documents/Convention_ENG.pdf], accessed on 8/5/2018.

[21] Art. 6 (3) TEU.

[22] E.g. TEU's preamble says how Member States were „determined to promote *economic and social progress* for their peoples, *taking into account the principle of sustainable development* and *within the context of the accomplishment of the internal market* and of reinforced cohesion and environmental protection, and *to implement policies ensuring that advances in economic integration are accompanied by parallel progress in other fields* (…). Art 3(3) TEU says the Internal Market „shall work for the s*ustainable development of Europe based on balanced economic growth* and price stability, a *highly competitive social market economy*, aiming at full employment and *social progress*. (…) It shall *combat social exclusion and discrimination*, and shall *promote social justice* and protection, *equality between women and men*, (…).

Numbers of recent EU documents promote social values as part of EU's long term perspective. If we just have a look at the Europe 2020 Strategy, we can see how it tackles several priorities: smart and sustainable growth, job creation and poverty reduction.[23] Such state of art leads to the conclusion: "social" and "economic" are intertwined, complementary aspects of the Internal Market. In another words, EU social model is deeply integrated into EU economy. Socio-economic, or in *Conchon*'s words, holistic approach is straightforwardly integrated into EU law.

In the next chapter, we will try to prove how contemporary EU Company Law tends to be more social and less market-driven. In third chapter we are focusing on the question should EU Company Law implement its social objectives through company law. In concluding remarks, we have summarized some of our main points.

2. MORE SOCIAL AND LESS MARKET DRIVEN COMPANY LAW

Recent developments and legislative initiatives in the area of EU Company Law and Corporate Governance show that this area has become more than just a set of market-driven rules focusing on overcoming legal barriers in cross-border investment. To name just a few: interconnection of business[24] and insolvency registers[25] as instruments for increasing pan-EU transparency and enabling potential creditors (including workers) to react promptly in order to save their claims. Revised Directive on Shareholders' Rights has provided even higher

"TFEU's preamble says how Member States were „resolved to ensure *the economic and social progress* of their States by common action to eliminate the barriers which divide Europe (…). " Art. 151 how „the Union and the Member States, having in mind fundamental social rights such as those set out in the European Social Charter signed at Turin on 18 October 1961 and in the 1989 Community Charter of the Fundamental Social Rights of Workers, shall have as their objectives (…) *dialogue between management and labor* (…)."

[23] See [http://ec.europa.eu/europe2020/europe-2020-in-a-nutshell/priorities/index_en.htm], accessed on 8/5/2018.

[24] Directive 2012/17/EU of the European Parliament and of the Council of 13 June 2012 amending Council Directive 89/666/EEC and Directives 2005/56/EC and 2009/101/EC of the European Parliament and of the Council as regards the interconnection of central, commercial and companies registers Text with EEA relevance, (OJ L 156, 16/6/2012), p. 1–9. For more details on this topic refer to Horak, H.; Dumančić, K., Poljanec, K.: *The Interconnection of Company Data - a Way Forward in Development of Freedom of Establishment?*, European Journal of Economics and Management, 3(1), 2016, pp. 134-152, [http://search.proquest.com/openview/5b16e74fbc3cb696b3d631acbb0a81ed/1.pdf?pq-origsite=gscholar&cbl=2035019], accessed on 14/5/2018.

[25] [https://e-justice.europa.eu/content_insolvency_registers-110-en.do], accessed on 8/5/2018.

protection of shareholders than it has been the case before. It aims at stimulating long-term engagement and increasing transparency.[26] The Directive on Non-Financial Reporting[27] has been a significant step towards making business accountable to society and it is a major success for the corporate accountability. Combating discrimination on the grounds of gender by implementing the principle of equal treatment of men and women in matters of employment, proposal for a new legislation aiming at attaining a 40% objective of the under-represented sex in non-executive board-member positions in publicly listed companies aim to accelerate progress towards a better gender balance on the boards of European companies.[28] In December 2015 the Commission launched consultations which aim gathering information to which degree different actors in investment chains take ESG[29] information into concern when investing.[30] Seeking a positive social or environmental impact of investments is considered as one the main rationales behind ESG.[31]

Considering EU secondary law – directives and regulation– one may notice that development of EU company law shows two straightforward ideas: abolishment of impediments to cross-border doing business[32] and the one which could be described as „triple p": prevention, protection, publicity.

[26] Directive 2017/828 of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (OJ L 132, 20/5/2017), p. 1–25.

[27] 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, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC (Directive 2013/34/EU) (OJ L 182, 29/6/2013), p.19. Amended by 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 (Directive 2014/95/EU) (OJ L 330, 15/11/2014), p. 1–9 and Council Directive 2014/102/EU of 7 November 2014 adapting Directive 2013/34/EU of the European Parliament and of the Council on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, by reason of the accession of the Republic of Croatia Text with EEA relevance, (OJ L 334, 21/11/2014), p. 86–87.

[28] See Strategic Engagement for Gender Equality 2016-2019, p. 14, [http://ec.europa.eu/justice/gender-equality/document/files/strategic_engagement_en.pdf], accessed on 9/5/2018.

[29] Environmental, social and governance information.

[30] Summary of the Responses to the Public Consultations on long-term and sustainable investment, Brussels, October 2016 JUST/A3, [http://ec.europa.eu/information_society/newsroom/image/document/2016-44/feedback_final_pc_30068_en_19173.pdf.], accessed on 8/5/2018.

[31] Summary, p. 6.

[32] On freedom of establishment and related freedom of capital movements as fundamental freedoms aiming at enforcement of cross-border investments, see Horak, H.; Dumančić, K.; Poljanec, K., *European Market Law: Textbook*, Vol. I, Zagreb, University of Zagreb, Faculty of

„Triple p" is clearly a reflection of more social approach into company law area. In another words, the EU has been trying to meet social policy objectives through secondary legislation. Through the years, the attempts to find a solution on EU level *in favorem* of freedom of establishment and the internal market have shown that half solutions and compromises simply cannot work in business practice.[33] Alternatively, more accurately, some solutions cannot find their way to actual implementation due to the (future) 27 different company law systems.

There have been some new initiatives, which relate to some aspect of protecting fundamental social rights and integrating them into EU law. Social oriented policy is well embedded into the core of EU Company Law. In that regard, it is encouraging for all stakeholders and the future of Social Europe[34] to see that the present European Company law package takes an approach *in favorem* of shareholders, employees and creditors, creating the much-needed legal security. Namely, in April 2018 the Commission launched so called 'European Company Mobility Package'.[35] In two proposals,[36] one can notice furthering social approach when it comes to development of company law at supranational level. According to the European Economic and Social Committee,[37] the new company law rules will make it easier for companies to merge, divide

Economics and Business, Zagreb, 2015, pp. 101-107 and pp. 120-141, [http://web.efzg.hr/dok/KID//European%20Market%20Law%20online.pdf.]

[33] Vitols, S.: *EU Company Mobility Package: Implications for Social Europe*. Available at [https://www.socialeurope.eu/eu-company-mobility-package-implications-for-social-europe], accessed on 11/5/2018.

[34] See [http://institutdelors.eu/publications/a-new-start-for-social-europe/?lang=en], accessed on 11/5/2018. This Report, commissioned by the Ministry of Labour, Employment and the Social and Solidarity Economy of Luxembourg, focuses on 'Why' a new start for Social Europe is necessary, and on 'How' a new start for Social Europe is feasible. It identifies three pillars on which the Social Europe project should be grounded:

1) an investment strategy in human capital which can set the basis for growth and competitiveness based on social inclusion and resilience;

2) an enhanced and fairer labour mobility across EU member states to build a truly European labour market;

3) a pro-convergence reform of the European economic governance that can reconcile social and macroeconomic objectives.

[35] See more [https://ec.europa.eu/info/publications/company-law-package_en], accessed on 16/7/2018.

[36] Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions COM/2018/241 final - 2018/0114 (COD) (hereinafter as: Proposal, Cross-border…) and Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards the use of digital tools and processes in company law Com/2018/239 Final - 2018/0113 (COD).

[37] See [https://www.eesc.europa.eu/en/tags/company-law], accessed on 16/7/2018.

or move within the Single Market. In addition, the new rules will ensure that employees' rights are well protected and tax abuse is prevented. So maybe it is new path, as some author's note,[38] for building social business in Europe?

The answer should be in affirmative. In August 2018, the EU Parliament has issued the draft report on proposal of amendment of EU legislation in the area of cross-border conversions, mergers and divisions.[39] The EU Parliament confirmed the necessity of strong safeguards and proper protection for stakeholders (creditors, employees, shareholders).[40] Particular emphasis is on protection of workers.[41] Even stronger accent is on employee participation, employees' information and consultation rights.[42] Thus, one can notice the trend of furthering the idea of building social business in Europe.[43]

In methodological terms, the EU is trying to enforce *ex ante* approach when dealing with company law and corporate governance issues. By asking for more equality, more disclosure and transparency, more diversity and more representation, it in fact aims at *preventing* problems before they actually occur. At the same moment, EU law protects vulnerable social groups from being underrepresented and thus socially marginalized (protective element) or cheated by those who hold stronger position in asymmetric social relations (publicity element). This way the EU has introduced a sort of "joint responsibility" of

[38] Möslein, F.: *Building Social Business in Europe*, European Company Law, 12(6), 2015, pp. 268–269.

[39] See DRAFT REPORT on the proposal for a directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions (COM(2018)0241 – C8-0167/2018 – 2018/0114(COD)), [http://www.europarl.europa.eu/meetdocs/2014_2019/plmrep/COMMITTEES/JURI/PR/2018/09-03/1161004EN.pdf], accessed on 9/10/2018. Hereinafter as: EP Draft Report.

[40] See in particular EP Draft Report, Amendment 1; EP Draft Report, Amendment 3, EP Draft Report, Amendment 23,; EP Draft Report, Amendment 49. see also Explanatory Statement, EP Draft Report, p. 88.

[41] See EP Draft Report, Amendment 2,

[42] See (in cogent manner) in particular the following amendments: EP Draft Report, Amendment 5,; EP Draft Report, Amendment 9,; EP Draft Report, Amendment 10,; EP Draft Report, Amendment 11,; EP Draft Report, Amendment 15; EP Draft Report, Amendment 16; EP Draft Report, Amendment 18; EP Draft Report, Amendment 20; EP Draft Report, Amendment 48; EP Draft Report, Amendment 59; EP Draft Report, Amendment 64; EP Draft Report, Amendment 65; EP Draft Report, Amendment 66; EP Draft Report, Amendment 68; EP Draft Report, Amendment 88; EP Draft Report, Amendment 119.

[43] As it has been well put by the EU Parliament: '' Employees are the most worth protecting stakeholders. They have a genuine interest of sustainability and long-term success of the companies as their jobs depend on the companies' success. In the light of the European Pillar of Social Rights, laws must upheld and strengthen the position and protection of workers and employees''. See EP Draft Report, p. 88; see also EP Draft Report, pp. 89-90.

the EU, the Member States and private actors – companies – for solving social issues. A state is not anymore sole responsible for social stability. Public and private factors have somehow split this task among themselves.

3. IMPLEMENTATION OF EU SOCIAL POLICIES *VIA* COMPANY LAW?

As company lawyers, we feel slight skepticism towards the idea of using company law and corporate governance as tools for achieving social aims. Yet, EU Company Law has "EU" attribution, which implies above-mentioned socio-economic component of EU law.

Recent trends are not result of some short-term idealistic viewpoint of the Commission. Even if we look purely formalistically, those trends are deeply rooted into EU's fundamental law. I.e. they have been approved by Member States themselves. Firm standpoint of the EU as social market economy was emphasized in Juncker's State of the Union 2016 speech and has marked his mandate.[44]

As consequence of the financial crisis, the way companies are governed is not considered only through economic lens. This paper has already stressed how pure shareholder-based thinking had a role in the problems that the EU faced.[45] Public and private interests are not (as it sometimes might seem) necessarily opposed. By developing shareholders' rights, market abuse prevention, employee participation, interconnection of business registers, transparency and disclosure requirements, EU Company Law and Corporate Governance contribute both to company's sustainability and public interests in general. Furthermore, efficient functioning of corporate governance and implementation of company law norms, as well as maintaining control guarantee efficient functioning of capital markets. This will eventually lead to attracting investments, higher economic growth and employment rate. Again, a company will benefit. The financial crisis taught us how non transparent operations under weak corporate governance can affect not only the company itself but the entire economy,[46] even on the global level.

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[44] See [http://europa.eu/rapid/press-release_IP-16-3042_en.htm], accessed on 9/5/2017.

[45] Mähönen, J.: *Law and Economics in European Company Law,* Working Paper Annual Legal Research Network, 2009., p. 3, [https://www.researchgate.net/publication/242174162_Law_and_Economics_in_European_Company_Law], accessed on 29/4/2018; Vives, A., *Corporate Social Responsibility: The Role of Law and Markets and the Case of Developing Countries'*, Chi.-Kent.L.Rev., 199(83), 2008, p. 207., [http://scholarship.kentlaw.iit.edu/cklaw-review/vol83/iss1/12], accessed on 16/7/2018.

[46] About the relationship between these factors see more in Hopt, K.; Wymeersch, E.; Kanda, H.; Baum, H. *Corporate Governance in Context: Corporations, States and Markets in Europe, Japan and the US*, Oxford, 2005.

The classical definition of the corporate governance includes the relationship between shareholders, creditors and corporations; between financial markets, institutions and corporations; and between employees and corporations.[47] In another words, corporate governance integrates both "social" element and "corporate" element. It is also a field in which artificial division among "corporate" and "social" seems futile. As *Hopt* expressed it metaphorically, this field is today one of the most active melting pots of economic, legal and social sciences research.[48] Companies are becoming socially responsible when they consider social, environmental, ethical, consumer and human rights concerns as part of business strategy and operations.

Issue of Corporate Social Responsibility (CSR) is also important for the sake of a company. In the ambit of EU law, the EU Directive on Non-Financial Reporting is an example and significant step towards making business accountable to society and it is major success for the corporate accountability. This Directive enhances transparency through obligatory disclosure of human rights policy, social and environmental risks in largest companies on the EU market because that information have the same impact as a disclosure of financial information. Management over a company tackles company's duties towards stakeholders in social, financial and ecological areas. Salaries policy, rewards and bonuses for managers stand in close relation to financial, social and ecological performances and correlate to social expectations of just and sound remuneration policy. That is exactly the reflection of the equilibristic idea of the founding treaties. As *Vitols* nicely pointed out "the growing interest in CSR is also a reflection of the recognition that shareholder value does not address social and environmental needs.[49]

In spite of affirmative viewpoint on infiltration of public interest into EU Company Law, some sort of balance between "social" and "economic" should be kept. Let us take one example.

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[47] Classens, S.; Yurtoglu, B., *Corporate governance in emerging markets: A Survey*, 2012, p. 4, [http://ssrn.com/abstract=1988880], accessed on 16/7/2018. One of the most used definitions of corporate governance is one given in OECD Principles of Corporate Governance first realized in 1998 and last time revised in November 2015. Available at [http://www.oecd.org/corporate/principles-corporate-governance.htm.], accessed on 16/7/2018. For other definitions see also Shleifer, A.; Vishny, R. W., *A Survey of Corporate Governance*, The Journal of Finance, 52(2), pp. 737-783, [http://www.jstor.org/stable/2329497], accessed on 16/7/2018. See also Hopt, K. J.; Leyens, P.C., *Board models in Europe. Recent developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy*, Law working paper no. 18, 2004, p. 3, [http://ssrn.com/abstract=487944], accessed on 16/7/2018.

[48] Hopt, K. J.: Comparative Company Law, in: Reimann, M.; Zimmerman, R. (eds.), *The Oxford Handbook of Comparative Law*, Oxford, Oxford University Press, 2008, p. 1187.

[49] Vitols; Kluge, *op. cit.* (ref. 1), p. 20.

Revised Shareholder's Directive introduced right of shareholders to cast binding or advisory vote on the remuneration policy of the directors of their company.[50] It is a clear tendency to grant additional shareholders' rights and result of contemporary tendencies around the world, which fight for enhancing shareholders rights.[51] Revitalization of private shareholders rights by granting them more rights (and facilitating their use at the same moment) is a modern tendency.[52] Nevertheless, this might show tricky as Swiss example shows.

In 2013 Swiss voters decided to introduce binding say-on-pay for shareholders of all publicly traded firms. The result was positive and referendum outcome was implemented into constitutional amendment. Although such public, direct democratic procedure has led to empowerment of shareholders, it in fact shaped investors' rights and interfered with, from the private law perspective, internal matters of Swiss companies. However, the fear of those same shareholders was that the directors might hold up – the directors' might feel reluctant to invest more incentive into decision –making. That may lead to lower firm value. As *Wagner* and *Wenk*[53] noted "while the idea of shareholder power may appeal to the public as a control mechanism, shareholders themselves may feel that less can be more when it comes to shareholders rights. Shareholder power reduces agency costs, but accentuates hold up problems."

Since revised Shareholders' Rights Directive leaves it for the Member States to enable binding and advisory say-on-pay, one should consider the consequences of such solution. Although shareholders believe that binding say-on-pay brings benefits, such model can affect negatively on managerial incentives.[54] Paradoxically, maintaining *status quo* concerning shareholder power might be better solution for shareholders than to maximize their powers.[55] In another words, shareholder democracy should not contravene shareholder's best interests. Moreover, any legislative proposals should take into concern economic implications of direct societal interference. As *Wagner* and *Wenk*[56] pointed out, tension within companies and companies and society should be mitigated.[57]

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[50] Revised Shareholders' Rights Directive, recital 29.

[51] Wagner, A. F.; Wenk, C., *Agency versus Hold-Up: Benefits and Costs of Shareholder Rights*, Financial Working Paper, No. 500, 2017, p. 31, [http://ssrn.com/abstract_id=1793089], accessed on 12/5/2018.

[52] Hopt, *op. cit.* (ref. 48), p. 1186.

[53] Wagner; Wenk, *op. cit.* (ref. 51), p. 9.

[54] *Ibid.*

[55] Wagner; Wenk, *op. cit.* (ref. 51), p. 36.

[56] Wagner; Wenk, *op. cit.* (ref. 51), p. 32.

[57] Mitigation of social tension at legislative level one can notice by refering to cross-border conversion. The protection of workers' rights in light of new proposal on cross-boder con-

From the legal perspective, private and public law rules should ensure effective regulatory framework. From the corporate governance perspective, beside the hard law rules, the self-discipline within a company and board can been achieved through the set of soft law rules.

There is a need for modern set of binding rules bearing in mind that soft-law rules[58] in the form of recommendations haven´t efficiently achieved certain goals. On the other hand, it must be born in mind that mandatory rules can reduce the focus on the substance of good governance and they can remove the key responsibility of boards and shareholders for the quality of corporate governance and reduce the governance to the compliance debate with the regulators. Formalistic "comply or explain"[59] approach leads to a legalistic board approach with no in-depth board discussion on the governance of firm but with lawyers and auditors that have to fulfill necessary formalities.[60] Again, introduction of rules urges for a balance between hard law and soft law solutions.

From the above considerations, we can conclude that corporate governance; in particular, CSR, as well as employee participation will continue to stand for key areas of EU Company Law in terms of further promotion of social objectives. [61] Previous experience has shown that it can be achieved *via* hard law approach as well. In fact, hard law instruments incorporating social note have shown to be more successful initiatives than mainstream company law proposals.

versions shows that social approach has been in focus of that regulation. See rec. 4 Proposal, Cross-border…

[58] About soft law see more in Bodiroga Vukobrat, N.; Horak, H.: Corporate Governance Codes – an instrument of the social responsible governance, in: *Socially Responsible Governance, Collection of Papers*, Zagreb, 2008., p. 201. See also Wymeersch, E.: Implementation of the Corporate governance Codes, in: Hopt, K; Wymeersch, E.; Kanda, H.; Baum, H., *Corporate Governance in Context: Corporations, States and Markets in Europe, Japan and the US*, Oxford, 2005.

[59] See more about "comply and explain" principle and the role of the corporate governance codes in Horak, H.; Bodiroga-Vukobrat, N.: *EU Member States´ Experiences with the „Comply or explain" Principle in Corporate Governance*, Croatian Yearbook of European Law and Policy, 7(7), Zagreb, 2011, pp. 179-200. See also Seidl, D.; Sanderson P., *Applying „Comply or explain": conformance with codes of corporate governance in the UK and Germany*, Centre for Business Research, University of Cambridge Working Paper No. 389 , 2009, p. 5., [http://www.cbr.cam.ac.uk/pdf/WP389.pdf], accessed on 14/5/2018.

[60] EcoDa „Comply or explain", Preserving governance flexibility with quality explanations, Report, EcoDa Annual Conference, 2012, p. 7., [http://www.ecoda.org/docs%20-%20OK/Conferences/2012_03_27%20Comply%20or%20Explain/2012AnnualConf-ecoDa-CoEreport.pdf], accessed on 14/5/2017.

[61] According to *Hopt*, the pros and cons of labor cp-determination will be one of the areas of future economic and legal research in the core comparative company law. See Hopt, *op. cit.* (ref. 48), p. 1187.

4. CONCLUSION

Last financial crisis revealed shortcomings of the model focusing solely on shareholders as key factors in corporate governance schemes. Trends in revisiting EU Company Law show shift from purely market-driven concept of company law to the stakeholder model of sustainable company. Clear call for more disclosure, more stimulation of institutionalized employee engagement and long –term investments, more care for gender diversity, as well as stronger control over directors' remuneration are some of the indicators of that shift. Such shift recognizes deep integration of European social model into Company Law. In the ambit of EU Company Law such shift has firm fundaments in primary and secondary law, with tendency to move forward towards even more holistic, integrative approach.

It is too early to predict how effective EU Company Mobility Package will be. We should wait and see implementation in practice. Some parts of this package stress the need to comply with objectives of European integration such as social protection (in particular the protection of workers). Inclusion of societal objectives into EU Company Law seems necessary for further development of EU Company Law and the EU should continue to include them into its legal corpus. In another words, sustainability of social values will eventually lead to sustainability of company law. In this context, CSR and employee participation seem to be an apt legal niche for further integration of social elements. Not only by means of soft law instruments but hard ones too.

Nevertheless, the EU still has not reached its paramount when it comes to achievement of social values through its law. It is obvious that ongoing work on CSR schemes and company law is going to continue with implementing social policy. Pending "Women on Boards" and "Working Parents and Caregivers" initiatives prove such thesis.

EU company law has been developing within EU social model. Even countries that are most immune to strict social models had to reconsider their positions and loosen their viewpoints. Artificial social de-contextualization of a company is not possible and certain level of infiltration of social interests is indispensable element of contemporary and future EU company law and corporate governance. Without integrative, socio-economic model of EU company law, company law will become poorer. As failed legislative initiatives of the Commission have shown, artificial division among labor law and pure, mainstream company law bring no good to further development of EU Company Law. EU Company law without its social component will be stuck in a deadlock.

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'OLD ECONOMY' RESTRICTIONS IN THE DIGITAL MARKET FOR SERVICES

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ABSTRACT

Freedom to provide services is one of the cornerstones of the EU internal market. Facilitated by the digital technologies, new and innovative service markets are emerging. However, innovations often bump into existing obstacles. Whether constrained by inadequate regulatory environment, or opposition from existing service providers in the market, the fact remains that 'old economy' is not ready for innovation. The free movement of services is not so 'free' when it is about services in a non-harmonized field or when the particular type of service is for some reason awarded a 'special' status in primary or secondary EU law. The services in the field of transport, for example, fall under the EU's competences in the field of common transport policy and their provision is still, to a large extent, left to the regulation at the Member States' level. The problem arises when innovative services, such as those associated with ICT and digital economy, are labeled as and molded into existing services, because there is simply no appropriate regulatory framework to recognize their innovativeness. This paper will analyze and critically evaluate the legal challenges of service provision in the online platform economy and offer possible guidelines for the creation of a suitable legal framework for their operation.

KEYWORDS: *free provision of services, EU internal market, digital economy, online platforms*

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1. INTRODUCTION

Innovation drives the economies for centuries. This Schumpeterian idea is especially evident in the last decades, with digitalization and technological innovations transforming the traditional business landscapes. This digital revolution and interconnectivity have provided us with the vast array of possibilities. Just as our phones have evolved into smartphones, anything from our cars and houses to whole cities and economy is becoming 'smart(er)' every day, powered by the new digital technologies.

The law and regulation can hardly keep up the pace with the accelerated digitalization of society. New legal issues in the digital era arise in all legal fields and entail profound changes of regulatory policies and legislative framework. The digitalization of economy is in full sway, so much that in its broadest meaning, the 'digital' economy may encompass practically every aspect of modern economy, because it is more or less affected by digitalization.[1]

Many economists and scholars have tried to define and conceptualize the notion of digital economy. Many different definitions have emerged since 1996 when Don Tapscott called it the "Age of Networked Intelligence"[2] and stressed that the "digital economy explains the relationship between the new economy, new business and new technology, and how they enable one another".[3] Broadly speaking, digital economy is an economy supported by digital technologies. However, there is no uniform definition. Bukht and Heeks observe that existing definitions are shaped and influenced by specific tendencies which evolve over time, from the first definitions mentioning the Internet to the latest definitions which are placing the accent on new technologies (e.g. mobile networks, cloud computing, big data…).[4] While the first definitions have been focused primarily on the phenomena of e-commerce, in the last five years the definitions have been more concerned with innovation, rights, cyber-security, and digital literacy.[5] The regulators and scholars are more focused on the policies for the regulation and sustainability of digital economy, then on providing a

[1] See International Monetary Fund (IMF), *Measuring the digital economy*, Policy paper, February 2018, p. 7, [https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/04/03/022818-measuring-the-digital-economy], accessed on 20/08/2018.

[2] See Tapscott, D.: *The Age of Networked Intelligence*, McGraw-Hill, New York, 1995.

[3] Bukht, R.; Heeks, R.: *Defining, Conceptualising and Measuring the Digital Economy*, GDI Development Informatics Working Papers, no. 68, Global Development Institute, The University of Manchester, Manchester, 2017, p. 6.

[4] *Ibid*., p. 4.

[5] *Ibid*., p. 8.

clear definition.[6] We can agree that digital technologies are the core part of the digital economy. However, it is difficult to draw the line between the economic activities forming part of the digital economy, and those left outside. For the purpose of our discussion, the definition of digital economy proposed by Bukht and Heeks best explains the digital economy as "that part of economic output derived solely or primarily from digital technologies with a business model based on digital goods or services".[7] This definition is wide enough to cover future developments in the digital area.

Lacking the common definition of digital economy has prompted economists who attempt to measure its effects to turn to a more 'palpable' term of digitalization of economic activity, to depict "the incorporation of data and the Internet into production processes and products, new forms of household and government consumption, fixed-capital formation, cross-border flows, and finance."[8] The IMF has therefore concentrated on measuring the much narrower 'digital sector', which comprises "online platforms, platform-enabled services, and suppliers of ICT goods and services".[9] This paper will examine the main legal challenges associated with the provision of services created and offered by "producers at the core of digitalization",[10] particularly platform-enabled services.

Digitalization of service provision raises many novel legal issues, not just those limited to data protection and liability of online service providers and online platforms. This paper will analyze whether the existing legal environment in the EU internal market is fit for digitalization of service provision and what legal and factual obstacles hinder the full potential of this sector. This research focuses on the effects of digitalization and innovation in the service provision, and not on the provision of digital services *per se* (such as cloud computing, big data, data mining and analysis or the Internet of Things). The innovative

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6 *Ibid*., p. 9.

7 *Ibid*., p. 13.

8 International Monetary Fund, *op.cit*., p. 1. See also OECD Digital Economy Outlook 2017, OECD Publishing, Paris [http://dx.doi.org/10.1787/9789264276284-en], accessed 21/08/2018.

9 "Platform-enabled services include the sharing economy, whose main components are peer-to-peer short-term property rentals and peer-to-peer labor services (e.g., Uber). Collaborative finance (e.g., peer-to-peer lending) may also be included in the sharing economy. Platform-enabled services to businesses in the "gig economy" include crowdsourcing platforms (e.g., Freelancer, and Upwork)." See International Monetary Fund, *op.cit*., p. 7.

10 *Ibid*., p. 7. On the provision of services in the platform economy see more in: Han, X.; Martinez, V.; Neely, A.: Service in the Platform Context: A Review of the State of the Art and Future Research, in: Smedlund, A.; Lindblom, A.; Mitronen, L. (Eds.): *Collaborative Value Co-creation in the Platform Economy*, Springer Singapore, 2018.

nature of the platform-enabled service provision collides with the traditional, 'physical' world barriers. The relation between an online intermediation service and the service which is actually being provided is especially interesting, because it entails the application of concurrent legal regimes. Should such services be treated independently or as composite parts of the same service? In the latter case, it seems that the (inevitable) material component of a certain service may inadvertently bring it back to the analog era and analog restrictions.

2. FREE PROVISION OF PLATFORM-ENABLED SERVICES IN THE DIGITAL ECONOMY

Free provision of services is one of the cornerstones of the EU internal market. Regulatory fragmentation has traditionally been one of the main obstacles in the internal market for services. Digitalization and innovative business models have introduced enhanced possibilities for the provision of services in all economic sectors. However, market access barriers, such as licensing requirements may still apply. It is all a matter of proper classification of a certain service. A provider of a service in the digital environment is faced with obstacles typical for that environment, concerning privacy protection and use of personal data, consumer protection, geo-blocking, liability, specific competition law issues, etc.[11] The position of online intermediation service providers is even more complicated. This is especially the case with the platform-enabled services. A platform may be deemed to be a provider of the underlying service, in addition to providing an information society service.[12] Such providers are then subject to the relevant sector-specific regulation, which in the end means that the provision of such services could be subject to limitations.

2.1. LEGAL FRAMEWORK FOR ONLINE PLATFORMS IN THE EU

Currently, there are no binding EU rules in force specifically addressing and regulating online platforms. However, the policy-making activity is in full sway.[13] The simplest definition of online or collaborative platforms can be dis-

[11] See, e.g. European Commission, Commission Staff Working Document: A Digital Single Market Strategy for Europe, SWD(2015) 100 final, Brussels, 6.5.2015, p. 53 and further.

[12] 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: A European agenda for the collaborative economy, COM(2016) 356 final, Brussels, 2.6.2016, p. 6.

[13] The most important Commission's communications and working documents concerning platform economy include: Communication from the Commission to the European Parliament,

cerned from the 2016 Commission's Communication "A European Agenda for the Collaborative Economy", that such platforms are intermediaries that connect providers with users and facilitate transactions between them.[14] In an earlier Communication from 2015, the Commission seems to rely on a more detailed definition of online platforms as "software-based facilities offering two-or even multi-sided markets where providers and users of content, goods and services can meet", such as communications and social media platforms, operating systems and app stores, audiovisual and music platforms, e-commerce platforms, content platforms and search engines.[15] Platforms 'related to the sharing economy' are included in this taxonomy as 'other types of platforms'.[16]

The versatility of online platforms (they "come in various shapes and sizes")[17] seems to cloud and obviate any attempt to find a suitable legal definition of the term. Instead, online platform service providers are left with the existing legal framework applicable to online intermediation services, which could fall within the scope of 'information society services'; or are otherwise placed under the regime applicable to the underlying service. In other words, platforms as intermediaries provide information society services; but sometimes, platforms are not mere intermediaries. The question is: when and under what circumstances do platforms 'outgrow' their intermediary role and what are the consequences?

the Council, the European Economic and Social Committee and the Committee of the Regions: *A Digital Single Market Strategy for Europe*, COM(2015) 192 final, Brussels, 6.5.2015; Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: *Online Platforms and the Digital Single Market Opportunities and Challenges for Europe*, COM(2016) 288 final, Brussels, 25.5.2016; Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: *A European agenda for the collaborative economy*, COM(2016) 356 final, Brussels, 2.6.2016, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the Mid-Term Review on the implementation of the Digital Single Market Strategy: *A Connected Digital Single Market for All*, COM(2017) 228 final, Brussels, 10.5.2017.

[14] See COM(2016) 356 final, p. 3.

[15] SWD (2015) 100 final, p. 52.

[16] SWD (2015) 100 final, p. 52.

[17] COM (2016) 288 final, p. 2. On the main characteristics of online platforms in the sharing/collaborative economy see Hatzopoulos, V.: *The Collaborative Economy and EU Law*, Hart, Oxford and Portland, Oregon, 2018, p. 8 and further.

2.1.1. INFORMATION SOCIETY SERVICES

An 'Information Society service' is "a service normally provided for remuneration, at a distance, by electronic means and at the individual request of a recipient of services" (Article 1(1)(b) of Directive 2015/1535).[18] 'At a distance' means that the service is provided without the parties being simultaneously present; 'by electronic means' means that the service is sent initially and received at its destination by means of electronic equipment for the processing (including digital compression) and storage of data, and entirely transmitted, conveyed and received by wire, by radio, by optical means or by other electromagnetic means; 'at the individual request of a recipient of services' means that the service is provided through the transmission of data on individual request (Article 1(1)(b)(i), (ii) and (iii) of Directive 2015/1535). Annex I of the Directive 2015/1535 contains an indicative list of services not covered by this definition. In essence, services not provided 'at a distance' are services provided in the physical presence of the provider and the recipient, even if they involve the use of electronic devices. Services not provided 'by electronic means' include services having material content, even though provided via electronic devices; or offline services; or services which are not provided via electronic processing/inventory systems. Services not provided 'at the individual request of a recipient of services' involve the so-called 'point to multipoint' transmission, such as television or radio broadcasting services. In any case, radio and television broadcasting services are also explicitly excluded from the scope of application of Directive 2015/1535 (Article 1(2) of Directive 2015/1535). Rules relating to matters which are covered by Union legislation in the field of telecommunication services, financial services and rules enacted by or for regulated markets are not covered by the Directive 2015/1535 (Article 1(3), (4) and (5)).

Directive 2015/1535 (colloquially referred to as the "Single Market transparency directive") has replaced and codified the Directive 98/34,[19] which has

[18] Directive (EU) 2015/1535 of the European parliament and of the Council of 9 September 2015 laying down a procedure for the provision of information in the field of technical regulations and of rules on Information Society services (codification), OJ L 241, 17.9.2015.

[19] Directive 98/34/EC of the European Parliament and of the Council of 22 June 1998 laying down a procedure for the provision of information in the field of technical standards and regulations, OJ L 204, 21.7.1998. Shortly after its adoption, Directive 98/34 was amended to include Information Society services (Directive 98/48/EC of the European Parliament and of the Council of 20 July 1998 amending Directive 98/34/EC laying down a procedure for the provision of information in the field of technical standards and regulations, OJ L 217, 5.8.1998), anticipating that the development of Information Society and national regulatory activity might give rise to restrictions on the free movement of services and the freedom of establishment and lead to a refragmentation of the internal market, over-regulation and regulatory

been substantially amended several times. Its aim is to prevent the creation of new technical trade barriers by requiring national authorities to inform the European Commission of any draft technical regulations[20] on products and information society services before they are adopted in national law. This allows the Commission to review their compatibility with the internal market rules and to detect potential protectionist measures and barriers to free movement before they are actually adopted and implemented in a certain Member State. In addition, under the so-called 2015/1535 Procedure, the Commission is able to assess the potential need for harmonized rules at EU level. Notified drafts are registered in the TRIS (Technical Regulation Information System) database and published online,[21] thus providing all interested stakeholders with the opportunity to submit their opinion during the standstill period whether the draft rule would present a technical trade barrier.

Given that the term 'technical regulation' covers also the rules on services, the Directive 2015/1535 clarifies what is meant under these rules. They imply a requirement of a general nature relating to the taking-up and pursuit of Information Society service activities, in particular provisions concerning the service provider, the services and recipients of services, excluding any rules which are not specifically aimed at those services (Article 1(1)(e) of Directive 2015/1535). The rule shall be considered to be specifically aimed at Information Society services where, having regard to its statement of reasons and its operative part, the specific aim and object of all or some of its individual provisions is to regulate such services in an explicit and targeted manner (Article 1(1)(f)(i) of Directive 2015/1535). Rules affecting Information Society services 'only in an implicit or incidental manner' shall not be considered as specifically aimed at such services (Article 1(1)(f)(ii) of Directive 2015/1535). The most common issue associated with the application of this Directive (and its predecessors) is whether a certain rule can be considered as a 'technical regulation' subject to

inconsistencies. The notification of technical regulations under Directive 98/34 in turn draw its background from an earlier Council Directive 83/189/EEC of 28 March 1983 laying down a procedure for the provision of information in the field of technical standards and regulations, OJ L 109, 26.4.1983.

[20] 'Technical regulation' means "technical specifications and other requirements or rules on services, including the relevant administrative provisions, the observance of which is compulsory, de jure or de facto, in the case of marketing, provision of a service, establishment of a service operator or use in a Member State or a major part thereof, as well as laws, regulations or administrative provisions […] prohibiting manufacture, importation, marketing or use of a product or prohibiting the provision or use of a service, or establishment as a service provider" (Article 1(1)(f) of Directive 2015/1535).

[21] European Commission, TRIS database, [http://ec.europa.eu/growth/tools-databases/tris/en/], accessed 30/8/2018.

the notification obligation. For example, in a recent case C-255/16, the Court of Justice of the EU[22] adjudicated that a national provision which provides for criminal sanctions where an unauthorized offer is made of gaming, lotteries or betting on the national territory does not constitute a technical regulation. However, a national provision which provides for sanctions in the event of advertising for unauthorized gaming, lotteries or betting, does constitute a technical regulation subject the notification obligation, because the object and the purpose of the latter rule is to extend a pre-existing prohibition on advertising to cover online gaming services.[23] The object and the purpose of the disputed rule, however, were not readily discernible from the national rule itself, but from the *travaux préparatoire* which has led to its adoption. Consequently, the wording of the national provision does not necessarily have to refer specifically to information society services, if this conclusion may be drawn by applying the relevant national rules of interpretation.[24]

A similar problem arose in the case Uber France,[25] where the national court was in doubt whether the national rules regulating the provision of taxi services could fall under the term 'technical regulation' subject to the notification obligation. This case brings us to the next issue, whether online sharing platforms can be considered as providers of information society services.[26]

2.1.2. ONLINE SHARING PLATFORMS AS PROVIDERS OF INFORMATION SOCIETY SERVICES?

The first case in which the CJEU had to decide on the nature of services provided by the infamous ride-sharing platform Uber was Uber Spain case.[27] The case started as a complaint about alleged infringement of the Spanish law on unfair competition, initiated by a professional taxi drivers' association in Barcelona against Uber Systems Spain. At the center of the dispute was the innovative online platform business model, which has caused a similar disruption

[22] Hereinafter referred to as 'CJEU'.

[23] CJEU, Case C-255/16, Criminal proceedings against Bent Falbert and Others, EU:C:2017:983, para. 37.

[24] In this case, the wording of the Paragraph 10(3)(3) of the Danish Law on gaming (prohibition of advertising for unlicensed gaming) was such that it neither explicitly referred to information society services, nor has drawn any distinction between services provided offline and services provided online. See Case C-255/16, para. 31.

[25] CJEU, Case C-320/16, Criminal proceedings against Uber France, EU:C:2018:221.

[26] This case will be further discussed in the next section (2.1.2.) of this paper.

[27] CJEU, Case C-434/15, Asociación Profesional Elite Taxi v Uber Systems Spain, SL, EU:C:2017:981.

in the traditional taxi sector all around the world. That business model relies on the provision of platform enabled-service which connects drivers with passengers in need of a ride in real time, through smartphone application, in a completely cashless transaction (online payment of a fare is made through the platform, which keeps its fee and transfers the rest to the driver). The model creates a triangular relationship between a driver, a passenger, and a platform, whereby the platform acts as an intermediary between the driver and the passenger.[28] The problem was that neither the drivers nor the platform possessed any administrative license or authorization for such passenger transport.[29] Without going into further details about the innovativeness of the business model or the technology which facilitates it, it is clear that it was bound to disturb the usual ways of doing business and put the national licensing requirements, along with the functioning of the internal market for services to the test. According to the CJEU, an intermediation service that enables the transfer, by means of smartphone application, of information concerning the booking of a transport service between the passenger and the non-professional driver using his/her own vehicle in principle meets the criteria for classification as an information society service. If classified as an information society service, Uber's platform-enabled service would benefit from the full scope of the free provision of services in the internal market, in accordance with Article 56 TFEU, Directive 2006/123 (Services directive[30]), Directive 98/34 (now Directive 2015/1535, Single market transparency directive) and Directive 2000/31 (E-commerce directive[31]). Any derogation of the free provision of such services has to be justified in light of the legitimate public policy objectives and proportionate. However, if it is something more than a mere intermediation service, it could be subject to the different legal regime. Since Uber connects passengers with drivers offering non-public urban transport services, such as taxi transport, this would be the legal regime for services in the field of transport. Services in the field of transport are exempt from the internal market rules on the free provision of services and fall under the common transport policy.[32] This means that where there is no common legal framework in the

[28] See Hatzopoulos, V.; Roma S.: *Caring for Sharing? The collaborative economy under EU Law*, CML Rev (2017) 54:81-128, p. 95.

[29] Case C-434/15, para. 14.

[30] Directive 2006/123/EC of the European Parliament and of the Council of 12 December 2006 on services in the internal market, OJ L 376, 27.12.2006.

[31] Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market, OJ L 178, 17.7.2000.

[32] Article 58(1) TFEU. See more in Bodiroga-Vukobrat, N.; Martinović, A.: *Disruption and the Law in the Digital World: Some Thoughts on the CJEU Uber Spain Judgment*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci (forthcoming).

EU for specific transport services, Member States are free to regulate the conditions under which such services (including intermediation services forming part thereof) are to be provided.[33] The CJEU concluded that the intermediation service provided by Uber must be regarded as forming an integral part of an overall service whose main component is a transport, and therefore has to be classified as a 'service in the field of transport' and not as an 'information society service'.[34] The CJEU relied on two main arguments to substantiate its conclusion that the 'physical', transport service prevails over 'digital', intermediation service: (i) without Uber, there would be no transport service (i.e. a new market is created); and (ii) Uber has a decisive influence over the conditions under which the service is provided.[35]

From this judgment on, platform-enabled services 'slipping' from the digital into the 'real' world are to be regarded as complex, composite services. Which regime is going to prevail will depend on the facts of the case and the guidelines provided by the CJEU's case-law.[36]

In the subsequent Uber France case,[37] the question was whether the French national legislation prescribing the terms for performance of non-public urban passenger transport, i.e. taxi services, should have been notified to the Commission before it was adopted, in accordance with (at the time applicable) Directive 98/34 on information society services. The provision of a national law laid down criminal penalties for the organization of a system for putting customers in contact with persons carrying passengers by road for remuneration using vehicles with fewer than 10 seats, without being authorized to do so.[38] The service in question consisted of putting, by means of a smartphone application and for remuneration, non-professional drivers in contact with passengers. Following the legal classification of the same service from the earlier Uber Spain case,[39] the CJEU concluded that such a service is more than an intermediation service, since the provider of that service fixes the rates and collects the fare for each journey from customer before transferring it to the driver of the vehicle. As such, it is part of an overall service, with transport being its main component. It was therefore deemed as a 'service in the field of

[33] Case C-434/15, para. 47.

[34] Case C-434/15, para. 40.

[35] Case C-434/15, para. 39. For further analysis, see Bodiroga-Vukobrat, N.; Martinović, A., *op.cit.*

[36] This issue will be discussed in the next section (2.2.) of this paper.

[37] Case C-320/16.

[38] C-320/16, para. 15.

[39] Case, C-434/15.

transport', which means that neither Directive 98/34 nor Directive 2006/123 on services was applicable in this case.

As far as the CJEU is concerned, the fate of Uber's platform-enabled service is sealed.[40] For other online platforms enabling services, the degree of control exercised by the online platform over the underlying service will be crucial for classifying the service provided by the platform either as an information society service, or as another type of service, depending on the nature of the material service performed.

2.2. DETANGLING COMPOSITE SERVICES

When online platforms enable the provision of other services (e.g. transport, accommodation, housework, or even intellectual services), we are faced with the problem of composite services. The concept of composite services is rather self-explanatory, but it is not a legal term. Advocate General Szpunar refers to composite services as those "comprising electronic and non-electronic elements".[41] According to him, when the electronic or online element has no self-standing economic value, or in the case of Uber, when the online platform service has no economic meaning without the transport component, it should be considered as a service in the field of transport. We agree with Adamski who states that this classification of online intermediation services as 'composite services' "leads to far-reaching fictions".[42]

However, the CJEU in its Uber Spain and Uber France judgments seems to avoid using the term 'composite service' and instead refers only to Uber's intermediation service as "integral part of an overall service whose main component is transport service".[43] The CJEU substantiates this conclusion by relying on its earlier case-law interpreting what is meant under the concept of services in the field of transport ('any service inherently linked to any physical act of moving persons or goods from one place to another by means of trans-

[40] Another preliminary reference concerning Uber's services Germany, which involved licensed drivers, but where the platform-enabled transport service contravened the German law on the transport of passengers was lodged by the German Bundesgerichtshof on 19 June 2017. However, following the Uber Spain judgment, the German court has decided to withdraw its request. See CJEU, Case C-371/17, Uber BV v Richard Leipold, Order of the President of the Court of 12 April 2018, EU:C:2018:313.

[41] Case C-434/15, Opinion of Advocate General Szpunar, EU:C:2017:364, para. 33.

[42] Adamski, D.: *Lost on the digital platform: Europe's legal travails with the digital single market*, CML Rev (2018) 55:719-752, p.743.

[43] Case C-434/15, para. 40.

port')[44]. It makes sense to avoid the argument concerning the self-standing economic value of the electronic component of the online intermediation service. It is really difficult to argue that the online intermediation service offered by Uber or similar platform has no economic meaning, because that argument simply cannot be substantiated through interpretation of the legal definition of information society services. A part of the definition of information society service is that it is provided 'by electronic means'. A service is provided by electronic means if it is "sent initially and received at its destination by means of electronic equipment for the processing (including digital compression) and storage of data, and *entirely* [emphasis added] transmitted, conveyed and received by wire, by radio, by optical means or by other electromagnetic means" (Article 1(1)(b)(ii) of Directive 2015/1535). An online intermediation service, whether it enables transport, accommodation, small home repairs, delivery or any other service actually *is* entirely transmitted electronically, as it represents an entirely new type of service (and market). The value lies in the service which enables another service.[45] It is valuable for the service recipients, as it makes it easier and more efficient to search for, book and pay for another service. It is valuable for the service providers, because it enables them to expand their market. So, it could be a win-win situation. The regulatory restrictions concerning the access to and conditions for the provision of services may still continue to apply on service providers, but not on the platform itself. By making the online connection subject to the legal regime applicable to the underlying 'physical' service, the digitally-enhanced innovation is annihilated.

2.3. THE NEXT STEP: PLATFORM-ENABLED ACCOMMODATION SERVICES

Uber Spain case will certainly be tested in an interesting case concerning another online platform, which is currently pending before the CJEU.[46] It concerns Airbnb, a digital platform connecting providers and recipients of short-term lease services. The Tribunal de grande instance de Paris has lodged the

[44] Case C-434/15, para. 36. The CJEU refers to its judgment in Case C-168/14 where it was found that the Services directive does not apply the activity of vehicle roadworthiness testing centres as it is ancillary, but indispensable to the exercise of the transport service. See CJEU, Case C-168/14, Grupo Itevelesa SL and Others v Oca Inspección Técnica de Vehículos SA and Generalidad de Cataluña, EU:C:2015:685, paras. 45 and 46.

[45] See more on this issue Schaub, M.Y.: *Why Uber is an information society service*, EuCML 3(2018), pp. 109-115, p. 113.

[46] CJEU, Case C-390/18, Criminal proceedings against YA and AIRBNB Ireland UC, Application, OJ C 294, 20.8.2018. See also Busch, C.: *The sharing economy at the CJEU: Does Airbnb pass the 'Uber test'?*, EUCML 4(2018), pp. 172-174.

preliminary reference to the CJEU on 13 June 2018, asking, primarily, whether the services provided in France by Airbnb Ireland via its electronic platform, which is operated from Ireland, fall under the freedom of services guaranteed by Article 3(2) of Directive 2000/31/EC (E-commerce directive).[47] The case originated from a complaint made by the Association pour un hébergement et un tourism professionnel (Ahtop) to the Public Prosecutor's Office that Airbnb is violating the rules of the French law regulating the activities of real estate brokers. The disputed rules prescribe criminal sanctions for entities that perform real estate brokerage activities without holding a proper license and adhering to other obligations prescribed under that law.[48] Airbnb claims that its activities do not represent a real estate brokerage and that the application of that French law would contravene with the E-commerce directive. Under the E-commerce directive, Member States may not restrict the freedom to provide information society services from another Member State.[49]

Airbnb is an online platform for accommodation services, connecting hosts with guests in need of accommodation. Virtually everyone can create a profile and use the Airbnb services as a host or guest, or both. Again, a triangular relationship between the host, the platform and the guest is created. A host is the non-professional accommodation service provider, who can list his or her space (entire home or room) for free at the Airbnb online platform in just a few easy steps.[50] The host controls availability, prices,[51] house rules, check-in time, model of interaction with guests, etc. For its services, Airbnb charges host and guest service fees. The responsibility for complying with the local rules, conditions or restrictions for short-term rentals lies entirely on the individual host.[52] Like Uber, this business model has also provoked tectonic changes in the industry. In the case of Airbnb, the accommodation sector of the hospi-

[47] Case C-390/18.

[48] See Busch, C., *op.cit.*, pp. 172-174. The facts of the case presented here are based on Busch's account in the above mentioned comment, as there was no other available information on this case at the time of writing of this paper.

[49] Article 3(2) Directive 2000/31. E-commerce directive refers to the definition of information society services from Directives 98/34/EC and 98/48/EC (now Directive 2015/1535).

[50] Airbnb official website, [https://www.airbnb.com/host/homes?from_footer=1], accessed 28/8/2018.

[51] The host can choose to apply the Airbnb Smart Pricing tool, which is based on the type and location of the listing, season, demand, nearby events and other factors, and which allows for automatic raising or lowering the prices based on changes in demand for similar listings.

[52] However, Airbnb may be responsible for advertising unregistered holiday rentals; see "*Airbnb fined 300,000 euros by the Balearic government*", [https://majorcadailybulletin.com/news/local/2018/02/19/50973/airbnb-fined-300-000-euros-the-balearic-government.html], accessed 28/8/2018.

tality industry is now, in principle, open to any homeowner. The downside is that the profitability of short-term holiday rentals has an adverse effect on the housing markets, as it reduces the number of available long-term housing at affordable prices. This concern has led many communities to impose strict(er) rules on short-term rentals.[53]

At first glance, the service provided by Airbnb is a service normally provided for remuneration, at a distance, by electronic means and at the individual request of a recipient of services. Therefore, it easily fits within the scope of 'information society services', to be provided freely and without obstacles, subject to the notification obligation of new technical rules. However, if we remember the reasoning applied in the Uber Spain judgment, we have to take a look whether the service offered by Airbnb is more than a mere intermediation service. In other words, is it a composite service? To answer this question, the CJEU will probably apply the 'new market' and the 'decisive influence' or degree of control test developed by the CJEU in the Uber Spain judgment.[54]

It is important to note that accommodation, which is the underlying service here, is not subject to any special legal regime in EU law. It falls under the free provision of services in the internal market, subject to primary[55] and secondary[56] EU law sources. A recently published study on the legal framework applicable to accommodation sector in the collaborative economy in the EU Member States has revealed that this sector is governed by "a range of pre-existing regulatory frameworks which have not been tailored to the collaborative economy".[57] In other words, national authorization or registration requirements concerning accommodation service providers and concerning the collaborative platforms are not adapted to new business models in the digital economy environment.

And what about other services, such as delivery? For example, online platforms are increasingly used for delivery services, for anything from food[58]

[53] For an overview of applicable restrictions in the major tourist hot-spots see "*What Airbnb really does to a neighbourhood*", [https://www.bbc.co.uk/news/business-45083954], accessed 28/8/2018.

[54] Case C-434/15, para. 39. For a further discussion on this case see Busch, C., *op.cit*.

[55] Articles 56 – 62 TFEU.

[56] Primarily the Directive 2006/123 on services.

[57] For a detailed account of the regulatory framework applicable to collaborative economy in the accommodation sector in the EU Member States see European Commission, Study on the assessment of the regulatory aspects affecting the collaborative economy in the tourism accommodation sector in the 28 Member States (580/PP/GRO/IMA/15/15111J), 2018, p. 154, [https://publications.europa.eu/en/publication-detail/-/publication/784303f0-5271-11e8-be1d-01aa75ed71a1/language-en/format-PDF], accessed 26/8/2018.

[58] Such as Deliveroo, Foodora, Doordash, etc.

to marijuana.[59] 'New' online-food delivery platforms are creating new markets,[60] as they include restaurants that do not have traditional delivery and customers who might not order a takeaway were it not so readily available by means of a smartphone application. Many of these platforms set delivery prices and provide their driver partners with high-quality gear like phone holders, protective clothing, helmets and lights, all with the platform's distinctive colors and logo attached.[61] It seems that none of these platforms would pass the CJEU's Uber test.

3. PLATFORMS AS PROVIDERS OF ONLINE INTERMEDIATION SERVICES

In April 2018 the Commission has prepared the proposal for a Regulation of the European Parliament and the Council on promoting fairness and transparency for business users of online intermediation services.[62] The general objective of the draft Regulation is "to establish a fair, predictable, sustainable and trusted online business environment, while maintaining and further encouraging an innovation-driven ecosystem around online platforms across the EU".[63] The Commission acknowledges that online intermediation services can be crucial for the commercial success of undertakings that use and depend on such services to reach their customers.[64] The proposal therefore aims to regulate platform-to-business (P2B) relations, in particular to ensure appropriate transparency through various requirements concerning the terms and conditions of use of such platform services and effective redress possibilities. Online search engines are also covered by the scope of the draft Regulation.

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[59] In countries where marijuana is legalized for medicinal purposes, such as Eaze, GreenRush, Baker, etc.

[60] See Hirschberg, C. *et al.*: *The changing market for food delivery*, [https://www.mckinsey.com/industries/high-tech/our-insights/the-changing-market-for-food-delivery], accessed 25/8/2018.

[61] See for example [https://deliveroo.co.uk/apply?utm-campaign=ridewithus&utm-medium=organic&utm-source=landingpage] or [https://www.doordash.com/dasher/signup/], accessed 26/8/2018.

[62] European Commission, Proposal for a Regulation of the European Parliament and of the Council on promoting fairness and transparency for business users of online intermediation services, COM(2018) 238 final, Brussels, 26.4.2018.

[63] COM(2018) 238 final, p. 7.

[64] See Recital 2 to the Proposal for a Regulation of the European Parliament and of the Council on promoting fairness and transparency for business users of online intermediation services 2018/0112(COD).

However, the platforms as providers of online intermediation services covered by this initiative include in principle online e-commerce market places, online software application stores and online social media. Their main common features identified by the Commission are that they allow for an online presence of business users that offer goods and services to customers, without those business users being required to operate their own website and that they frequently facilitate direct communications between individual businesses and consumers, through an embedded online communications interface.[65] In this context, it is interesting to analyze the new legal definition of 'online intermediation service' from Article 2(2) of the draft Regulation. According to that provision, 'online intermediation services' means services which cumulatively meet all of the following requirements: (a) they constitute information society services within the meaning of Article 1(1)(b) of Directive 2015/1535; (b) they allow business users to offer goods and services to consumers, with a view to facilitating the initiating of direct transactions between those business users and consumers, irrespective of where those transactions are ultimately concluded; and (c) they are provided to business users on the basis of contractual relationship between, on the one hand, the provider of those services and, on the other hand, both those business users and the consumers to which those business users offer goods or services.[66] 'Business user' means any natural or legal person which through online intermediation services offers goods and services to the consumers for purposes relating to its trade, business, craft or profession.[67]

The intention was to define online intermediation services "in a precise and technologically-neutral manner"[68]: the accent is on the fact that they involve information society services which aim to facilitate direct transactions between business users and consumers, regardless whether the transaction is ultimately concluded on the online portal of the provider of online intermediation services or of the business user; or offline. Examples, as included in Recital 9 of the draft Regulation, include "online e-commerce market places, *including collaborative ones in which business users are active* […]" (emphasis added).

[65] COM(2018) 238 final, p. 1.

[66] Article 2(2) of the Proposal for a Regulation of the European Parliament and of the Council on promoting fairness and transparency for business users of online intermediation services 2018/0112(COD).

[67] Article 2(1) of the Proposal for a Regulation of the European Parliament and of the Council on promoting fairness and transparency for business users of online intermediation services 2018/0112(COD).

[68] See Recital 8 to the Proposal for a Regulation of the European Parliament and of the Council on promoting fairness and transparency for business users of online intermediation services 2018/0112(COD).

Regulation does not apply to online advertising serving tools or online advertising exchanges or to online payment services.[69]

It is not entirely clear what is meant under the inclusion of collaborative market places on which business users are active. It certainly involves collaborative platforms for the sale of handmade goods, such as Etsy, Amazon Handmade, but what about collaborative platforms for the provision of services? Since the definition of 'online intermediation service' refers and depends on the existence of 'information society service', we will be left with the CJEU's Uber line of case law to deal with this issue.

4. CONCLUSION - "OLD" RESTRICTIONS OR NEW CHALLENGES

From all of the above, it seems that 'real' online intermediation services will be rare in case of platforms acting as intermediaries for services.[70] This is unsatisfactory for all the reasons presented above. It is inherent in the nature of intermediation services to be closely related with the underlying service. Despite the limitation of liability for the performance of the underlying service itself, a platform will have to establish and keep a certain degree of influence over its providers, because its business model rests on the trust of service recipients that the platform is the easiest way to connect with the reliable service providers.[71] However, that does not mean that platforms should be treated as the providers of underlying services. For sharing platforms, the online intermediation is not just a part of the service or model of operation, it is the main economic reason for their existence. Both service providers and service recipients pay a fee for this service. The technology has enabled a quick and

[69] Online advertising serving tools or advertising exchanges do not aim to facilitate direct exchanges between businesses and consumers, whereas online payment services are auxiliary to the transaction for the supply of goods and services to the consumers. See Recital 9 to the Proposal for a Regulation of the European Parliament and of the Council on promoting fairness and transparency for business users of online intermediation services 2018/0112(COD).

[70] Advocate General Szpunar mentions platforms for the purchase of flights or hotel bookings as examples of 'real' online intermediary services, where the "supply made by the intermediary represents real added value for both the user and the trader concerned, but remains economically independent". Opinion of Advocate General Szpunar in Case C-434/15, para. 34. However, if this argument is accepted, it would mean that only platforms that create virtual marketplaces for e-commerce would be online intermediaries, while platforms creating new markets would not.

[71] Codagnone and Martens present a systematic review of literature concerning the real motivation of consumers for participating in sharing platforms, see Codagnone, C.; Martens, B.: *Scoping the sharing economy: Origins, definitions, impact and regulatory issues*, Institute for prospective technological studies, Digital economy working paper 2016/1. JRC100369, 2016, p. 19 and further.

more efficient way of connecting service recipients with service providers. Assimilation of new, innovative digital services with the 'old', physical services means applying 'old' restrictions under the existing legal framework to them. It is necessary to adopt new legal instruments capable of dealing with emerging challenges associated with new technologies. This is indispensable if the EU is to deliver on its promise of unlocking the full potential of the digital single market. We believe that, in the case of platforms such as Uber, Airbnb, etc., the legal framework regarding the liability of platforms to ensure that providers of services possess the necessary licenses and authorizations should be strengthened. However, even under the existing legal framework, as argued above, it is not plausible to treat these platforms as providers of transport or accommodation services.

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    – DOI: https://doi.org/10.1787/9789264276284-en

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THE POTENTIAL IMPACT OF BLOCKCHAINS ON CORPORATE GOVERNANCE: A SURVEY ON SHAREHOLDERS' RIGHTS IN THE DIGITAL ERA

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ABSTRACT

Blockchains offer a revolutionary application of cryptography and information technology to old financial record-keeping issues while forging great hopes with regard to lower cost, greater liquidity, more accurate record-keeping, and transparency of ownership. There is also an increasing demand from individual companies to employ blockchains in their activities as some stock exchanges see blockchain technology as a new method for trading corporate equities and tracking their ownership.

At the same time, an expanded use of this new technology may introduce new risks on the market and lead to far-reaching changes in corporate governance. The end of anonymity is one of these issues but other corporate governance issues may be raised. While EU regulation regarding shareholders' rights is moving forward, these risks have not been taken into account so far: the potential impact blockchains may have on shareholders' protection in the EU Market and elsewhere is absent. European institutions seem to have dodged consideration of this impact.

This paper evaluates the potential implication blockchains may have in a near future, assessing whether and how this new technology may modify the balance of power among managers, institutional investors, small shareholders, proxy advisors and other parties involved in corporate governance.

KEYWORDS: *blockchains, corporate governance, shareholders, managers, proxy advisors, check and balance, voting rights, EU Directive, third parties.*

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1. INTRODUCTION

Soon, BC technology may offer a significant alternative to classical ownership ledgers, an important topic which is worth dealing with on a legal perspective. In the last years, the Blockchain technology has grown in reputation, trending in the press and on social media. As a result, more and more companies rely on that technology in order to provide new products and services. The Fintech industry illustrates the use of the Blockchain technology to provide enhanced payment, banking and financial services[1]. To facilitate the implementation of these new services, some actors require changes in regulation. Some even argue that the rise of the Blockchain is likely to put an end to the need of any legal system, quoting Lawrence Helsing without fully understanding him[2], under the famous "Code is Law"[3] and its derivative, *Lex Cryptographica*[4]. No more judges and no more central authorities needed under a transparent, secured and autonomous organization[5]. Conversely, voices are rising to claim that the Blockchain is only a trend in social media and should soon vanish, as is the fate of many other trends before.

On a more moderate tone, we think on the contrary that the Blockchain is a new and promising technology that will only slightly alter corporate law. It is not, however, a new paradigm. On the one hand, the technology increases

[1] For instance, the Depositary Trust and Clearing Corporation (DTTC), the leading company in Post-trade services has announced the launch of a Credit Default Swap register based on distributed Ledger Technology.

[2] As the author explains in his paper that the architecture of the code is able to reflect the value – or the absence of value – of a society, protecting or denying protection for privacy or other fundamental rights.

[3] [https://harvardmagazine.com/2000/01/code-is-law-html], accessed on 28/08/2018.

[4] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 32, p. 49 and p. 193: Lex Cryptographica is the idea that the best regulator in a technological infrastructure is the code of that infrastructure itself. The use of the technology can be shaped in order to forbid technically unwanted use of the technology (as illegal music downloading), thus lowering the need of human regulation.

[5] De Fillippi P., Wright A., Ibid., p. 194 : the authors express the idea that "Technical rules could increasingly assume the same role and functionality as legal rules". The authors advocate the use of technology to achieve more predictable rules as opposed to law written in natural language. But these advantages must be carefully balanced. First, the implementation of the rules into the code would forbid a user to commit a breach of the law. the virtue of perfect predictability is minored by the fact that no adjustment can be made in order to ensure the rights of the user to their particular situation. Second and more importantly, such a system is dangerous in regards to the respect of fundamental rights. A free state is is based on a liberty principle where the citizen are free to act but would suffer the punishment for a breach of law. Liberty means fundamentally an ex-post control system, not an ex-ante system where liberty would be immediately hampered by the code.

efficiency in exchanges and group organization, especially in the organization of corporations. On the other hand, it could be detrimental to certain aspects of the Law and could facilitate fraud and money laundering. As many technologies before, especially the Internet, blockchain will bring forth legal changes only if its use is deemed beneficial.

But what is a Blockchain? Blockchain technology has been implemented by a person or group called "Satoshi Nakamoto", alongside with a paper explaining the technical aspects of the technology and its purpose: "Bitcoin: A Peer-to-Peer Electronic Cash System"[6]. The main purpose of the Bitcoin is to settle a global database permitting the exchange of a new digital currency called "the Bitcoin". The decentralized characteristic of the technology should bring an end to the need for a Third-Party such as a central bank[7]. A decade later, a new system called Ethereum was born with new functionalities such as a better use of Tokens and the implementation of "Smart Contract" enabling the coding of a growing number of applications[8]. Rather than a new technology, it is the improvement of the former as it will be itself the root of further improvements.

The Blockchain system works as a Peer-to-Peer system, a system where all participants act as a supplier and consumer of information, as opposed to a server-based system where a central server furnishes the information to all clients. The system by itself possesses a certain number of characteristics, in order to establish an autonomous system, which does not rely on a central authority. The Blockchain needs to combine both a high level of security based on cryptography and the absence of third-party acting as central authority[9]. To settle an efficient and autonomous system, the Blockchain relies on nodes: basically, computing power used to create hash codes to link each new block to the chain. This activity is called "mining" as it allows the owners of the nodes to collect bitcoins or other tokens[10]. It is not the purpose of this paper to expla-

[6] [https://bitcoin.org/bitcoin.pdf], accessed on 28/08/2018.

[7] The Bitcoin was a response to the financial crisis of 2008 resulting in a trust-crisis toward central authorities and the banking system.

[8] [https://github.com/ethereum/wiki/wiki/White-Paper], accessed on 28/08/2018.

[9] Before the Bitcoin they were digital currencies. But to avoid the issue of double spending, they relied on a central authority. As a matter of fact, a digital currency is merely a sum of bits. An actor who own 5 of them can send 5 to a friend and 5 to another friend. No one is able to know that this actor has effectively spend its 5 coins. Therefore, he was able to send 10 coins. He has committed a fraud, spending more coins that he owns and created inflation. It is the basic issue of forged money. Hence the need of a central authority to whom all the transactions will be send for regulation.

[10] Each transaction is put in a block which is chained to the previous block. That block use the hash code of the previous one (acting as a timestamp) and will get its own hash code based on the transactions that are coded inside. To code it, several node proceeds by creating the

in how the system function since it has already been explained[11]. Nevertheless, the fundamental purpose of a Blockchain must be summarized to confront them to Corporate Law and Corporate Governance.

Basically, a Blockchain is a Public Register (1) that can both offer a way to exchange assets (2) and establish complex organizations and governance systems (3).

1. Public Register: by itself, the Blockchain is a Public Register. The Public feature of the Blockchain is required to achieve transparency. As there is no third party or central authority overseeing the system, the public itself must be able to access all the transactions occurring on a blockchain, either to use them (as nodes do) or to supervise them. Each Blockchain can therefore be downloaded by all users, containing all the past transactions since its creation. The Register can also allow access to more complex information such as music or pdf files, medical information[12], *etc*. However, the fundamental feature of this function is the inalterability of the register, which participates in its security. In order to manipulate the register, it would be necessary to change all the past history of the register on a global scale: each and every version of the blockchain on all existing and active nodes would have to be similarly impaired. Such a manipulation would need an overwhelming computing power to "mine" new blocks in a more efficient and incentive way [13]. At last, the inalterability of the blockchain can allow the dissemination of authenticated information such a personal data or bank account information[14].

2. Exchange Function: The second function of a Blockchain is to allow the exchange of assets. From a rather simple asset such as the Bitcoin to more developed one allowed by Ethereum, Blockchains allow a secured way to exchange resources. Blockchain allows also the use of tokens – called Ether for Ethereum – which represent a right to a given service or the use of a

hash with a Proof-of-Work system. The first node that manage to find a solution send it to all the other nodes. The new block is chained to the others and a new version of the blockchain is downloaded by all the other nodes. Tokens and transactions fees are transferred to the node who first found the solution as an incentive.

[11] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 13-32.

[12] For instance MedRec: [https://ieeexplore.ieee.org/abstract/document/7573685/], accessed on 28/08/2018.

[13] Therefore, one who would possess such a computing power will earn more by using the power to the benefit of the system rather than to its detriment.

[14] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 18.

prerogative such as a vote in a general meeting or the right to receive dividends. The exchange Function can be more sophisticated with the use of smart contracts, which allow automatization of exchanges. Using a single rule of "If… then…", a smart contract is a program functioning on the basis of Tokens. If a specific condition is fulfilled, the program will proceed by sending or blocking the use of an amount of Token or money. Such smart contracts can be linked together to build complex organization, where validation by the first is needed in order to use the second (and then third, and so on…). Such exchanges lower transaction costs as no intermediaries are needed, execution of contracts is instantaneous. Moreover, markets functioning on blockchain would access full efficiency as demonstrated by Fama[15], given that certified information is accessible on real-time and without cost. As information and trading cost are equal to 0 on such a market, the price of the tokens will reflect perfect economical value of the underlying assets.

3. Organization and Consensus Facilitation: The global use of smart contracts leads to completely automatized and decentralized organization. The use of blockchain can facilitate the coordination of a social activity. A social institution is based on a collective idea put in motion by given governance and a decision system[16]. Some companies allow the automatization of governance systems such as the French Republic Constitution[17]. In theory, a business corporation could be organized solely on blockchain. The system would allow shareholders to register their titles in the blockchain and cast votes during purely virtual general meetings.

As previously described, a blockchain needs not a third-party to operate. Nonetheless, it is possible to restrain a blockchain by allowing a central authority to oversee it. Such a blockchain will lose its public and autonomous functions as the central authority will be able to supervise the transaction by itself, to unilaterally alter how the code functions and limit access to the blockchain[18]. Such "private" blockchain are referred under the term of "permissioned blockchain"[19]. Notwithstanding the loss of the philosophy behind the bitcoin in such a system, it remains a blockchain.

[15] Fama E., Efficient Capital Market: A review of Theory and Empirical work, The Journal of Finance, 25(2), 1970, p. 383; Fama E., Efficient Capital Markets: II, The Journal of Finance, 46(5), 1991, [https://doi.org/10.1111/j.1540-6261.1991.tb04636.x], p. 1575.

[16] To summarize the idea behind Maurice Hauriou institution: Millard E., *Hauriou et la théorie de l'institution*, Droit et société, 30-31, 1995, p. 381.

[17] [http://klsn.io], accessed on 28/08/2018.

[18] As it is the case for DTCC, for instance.

[19] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 31.

What is the potential impact on corporate law and corporate governance? The rights traditionally granted to shareholders by law are principally exercised at the annual general meeting. These rights are twofold and comprise voting rights on one part, and financial rights on another. Closely connected to these two sets of rights, the information rights are also granted by law in order to make votes and financial rights more efficient, with legal intent prevailing over black-letter law.[20] Beyond legal aspects, these rights are a strong element of corporate governance too, mainly the mainstream version of it, the 'shareholder primacy model'.[21] This corporate governance model, focusing on the primacy of shareholders, seeks to maximize shareholder wealth and consequently avoid the existence of informational asymmetries between managers and shareholders. Emerging in the specific economic context of the 'modern corporation' fathered by Berle and Means[22], it refers to large-scale manufacturing corporations in the wake of the second industrial revolution. It points out the lack of control on managers and potential conflicts of interests, occurring when managers act in their own self-interest -allocating high remuneration packages to themselves for example-, and extract benefits from the company. [23] First developed in the United States, this theory later spread all over the world where a growing need for capital to build large infrastructure projects existed.[24] Although this mainstream version of corporate governance model was challenged by other models[25], pursuant to the Dodd doctrine[26], it became the 'dominant ideology'[27] in practice.

[20] Germain, M. and V. Magnier, Ripert et Roblot, p. xxx.

[21] Magnier V.: *Comparative corporate governance. Legal Perspectives*, Elgar ed., 2017, p. 15.

[22] Berle A.A. and G. Means: *The Modern corporation and Private Property*, New York, Harcourt, revised ed. 1968.

[23] Jensen M.C.; Mekcling, W.H., *Theory of the firm: managerial behavior, agency costs and ownership structure*, Journal of Financial Economics, 1976, 3, p. 305.

[24] Dignam, A. and M. Galanis: *The Globalization of Corporate Governance*, Farnham, Ashgate Publishing, 2009; Gomez, P.-Y. and H. Korin: *Entrepreneurs and Democracy: A Political Theory of Corporate Governance,* London Business School, 2011.

[25] Blair M.M; Stout, L.A: *A team production theory of corporate law*, Virginia Law Review, 1999, 2 (85), p.238; Blair, M.M: *Shareholder value, corporate governance, and corporate performance: a post-Enron reassessment of the conventional wisdom*, in Cornelius P;K. Kogut B. eds: Corporate governance and capital flows in a global economy, Global outlook Book series, Oxford University press, 2003, p.53; Millon in Vasudev, P.M; Watson, S,: *Corporate governance after the financial crisis*, Edward Elgar, 2012.

[26] Dood E., *For whom are Corporate Managers Trustees?,* Harvard Law Review, 45, 1932, p.1145.

[27] Hansmann H. and R. Kraakman: *The End of History for Corporate Law*, Georgetown Law Journal, 89, 2001, p. 439.

The right to vote and its corollary, the right to information, are a major concern to legal policy makers, be it hard of soft law. At the international level, the OECD Corporate governance Principles are a noticeable first attempt at establishing a universal set of principles for companies operating worldwide, with respect to sustainable economic growth. [28] Whereas the OECD broadly defines corporate governance as 'a set of relationships between company's management, its board, its shareholder and its stakeholders', the principles focus on classical governance issues resulting from the separation of ownership and control. They mainly promote common rights and an equitable treatment for shareholders, with respect to shareholders access to information, to cross-border voting rights and the importance of fair and effective price discovery in stock markets. Following the same path, the EU institutions have issued the Shareholder Rights Directive 2007/36[29] revised in 2017.[30] These texts have sought to facilitate the effective exercise of rights for shareholders in a globalized world. The revised 2007/36 Directive, amended by the xxx Directive, goes further so as to fill certain governance gaps in relation to the behavior of companies and their advisors, shareholders, proxies and proxy voting agencies. Member States have xxx years to implement the revised directive. France has done so with the Act xxx that will be discussed in the next sections of this paper. [31]

How BC may impact corporate law and corporate governance? Whereas this question is precisely the focus of this paper, it first advocates for a quick overview of the literature considering the general impact of blockchains on law and the various ways in which the two interact.

Blockhain technology is a typical record-keeping mechanism[32] and as such may be considered as a '21st century version of the recording systems that have been around since people started chiseling marks on cave walls'.[33] In parallel, it is strongly argued that blockchains offer a revolutionary application of cryp-

[28] OECD Principles of corporate governance, 2014 version, [www.oecd.org/corporate/2014-review-oecd-corporate-governance-principles.html.

[29] 2007/36 Directive, Magnier V., La démocratie actionnariale, D. 2007, p.x

[30] 2017/828 revised Directive on shareholders rights [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0828&from=EN]

[31] Barban P. : *L'identification des actionnaires,* Revue des sociétés, 12, 2017, p. 678; *adde* Germain M. *et alii* : *Corporate governance in listed companies*, Fondation nationale pour le droit continental, Semaine juridique, Entreprise et affaires ed,, 47, nov. 2013, 1639, p.22.

[32] Among good other references, refer to chapter one entitled 'Blockchain technology basics' in Casey M. *et alii* eds : *The Impact of Blockchain Technology on Finance: A Catalyst for change*, Geneva Report on the World Economy, ICBM and CEPR, 21, 2018, p. xxx.

[33] Cecchetti C *et alii* : *Finance and blockchain*, [online ref] accessed on 08/28/2018

tography and information technology.[34] The key question is the following: would this new technology impact law so as to transform law in such a way that it could be embedded in code? A big debate started on this subject a few years ago. On the one hand, most authors agree upon the absence of 'neutrality' of the blockchain technology. It is more generally the technological artifacts that are said to be not neutral. At least, two dimensions should be accoutered for justifying this non-neutrality.[35] First, technology design is not neutral: [36] whatever the presence of any intention behind a technological artifact, its design ends up imposing some types of actions or, on the opposite, preventing or even forbidding others.[37] Second, they are politically-oriented. Put another way, the adoption of a specific technology, among others, reveals and influence the social and historical context in which this technology operates.[38] Consequently, not only the choice of a blockchain regime would influence law, due to its particular design, but also the way it would be adopted would have great social and political (and legal) implications. In other words, like any other technological artifacts, blockchain is not neutral but 'inherently political'.[39] On the other hand, authors go even further and have recently come up to argue that 'code is law'. This quote is referring to the idea that due to the highly performing codification process permitted by blockchains, code seems to be an extremely performing way to complete and even replace regulation.[40] The last state of thoughts describes how law and code so interact that the blockchain is progressively meant to acquire 'the status of a regulatory technology', i.e. 'a technology that can be used both to *define* and *incorporate* legal provisions into code, and to *enforce* them.'[41] Ultimately, such a system would happen 'irrespectively of whether or not there subsists an underlying legal rule'.[42] The authors do not say how this is feasible or desirable.[43] Regardless of the fact that

[34] Among good other references see De Filippi P. ; Hassan, S. : *Blockchain technology as a Regulatory Technology : from code is law to law is code,* unpublished paper [ssrn ref]

[35] De Filippi P.; Hassan S. : see ref. note xxx

[36] Winner, L.: *Do artifacts have politics?,* Daedelus, 1980, p. 121.

[37] See examples in Smith, N.: *The new urban frontier: gentrification and the revanchist city*, Psychology press, 1996 ; Winner 1980 (see ref. note xxx).

[38] Jeorges, B.: *Do politics have artifacts?,* Social studies of science, 29, 1999, p. 411.

[39] Mowshowitz, A.: *Computers and the myth of neutrality,* Proceedings on the ACM 12th annual computer science conference on SIGCSE symposium, 1984, p. 85.

[40] De Filippi, P.; Hassan, S. (see ref. note xxx).

[41] De Filippi, P.; Hassan, S. (see ref. note xxx).

[42] De Filippi,P .; Hassan S. (see ref. note xxx).

[43] For further discussion, see Yeung, K.: *Regulation by Blockchain: The Emerging Battle for Supremacy between the Code of Law and Code as Law* (July 2, 2018). Modern Law Review, Forthcoming. Available at SSRN: https://ssrn.com/abstract=3206546

policy makers would not agree to abandon part of their authority to code, and judge would be still be needed to interpret general or ambiguous rules, costs of this process should be evaluate first. At least, costs of the proof of work needed to update the blockchain, like computer hardware and electricity, should be accounted for first. We doubt this could be achieved in a near future. Therefore, we adopt a more realistic and balanced view of the interaction between law and blockchains in the remainder of the paper.

Returning to the question at hand, in thinking about the challenge of impacting corporate law and corporate governance, it is useful to consider the different ways by which a blockchain regime might impair shareholders rights and managers behavior like they are currently defended by corporate law and developed by corporate governance recommendations.

The thesis defended in the article: on the one hand, we agree that BC technology is not neutral for corporate law and may have beneficial implications on corporate governance practice. On the other hand, we consider that 'Code is law' is not the right answer to BC technology regime adapted to corporate law and governance. This situation would be very risky on a legal perspective in the sense that it could challenge the very existence of underlying corporate law rules and impair good governance practice. This is not conceivable right now and we have little idea whether or when this would happen. Consequently, we defend a more balanced position: BC may favor a more democratic regime in a way that it may significantly facilitate procedural mechanism and, as such, upend the balance of power among managers and shareholders. These changes are to occur mainly in large corporations and may partly favor their best interest. However, we identify some risks that may be detrimental to shareholders' rights and impact the company as a whole. These risks seem significant as they are more qualitative than procedural: corporate governance practice could qualitatively suffer for BC, even though these risks are difficult to fully assess so far. The EU institutions have not taken these risks into consideration, despite they had the opportunity when revising the so-called Shareholders' Directive.

We argue that these novel risks associated with a BC technology use by large companies should be accoutered for by policy makers. The remainder of the essay is organized as follows: section 2 provides a description of the impacts of BC use by companies, questioning the potential emergence of a more direct shareholder democracy; section 3 presents the improved management tools; section 4 identifies potential risks associated with corporate governance of companies under BC regime; section 5 concludes the paper summing up arguments for coming up legal reforms at the EU level.[44]

[44] NB: BC and company law and corporate governance might be studied in 2 aspects: (1) Governance under BC technology regime: how BC may affect Corporate law and corporate

2. THE POTENTIAL EMERGENCE OF A MORE DIRECT SHAREHOLDER DEMOCRACY?

2.1. OPEN ACCESS TO REAL-TIME INFORMATION

The register function of a blockchain offers a way to facilitate the flow of information from the company and toward it. As recording simple to complex information is at the center of the blockchain, it offers a costless and efficient way to build a central database. The information stored in such a system will profit two kinds of data. First, the company-related information – which is often required by law and the focus of corporate governance – could be transmitted and stored into a blockchain (2.1.1.). Second, the organization of the shareholding structure could also profit the company itself, as it would be simpler for it to collect data about shareholders, hence improving knowledge of its capital structure and communication to the shareholders and stakeholders (2.1.2.).

2.1.1. COMPANY RELATED INFORMATION

Corporate law favors information rights toward shareholders, as premises toward the good use of their political and financial rights[45]. Moreover, principles of corporate governance advocate transparency toward shareholders in order to create a true shareholder democracy. This focus on information is patent under the Action plan for European company law and corporate governance: "*Enhancing transparency – companies need to provide better information about their corporate governance to their investors and society at large. At the same time companies should be allowed to know who their shareholders are and institutional investors should be more transparent about their voting policies so that a more fruitful dialogue on corporate governance matters can take place.*"[46] Some of the changes advocated have been settled as rules in the so-called directive for Shareholders" rights[47]. Legal requirement imposes

governance (i.e. can it upend the balance of power in companies?); (2) Governance of BC: Issues related to the internal governance of BC, an important topic in the way that the organization of stock exchanges and other capital markets institutions is important today. This second series of issues will not be tackled with in the current presentation. Whereas the second point would be interesting to develop, the focus of this paper is on the first issue

[45] See Supra.

[46] Communication from the Commission to the European Parliament, Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies, (COM/2012/0740 final), 2012, 1. Introduction.

[47] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 the exercise of certain rights of shareholders in listed companies (as amended by the directive

the use of a central register, as in France the "Registre du commerce et des sociétés" in which key information about every company with legal capacity is accessible to the public (such as corporate name, business name, registered office, etc.). Major events in the life of a company are also registered, as change of representative in the company, opening of an insolvency procedure or its liquidation.

Moreover, it is the duty of the executive organ to report annually to the shareholders and establish the corporate accounts. In addition, auditors establish a special report in which corporate accounts and other sensitive information are certified. These duties are common to all companies, whether private or public.

Concerning public companies whose shares are negotiated on a regulated market registered in the EU, a set of European legal acts[48] adds an additional layer of financial information. The United States also has such legal requirements under the Sarbanes-Oxley act of 2002[49] and under S.E.C. Rules.

Firstly, information about the financial operation is due when a company asks for initial public offering and also seasoned public offering. The company will release a legal note including general overview of the company, accounting information and a description of the operation along with a resume.

Secondly, a public company must periodically release a report after each financial semester. Such a report, even if it shares some common features with the more classic annual report released by private companies, is often far more dense than the latter, as it contains more information related to the financial and non-financial affairs of the public company. It includes, for instance, all the corporate social responsibility information.

Lastly, a public company is obliged to immediately share to the public information that could impact the share price of the company, such as the withdrawal of an executive officer or an agreement with a major partner. Breach of such a duty can have major consequences as such undisclosed information

2017/828/EU of 17 May 2017 as regards the encouragement of long-term shareholder engagement), (OJEU 20/05/2017 L 132/1), (hereinafter, Shareholders' Rights Directive).

[48] Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive), (OJEU 16/04/2014 L 173/179), Directive 2017/1129 of the European Parliament and of the Council of 14 June on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, (OJEU 30/06/2017, L 168/12), Directive 2014/65/EU of 15 May 2014 on markets in financial instrument, (OJEU 12/06/2014 L 173/349), Directive 2004/109/EC 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, (OJEU 31/12/2004, L 390/38).

[49] United States of America, The Sarbanes-Oxley Act, (Pub.L. 107–204, 116 Stat. 745).

is qualified as insider information, which use on the market or simply transmission to a third-party is strictly forbidden and severely punished[50].

This kind of duty is criticized as excessively costly for the companies. A special division must often be settled in such companies, labeled "Financial communication" with several employees affected to it. Moreover, it is often time consuming for the executive managers and directors[51].

Could Blockchain help reduce the costs in terms of money and time of such information duties? The answer seems to be positive as the blockchain primarily works as a database register. It is no surprise then that the Delaware State now offers a Corporate Register built on that technology[52]. Blockchain can offer an alternative to the more ancient public registers and the most recent internet servers by offering a way to access immediately and cost-free as such information and to allow companies to provide this data under a rapid and automatized process. As long as complex information can be shared through the peer-to-peer system, as it is the case[53], the nature of this information is irrelevant. It is therefore possible to share documents written in prose[54] or numbers set into accounts[55], as it is already the case for the more classical Company Register. The quantity of information is also irrelevant once a system has been established. Private companies will have less information to transfer to the system, on the contrary of public companies which should also be more reactive to comply with the transmission of relevant information.

The advantages of such a system are clear. The information can be stored indefinitively and be time-stamped. Such information will be valuable in many fields only to verify that a company has correctly complied with its duty of information. In the case of insolvency law, such information is vital as it has a detrimental effect on the validity of some contracts and the rights to the creditors. For instance, in some countries, once an insolvency procedure is open, some contracts can be rendered void if they were concluded during a certain

[50] Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive), (OJEU 16/04/2014 L 173/179), Art. 3(2).

[51] Engel E., Hayes R. M., Wang X.: *The Sarbanes–Oxley Act and firms' going-private decisions*, Journal of Accounting and Economics, 44 (1–2), 2007, [https://doi.org/10.1016/j.jacceco.2006.07.002], p. 116-145.

[52] [http://fortune.com/2017/08/01/blockchain-shareholders-law], accessed on 28/08/2018.

[53] V. Supra.

[54] Such as the name of the company, the address of its registered office, the charts of association, activities reports to shareholders and so on.

[55] All the corporate accounts.

time gap before. It is the case especially for guarantee contracts. It is the same for the enforcement of contracts in France where creditors cannot ask anymore individually the enforcement of agreements. In that case, the time-stamp offers a perfect proof to settle disputes. We can also imagine, outside of corporate law, that if contracts are concluded in the form of a smart contract, the opening of an insolvency procedure will automatically void the smart contract or block its effects (in case of enforcement paralysis) without the need to ask that to a court.

What could be the architecture of such a system? Regarding public information, the system can be as basic as the bitcoin one. The data will be collected inside the system and made immediately public. Anyone logging on the system can access the information. The system will work based on mining by the companies themselves who will have to put some computing power in order to mine, mining allowing the right to send information to the blockchain. It is also possible, based on a token system, to allow auditors to access some private documentation in order for them to certify some data. The Blockchain could then offer File-Sharing services with restricted access to sensitive information[56]. In order to certify accounts, auditors need to verify how evaluations were made and if the statements are accurate, faithful and provide a true and fair view of the company financial situation. The use of token will assure the confidentiality of such private documentation and the blockchain will then act as a virtual data room.

Such a system can be either public with no intermediaries or private. In a public system, no authority will check the quality of information sent to the system. Oversight would remain outside the blockchain where a judge or court clerk will continue to play that role. Some other drawbacks exist as it will be difficult to change or delete any information on that database, even if needed. Moreover, no control *ex ante* will be made as it is the case today in many systems[57]. In a private system, one intermediary will have the duty to verify ex-ante and be able to delete sensible information and correct mistakes[58].

2.1.2. SHAREHOLDING STRUCTURE RELATED INFORMATION

Information is the key for a shareholder to use wisely and efficiently his shareholder's rights. It is necessary for him to receive information about the date of the annual general meeting, the place where it will be held, the proposed

[56] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 119.

[57] Usually, Court clerks verify the data sent before publishing it to the central register.

[58] See infra for more detailed drawbacks.

resolution and all the relevant information (such as a resume of a proposed new executive manager or member of the board). This information is not made public before and therefore, does not belong to the former studied kind of information (even if, at the end, the record of the vote is made public).

To effectively receive this information, a shareholder must provide a way for the company to send it to him. Also, knowing the nature of its shareholder can help a company both to improve its corporate governance and to dialog more effectively with the blockholders and other influent shareholders[59].

Nevertheless, the information that a company has over a shareholder is limited. It raises two intermingled questions. First, who is the effective shareholder in regard to corporate law; second, how to identify the effective shareholder?

The first question is vital as the effective exercise of the shareholders' rights only belongs to the person recognized by the local corporate law as shareholders. In small companies, such an issue does not exist: either the name and address of the shareholder is written in the article of associations (such as it is the case, in France, for the S.A.R.L.), either the title of the company is registered to a shareholder's account providing the name and address of that shareholder and managed by the company itself. Access and knowledge of this identity are obvious.

Usually, when the company becomes public, a more complex structure arises. Channels of intermediaries can be settled, where an intermediary will buy for the account of someone shares of the company. The latter can also be an intermediary who asked that on behalf of the final client who can also live outside the country where the company is registered. The titles are no longer nominal shares but bearers share, where the identity of the bearer can remain hidden. Also, in some systems, like the U.S., bank can buy large number of stocks and issue depositary receipts. They will be the main interlocutor with the issuer of the stock and receive the shareholders' information that they will transmit to the owners of the depositary receipts[60].

Is such a system, a company needs to know who their shareholders effectively are. Several systems in the European Union instituted a procedure of shareholders' identification that could either rely on the intermediaries themselves or a central securities depositary (CSD). Usually, such a system must be settled by the law of the company. A company must then ask to all the intermedia-

[59] On that subject: Becht M, Franks J., Mayer C., Rossi S.: *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, Review of Financial Studies, 22(8), 2009, p. 3093-3129.

[60] Bonneau T., Drummond F., *Droit des marchés financiers*, Economica Paris, 2010, p. 158.

ries to transmit the information of their client in a bottom-up fashion. When the option exists, it can ask the CSD to provide a complete cartography of its shareholding structure. Such a procedure is time-consuming and the company itself supports the costs. The So-called directive about Shareholders right harmonizes the procedure of identification which will mainly be based on duties imposed on intermediaries. When a chain of intermediaries exists, those will have a duty to transmit the request to the known intermediaries without delay and responses must be transmitted directly to the company itself[61].

Moreover, corporate law can also favor first layer owner of the share rather than the last layer. For instance, if an intermediary subscribed a share, on account of another intermediary on behalf of an investor, who will have the right to effectively cast the vote? Some systems, as France, favor the first layer as the owner of the share account is deemed to be the shareholder. Therefore, if such an intermediary casts a vote that does not comply with the instructions of its client, such a vote will be valid. Some countries, especially in Common Law systems, specifically make the choice to the final economic owner of the share that is the investor.

So, to summarize, there are two issues of corporate governance addressed here: information about shareholders and the effective use of shareholders' rights.

A blockchain system can solve both these issues. Such a system will be based on the identity of shareholders or intermediary and their inscription through a login. They can act either openly or pseudonymously in case of bearer shares[62]. In such a system, instead of shares being registered in a physical account held by the issuer or its intermediary, they will be created directly in the blockchain and then traded as any cryptocurrency. The main question is, however, the nature of such a share. Before the blockchain, shares could be traded on paper titles, the bearer of the paper being seen as the rightful owner of the share. They could also be held into the shareholder's account, which is the main system today in Europe. A central book is held by the issuer, and each issuance creates a given number of shares. For each shareholder, there will be a specific account created to register the number of shares he owns. Each one of those is the owner of an account with the number of shares he has purchased. For instance, if 1000 shares are issued, the issuer will mark this issuance in its book. It will then divide the 1000 shares between two subscribers: A would receive 400 shares and B 600 shares. Each investor will be the owner of own account.

[61] Shareholders' Rights Directive, Art. 3(a).

[62] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 38-39.

In account A there will be 400 shares registered and in account B, 600. If B sells 100 shares to A, then B will ask the issuer to transfer 100 of his shares into account A. The book administrated by the issuer is a way to recognize and enforce ownership upon the shares. This is the simplest stage, as the issuer can delegate the management of the accounts to a professional and a central securities depositary can centralize all the accounts of a large number of issuers.

The blockchain can be used in two ways. It can mirror the legal system of the shareholding with no binding effects. It would be necessary to translate the existing accounts into the blockchain to permit the flow of information. In such a system, if a shareholder sells his share, he must still give an order to the issuer or transmit the paper to the buyer. Then, someone has to register the transaction into the blockchain. Such a system is inefficient and there could be no synchronization at all between the real state of the capital and the one registered in a blockchain.

In is also possible to legally recognize a share registered on blockchain. In such a system, the issuance of shares would happen on the blockchain itself as well as the trading of the blockchain of shares. Such a system is more efficient hence some countries have adopted it, especially France, which allows the registering of shares either in a traditional account or on a blockchain[63].

Anyway, any user of the system would have to identify either as the issuer (which will be unique for each share it issues), intermediary or investor. Each of these entities or people will be linked to a specific login effectively replacing the current share registers. Therefore, when an investor invests in a company through several intermediaries (the investor may not even know that a chain has been created), the system is able to share this information immediately to the issuer.

There will be no need any more to ask each intermediary the identity of the client on behalf of whom they act. Information could then be sent on a real time and cost free. Moreover, depending on the rule of the country in which the issuer is registered, the blockchain system could tag any link of that chain of intermediaries as the effective shareholder, allowing him to receive a token to exercise its voting rights. Intermediary links of the chain are usually not affected, as the logic is either to give such rights to the first layer or the last one. According to the *lex fori*, the system would automatically sent voting rights as token and relevant information to the effective shareholder.

[63] France, Ordonnance n° 2017-1674 du 8 décembre 2017 relative à l'utilisation d'un dispositif d'enregistrement électronique partagé pour la représentation et la transmission de titres financiers, (JORF n°0287 du 9 décembre 2017, texte n° 24), art. 1 and curent art. L. 228-1 of the French Commercial Code.

2.2. VOTE AND SHAREHOLDERS' INVOLVEMENT

In this part, we discuss how the use of BC technology by companies and for corporate governance may impact the vote itself (2.2.1), and behavior from activists (2.2.2).

2.2.1. DIRECT VOTE

Voting. Current limits to voting rights, largely fought by policy makers -be at the international, European or national levels-, and by investors are well known, and also regularly discussed among scholars. They are mainly obstacles of the concrete exercise of voting rights and comprise among others inexact voter lists, incomplete distribution of ballots, and even chaotic vote of tabulation.[64] With the view to eliminate or at least alleviate these impediments to the correct exercise of voting, a few stock exchanges have experienced platforms for voting via blockchain technology.[65] Concretely, shareholders receive tokens, or so-called 'votecoins', that they can in return send to addresses on the BC in order to register their votes directly.[66] According to authors promoting the use of BC for votes, the expected benefits are significant: among others, accuracy of BC voting and greater transparency[67] would constitute a motivation for shareholders to participate more directly at the AGM. Hence, if used as a platform for voting, not only the BC would have effects on very practical issues in the exercise of the vote but would also significantly impact shareholders behavior. Consequently, it would permit a more direct shareholder democracy. Corporate governance issues, described in the Introduction part of this paper, would definitely benefit from the BC technology.

We fully agree that the exercise of the voting rights can benefit from the use of BC technology. First of all, the company would have a better knowledge of its shareholding, and this information would be available on real time. The list of voters should then gain in accuracy. The so-called 'record-date' mechanism, currently associated with the delays to register exchanges on a stock exchange, would be largely solved, letting this procedure aside and out of date.[68]

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[64] Kahan, M.; Rock, E.: *The hanging chads of corporate voting*, Georgetown law Journal, 2008, 96, p.1227; Germain M. *et alii*, see ref. note xxx ; Magnier V. see ref. note xxx.

[65] In feb. 2016, the NASDAQ Talinn (Estonia) SE as a significant example.

[66] Yermack, D. : *'Corporate governance and Blockchain',* 2016, Working Paper No. w21802 NBER 16.

[67] Wright, A.; De Filippi, P.: *Decentralized Blockchain technology and the rise of Lex Cryptographia,* 2015, unpublished paper, [ssrn.com/abstract=2580664]

[68] Stock trades in US and several EU member states require 1 to 3 business days for settlement to occur and ownership to be transferred from seller to buyer. In the meantime, funds are

Empty voting. A more crucial issue referred to as 'empty voting' consists in holding shares in a company while simultaneously selling them short. Consequently, an investor may use borrowed shares to temporarily cast a vote in a company without suffering from the economic exposure to the financial risks in the price of its stock. Separating the voting rights from the economic interest in the company represents a real threat to the basis of shareholder franchise.[69] Many policy makers including the European institutions have so far failed to regulate this technique. Using BC technology for share registration could limit this technique as it should provide more transparency and 'early warning of the rearrangement of voting rights prior to the AGM.'[70]

Other obstacles related to 'cross-border' vote[71] could be partly solved with the use of BC platforms for vote. Delegation to vote is a major issue. Economic surveys have shown that many elections in US companies ended up being decided in favor if management 'in a disproportionate' number of cases.[72] Pressure or even manipulation on a dispersed and little involved ownership could be the cause. In European countries like France the same lack of engagement from several shareholders prevails, leading to the so-called 'blank check' practice: it is a default rule that permits shareholders to be represented at the AGM by the President of the meeting, but preventing them to give specific instructions in this case. This practice automatically and erroneously tends to favor management policies.[73] The 2007/36 shareholder directive has failed to limit this practice. We suggest that any incentive to vote directly, including through a BC process, would hopefully favor direct voting and consequently diminish the influence from management on votes at the AGM.

The EU institutions particularly have to deal with the limited engagement of shareholders. Ironically, an additional issue related to delegation of votes came

exchanged between intermediaries and their clients, and shares are transferred on the books of the brokerage and the ledger of the company, under the supervision of the Clearing Central Depositary. Today, each settlement requires time and need numerous intermediaries. As rules fix the list of voters some (generally 3) days before the AGM is held, new shareholders are not registered for voting. Conversely, with a BC technology real-time information would permit to welcome new comers at the AGM.

69 Hu, H.; Black, B.*: The new vote buying: Empty voting and hidden (morphable) ownership*, Southern California Law Review, 2006, 79, p. 811. *Adde* Magnier V.: see ref. note xxx, p. 123.

70 D. Yermarck, see ref. note xxx.

71 For a thoughtful analysis of EU cross-border voting issues, see Noland, M. *et alii*: *The political economy of cross-border voting in Europe*, Columbia Journal of European law, 2009, 16, p.1.

72 Listokin, Y.: *Management always wins the close ones*, American law and Economics Review, 2008, 10, p. 159.

73 ref. Comment VM directive 2007/36, supra note xxx.

up as a side effect of the 2007/36 Shareholders' directive attempt to overcome the traditional rules set by Member States to limit delegations to vote. While the directive facilitated the exercise of voting rights opening this representation power to 'anyone' other the spouse or another shareholder, it gave way to representation by professional third-parties, the so-called 'proxy advisors'. Potential conflict of interests issues emerge when shareholders appealed to proxy advisors. It is worth confronting these issues with the BC use.

Proxy advisors. Proxy advisers are legal persons that analyses, on a professional and commercial basis, the corporate disclosure and, where relevant, other information of listed companies with a view to informing investors' voting decisions by providing research, advice or voting recommendations that relate to the exercise of voting rights[74]. They are key to the role of investment firms that own a large portfolio of shares and are unable to monitor the entire vote proposed at the AGM. The main purpose of proxy advisors is to analyze the resolution and give a recommendation to the voters. Often, the analysis is based on respect of corporate governance principles. They have major influence on certain votes such as remuneration of directors[75] and they help shareholders to effectively exercise their voting right and avoid blank check practices. By registering their recommendation on a blockchain, proxy advisors could help shareholders to obtain in a quick and efficient way this recommendation and even to decide to follow them automatically. Moreover, as proxy advisors organize voting platforms for their clients, such voting platform could be established on a blockchain that could, in return, be linked to the blockchain where the shares of the company are registered[76]. It can also help for proxy solicitation in the country where it is useful, that is when it is easy to establish proxy voting[77].

But such system is not neutral, as the proxy advisors can be subject to some conflict of interests as their profession is not neutral. For instance, they can both advise the company for establishing voting resolution and issue a recommendation. As blockchain facilitates the dissemination of the recommendation and the box ticking to fully vote following such recommendation, it can improve the detrimental effect of such conflicts[78]. Moreover, BC can facilitate a

[74] Shareholders' Rights Directive, Art. 2(g).

[75] ESMA 2012/212, Discussion Paper, 22 March 2012.

[76] As for instance Broadbridge, a U.S. proxy advisor company: [https://www.globalcustodian.com/thought-leadership/future-proxy-voting/], accessed on 28/08/2018.

[77] Such is the case in the U.S. where the proxy solicitation is oversight by the S.E.C. In France, it is much harder as it is limited to another shareholder, the spouse or the partner of a civil union when the company is private. Full liberty only exists in public companies: see art. L. 225-106 French Commercial Code.

[78] The European Union has for regulated the proxy advisors through transparency: Shareholders' Rights Directive, Art. 3(j).

proxy battle as the voting token could be easily transferred to such proxy advisors. As the issues linked to proxy fights are common knowledge, BC works similarly as a catalyst to them.

How assess the real impact of BC technology use for votes, so far? BC should definitely help moving towards a more direct democracy. At least, it could allow it. It remains to be seen if BC technology alone may restore and maintain confidence, one major corporate governance obstacle.[79] We argue that this may happen only provided that company law and corporate governance improve to make sure trust and confidence be maintained:

First, BC will not, on its own, stop mechanisms like last-minute lobbying or 'behind the scene' discussions[80] whose impact exceeds functional procedures. Corporate law and governance recommendations are still needed to restore the 'equal treatment of shareholders'.[81] Not all shareholders are involved in negotiations partially led between managers and some investors, prior or outside the AGM. Shareholders suffer from these arrangements as for company law principal of equality among shareholders.[82] Conversely, BC use for votes does not preclude lack of engagement from small or minority shareholders when voting is at cost. In this respect, BC may be qualified 'neutral'.[83] One major goal of the revised Shareholder directive in 2017 is to reinforce shareholders' engagement. A fair engagement still need to be encouraged by good governance practice like longer term perspectives and less selfish behavior from some investors. These obstacles to good governance practice are more qualitative than simply procedural. Finally, if BC technology could benefit to shareholder and help develop more democratic behaviors inside companies that have to BC platforms for voting, in a way that being addressed tokens directly on a BC allow votes to be quickly and securely recorded, it does not avoid a major risk, allowed by BC also, i.e. the lack of anonymity.[84]

2.2.2. ACTIVISM-RELATED ISSUES

If too little engagement from many shareholders is a corporate governance concern, activism from some others raises particular corporate governance issues. More specific to US/UK markets, activism is increasing in Europe due

[79] See supra, introduction

[80] 'Behind the scene' see ref, Magnier, p. 131.

[81] OECD Principles, see ref., note xxx.

[82] Magnier, V., supra note, p. 132.

[83] See supra, 1

[84] See infra, 4.

to active blockholders investing in European companies.[85] Powerful professional shareholders, activists put pressure on boards to comply with their own strategy, mainly a short-terms-maximization-of-profit strategy that may be detrimental to longer-term expectations of the company itself. Despite the broadening consensus that engaging proactively in a company is vitally important, informal activism lowers the level playing field between shareholders. Among authors who predict greater transparency and improved liquidity on BC, one assumes that the market could identify activists more easily, with a sort of *chilling effect* on activism, due to a more costly activism.[86] This assertion is based on economic models showing that blockholders' trades are highly profitable during the period *before* they are required to disclose their ownership positions, but less once these positions are disclosed.[87] This prediction favors the use of BC in company law. But, because these models are highly controversial, others coming up to the opposite conclusion, suggesting transparency helps major shareholders by improving liquidity and lowering their costs,[88] we cannot further discuss this uncertain impact of BC use on corporate law.

More convincing is the 'Exit' threat argument defended by other scholars,[89] because it works both ways. Depending on its real impact on the costs of selling, BC may modify the beneficial and strategic use of vote by activist shareholders. In the ever debated dilemma between 'voice' or 'exit',[90] it is argued that activists' strategy changes according to the costs of selling: they choose to influence the company' managers though negotiation and participation when the costs of selling are high. Conversely, the lower the cost of selling, the more used the 'Exit' tool. Assuming with authors[91] that a BC technology would significantly lower the costs of selling, we could anticipate that a BC frequent use by companies would have a great impact on their strategies: the 'Exit' threat could be reinforced and influence managers' strategic decisions so that

[85] Magnier V.: see ref. note xxx, p.128.

[86] Yermack, D. : see ref. note xxx.

[87] Kyle A.; Vila, J.-L, *Noise trading and takeovers,* RAND Journal of Economics,1991, 22, p. 54; Collin-Dufresne, P., Fos, V.: *Insider trading, Stochastic liquidity and Equilibrium prices,* Econometrica, 2016, 84, p. 1441; Collin-Dufresne, P.; Fos, V.: *Do prices reveal the presence of informed trading?,* Journal of finance, 2015, 70, p. 1555; Reported by Yermack, D.: see ref. note xxx.

[88] Reported by Yermack, D.: see ref. note xxx.

[89] Reported by Yermack, D.: see ref. note xxx.

[90] Voice or Exit ? ref

[91] Edmans, A.: *Blockholder trading, market efficiency, and managerial myopia,* Journal of finance, 64, p. 2481; Admati A.; Pfleiderer, P.: *The Wall Street walk and shareholder activism: Exit as a form of voice,* Review of financial studies, 22, p. 2455: reported by Yermack, D., see ref. note xxx.

they satisfy investors' requests more rapidly. In the trade-off between short-term - private benefits - versus long-term decisions - non-value maximizing projects -, the former would prevail on the latter. [92] If the impact of BC could then be beneficial to major investors, it could possibly do so at the detriment of the company. Depending on how deal with the conflict of interests issue, BC use could bring new risks to companies.[93]

3. IMPROVED MANAGEMENT TOOLS

3.1. A MORE EFFICIENT MANAGEMENT

Business companies are complex organizations. They can be classified from the simple state of one representative with no board or oversight council to complex groups of multiple and large corporations.

The organization of power inside the company is the key to achieve corporate governance. The stakes differ according to the repartition of power inside the company. Usually, there is arbitration between power to the executive officers and power among the shareholders. This balance uses both prerogatives given to the different stakeholders and the use of sanctions by which the shareholders can revoke an executive officer, revoke the board, or ask for compensation in a tort-based claim.

There are roughly three levels to organize a company: the legal rule, the articles of association and shareholder's agreement.

The stakes also differ according to the social form of the company and the nature of the legal system. In France for instance, the law provides for the balance of power in the famous "société anonyme". On the opposite, the balance of powers is freely decided in the articles of association by the founders who choose to create a "société par actions simplifiée"[94]. The legal norm can be more or less restrictive or even completely silent.

Where the law is silent, the articles of the association set the main organizational rules of the company. This is the second level of organization and the founders, later the shareholders themselves, can set rules regarding proxy power in the company, attributions to the organs and duty from the executive officers toward the shareholders. The articles of the association can also rely on lower

[92] Discuss here the potential impact of the Warren US project, the *Accountable Capitalism Act*.

[93] See infra, part 4.

[94] The law however asks for the institution of several organs and minimal attribution, such as the representative of the legal entity and the existence of an annual general meeting.

norms such as bylaws adopted by the board, detailing some aspects of the rule. For instance, the articles can provide for the creation of a special committee and direct the board to establish its rules through the enactment of bylaws.

Lastly, some shareholders can decide to enter a covenant and sign a shareholder's agreement. Such agreements deal with the sale of shares in view to protect the consistency of shareholders' covenant or the use of voting rights (with some limitations such as the prohibition of voting rights sales). Agreements can be translated into the articles of association so as to facilitate their enforcement. They become then a full part of these articles applicable to all shareholders. They can, on the contrary, remain outside the scope of the articles of association and then act as regular contracts.

Blockchain can help with such organization on two levels: by setting a decentralized and autonomous organization based on a new blockchain system (3.1.1) or an existing one, such as etherneum or by the use of smart contracts (3.1.2.).

3.1.1. DECENTRALIZED AUTONOMOUS ORGANIZATION (DAO)

A DAO is a digital organization working on the base of a blockchain system. It can be built around its own system or instead use a pre-existing one. As authors stated, "*Blockchains may serve as an interoperable layer for AI or algorithmic systems to interact and potentially even coordinate themselves with other code-based systems through a set of smart contracts acting as a decentralized autonomous organization*"[95]. The purpose of such a DAO is to settle an autonomous organization where external intervention is not required. The operations are based on the use of the BC register, the implementation of autonomous smart contracts and the use of tokens. It can be used to implement a simple lottery system or be built on a more complex architecture. Resources needed for the use of the blockchain system (such as ether) can be provided by the members of the organization. Such token can be used to access resources provided by the DAO, such as dividends, or to represent rights upon the DAO, such as voting rights. For instance, a company offers to create complex organization based on Ethereum and offers a transcription of the French Constitution as a demo for its application[96].

Once it is established, a company built around a DAO would need to function by authorization level. Each stakeholder must have a user login. Shareholders receive authorization to cast votes for AGM and the board members receive

[95] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 148.

[96] See for instance [klsn.io]

such an authorization for the matter relevant to their prerogatives. For instance, the distribution of dividends can be based on the net income in the database: shareholders cast a vote to decide whether to put it in a reserve account or to distribute them. If the latter is chosen, the DAO will automatically distribute dividends among the shareholders. Moreover, the use of a DAO could help render effective control upon remuneration instituted by the so-called shareholders' rights directive[97] and that also exists in France[98]. A company can or must make mandatory a previous agreement of the AGM prior to the payment of directors. Smart contracts can then retain that payment if the vote is negative. Related to remuneration, a DAO can also effectively manage the distribution and exercise of stock options. A director could receive his stock options when the financial results are obtained. When a golden parachute has been voted, distribution can be made upon revocation… As the code is public, it is also a better way for shareholders to manage more efficiently the global remuneration of directors and board members.

The shareholders' rights directive entitles the board to authorize some contracts between the company and related parties, as it is the case when a board member signs an agreement with the company itself. Such a procedure could be automatized[99].

More complex interactions can also be settled. Suppose that the election of a new board member is proposed to the AGM. If the candidate has a user login, a positive vote would have for effect to give him access to information stored on a blockchain and to receive a token for any vote inside the board.

As we can see, a company can be organized through a DAO but it needs the correct coding to achieve automatization. If the basic activities can be so coded, some activities cannot and there will always be the need to rely on human input inside the system itself. Some parts of the organization cannot be coded also, especially when the power given to the shareholders or the directors is too general and too vague. Where there is a fiduciary duty[100], it will be in fact impossible to translate such a duty into a DAO[101]. The breach of such a duty

[97] Shareholders' Rights Directive, Art. 9(a).

[98] France, Loi n° 2016-1691 du 9 décembre 2016 relative à la transparence, à la lutte contre la corruption et à la modernisation de la vie économique, (JORF n°0287 du 10 décembre 2016, texte n° 2), art. 161.

[99] Shareholders' Rights Directive, Art. 9(c).

[100] As it is the case in France, see Germain M., Magnier V., *Les sociétés commerciales*, L.G.D.J. Paris, 2017, n° 1671.

[101] It would be the same in the very frequent non-disclosure agreement, where the breach is impossible to code correctly.

will need court recognition. Moreover, if damages are requested, it will require an appreciation of the court if no penal clause was instituted. Other fields are subject to such uncertainty. For instance, the directive on shareholders' rights states that "Member States should ensure that material related party transactions are submitted to approval by the shareholders or by the administrative or supervisory body according to procedures that prevent the related party from taking advantage of its position and provide adequate protection for the interests of the company and of the shareholders who are not a related party, including minority shareholders."[102] Yet, the definition of a related party remains blurred. If the related party is directly a shareholder or a director, there are a few issues as those are registered on the blockchain. A simple system of recording some contracts into the system could help to initiate a procedure. But if the related party is not registered or is a hidden agent of the formers, then there is no way to allow the blockchain to cover such an event.

Therefore, most of the time, the DAO will be a hybrid contractual organization[103]. The articles of association will then be settled on prose as a master agreement, while all the simple and technical clauses will be settled on the blockchain. The master agreement, for some clauses, will then rely on the block chain and for other on the prose, when they are more open-ended.

Despite these limitations, the major decisions held by the AGM such as nominations/remuneration of directors, approving of financial statements and dividends can easily be coded. Those offers the shareholders access to instantaneous use of their rights and protect them from fraud or dilatory actions from the executive board or representatives of the company.

3.1.2. SMART CONTRACTS

When a shareholders' agreement is not enacted on the articles of association, it remains a contract ranging from simple ("if you sell your shares, you must buy mine at the same price") to very complex. But a contract written in prose can contain clauses far vaguer than contract translated in a program. The program can only function precisely if no human interaction is needed. The prose contract can contain definition clauses, a setting of goals but also general notions that can more easily embrace the totality of the hypothesis the contract tries to rule. On the opposite, smart contracts work solely on the basis of an "if…

[102] Directive 2017/828/EU of 17 May 2017 as regards the encouragement of long-term shareholder engagement, (OJEU 20/05/2017, L 132/1), whereas 42.

[103] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 76.

then…" rule. If conditions are vaguer and more human decision needed, then a human input is required, thus voiding the automatic aspect of smart contracts. However, it can prove impossible for some clauses to be translated, as vague terms or unknown conditions are prerequisites. It can prove useful for contractors to use general notions as "good faith" since several legal systems rely on this. Those broad notions help to cover the wide range of behaviors contractors could have or events they could face. Also, some goal can be set in a contract, usually at the beginning of it, to help to determine the correct behavior. Without these clauses, the future cannot be usefully managed and predicted. Yet, it is the main purpose of a contract. It simply means that some agreement will rely on human interaction, from the contractors themselves, an independent expert or a court decision. Therefore, some contracts will need to be hybrid contracts, as seen hereinbefore.

Aside this obstacle and postponing for now the risk aspects[104], such an organization of a shareholders' agreement offers two main advantages[105].

First, the monitoring costs decrease even to 0, as a smart contract automatically reacts if it gets the right inputs. It proves very useful especially for the two main clauses existing, the voting clauses and the shares selling clauses. If a voting clause is set, then the smart contract will automatically adjust the voting token of the debtors to the one of the creditors. If the creditors use their token to vote positively, the smart contract will use the token of the debtors to vote alongside. Similarly, the selling of the shares of the debtor of the clause to a buyer will cause the automatic selling of the creditor (who could get an option as a phone notification for instance, to react instantaneously). Therefore, the parties to the agreement won't need to oversee the contract but instead just let the smart contract work by itself.

Second, the smart contract will diminish the opportunistic behavior of the parties. On the one hand, the use of vague clause that can lead to discussions in court, and therefore delay the enforcement of the agreement, will be nullified. The program will need to put precise mechanisms that do not allow human interpretation. On the other hand, the contract based on a blockchain is protected against the risk of fraud, as long as one of the parties cannot own more than 50% of the mining power of the blockchain.

[104] See infra.

[105] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 80.

3.1.3. BC LEGAL EXPERT

The use of BC to organize a company could foster the rise of a new kind of employee, officer or director (even on board), or even a whole new service inside the company to help organize a blockchain-structured company. Such a field of expertise will require skills embracing both the IT field and the legal field, in order to transpose correctly an organization into a blockchain. Given the key role such an actor could have, and keeping in mind the incorruptible aspect of the blockchain once it is established, her or his role will be sensible during the transposition phase, when a new set of rules must be translated into computing language. Contractor managers, given they acquire the needed skills in computing, could prove valuable.

As such a service will have to manage sensible aspects to correctly translate legal or contractual terms in a smart contract and a DAO, some regulation would be needed. They will in fact act as internal controllers and other compliance officers, but not regarding activities of the firm rather its structure at its heart. The risk of capture by the management is high, especially if such an expert is an employee of the firm. Therefore, they would need to be neutral, have direct access to the core management but also be able to warn the shareholders in case of a major breach in the organization. They should at least benefit from the protection compliance officers have and, at the most, be totally independent, such as auditors are. The auditors could also embrace such an activity if the correct Chinese wall or incompatibilities are maintained, so that a unique auditors firm audits both accounting and the blockchain aspect.

3.2. RELATED-PARTY TRANSACTIONS ISSUES?

Related-party transactions are a major corporate law tool used to protect the company against conflicts of interests. Regulated in almost every jurisdiction it is based on a two-phase mechanism: traditional ex-post enforcement and an interesting ex-ante declaration process. The latter applies by prevention to agreements between the company and its managers or referential shareholders. Information is given to the board by the 'interested' person (in situation of potential conflict of interests). The board, with the exception of this director, authorizes (or not) the agreement and, later, this authorization is approved (or rejected) by shareholders (except the 'interested person') at the AGM. Damaging override of the rejection may lead to sanctions to the interested person. The preventive disclosure rules place a burden upon management to self-report these transactions and compliance may be subject to misinterpretation and uncertainties, when it is not respected at all. The revised Shareholders' directive has attempted to deal with issues related to third-party transactions (à comple-

ter). But more improvement is needed. As preventing people from breaching the rules should prevail on sanction, BC may help improving the rules in two ways. First, greater transparency offered by BC technologies would permit to engage in real-time control against fraudulent agreements. Damages to the company could hence be more easily avoided. Second, one could imagine an automatization of standardized and sequential agreements. This automatized process currently exists through a smart contract. Smart contracts are small snippets of code that are directly deployed on the BC and meant to be executed in a decentralized manner in the BC network.[106] As computer programs, they are neither smart (they still need a human intervention to be put it in place) nor real contracts (they only can represent copies of agreements or facts, or images etc…). Yet, these programs may help to emulate the correct execution of real agreements. If we follow Szabo, and De Filippi and Hassan[107] - with no need here to discuss the feasibility of transposing every single legal rule and document into code -, smart contract 'are able to automatically execute the terms of a specific agreement, providing trustless transactions via integrated enforcement mechanisms', we suggest that such a tool be useful to automatize at least a great deal of (if not all) related-party agreements in groups of companies. Not only these agreements are frequent, but most of them are also standardized and sequential. In such a case, BC technology would hence help improving and securing the ex-ante phase of the rules related to these agreements, consequently improving management tools.

3.3. GREATER TRANSPARENCY OF INSIDER TRADING OPERATIONS?

Again, if BC technology offers greater transparency, it would be interesting to question the impact of its use on insider trading. Insider trading is illegal in US and Europe, criminal related sanctions being recently reinforced in the European Union via the 596/2014 Rule and other texts.[108] Insider trading regulations constrain directors and managers from selling or buying shares of the company they manage benefiting from significant information prior to make it public to the market. Greater transparency on (public) BC would permit boards or shareholders observe managers' trades in real time, offering an accurate on-time control on these illegal behavior.[109]

[106] For more details on smart contracts, see Szabo, N.: *Smart contracts*, 1994, unpublished paper [http://Szabo.best.vwh.net/smart.contracts.html].

[107] De Filippi, P. ; Hassan, S. : see ref. note xxx

[108] EU insider trading rule [online ref]

[109] Discuss the benefit from legal or illegal insider trading as a compensation tool

4. THE POTENTIAL ALTERATION OF SOME CORPORATE GOVERNANCE ARRANGEMENTS: EMERGENCE OF NEW GOVERNANCE RISKS

The use of blockchain is not without risks. They can even void some security offered by the legal system itself, as they require renouncement of anonymity (which is sometimes the key). Three key features of a blockchain system can create new governance risks. Firstly, the transparency on a blockchain can prove adverse to governance and some management's decisions will lack the required confidentiality (4.1.). Second, the permanent structure of a blockchain can prove detrimental when a human intervention is needed, such as a court decision (4.2.). Moreover, errors in the blockchain can prove difficult to adjust, with the potential of global paralysis of the company (4.3). Finally, conflict of interest may remain or be worsened on a blockchain as it is code and algorithm based (4.4.).

4.1. LACK OF CONFIDENTIALITY UNDER A BC REGIME

A public blockchain is necessarily transparent. This feature is the key to the rise of a trustful system with no third-party. However, if transparency is required[110], some privacy may be maintained as clearly stated in Nakamoto original white Paper: "The necessity to announce all transactions publicly precludes this method, but privacy can still be maintained by breaking the flow of information in another place: by keeping public keys anonymous."[111] Nonetheless, it may prove hard to keep key information private in such a system, both in the detriment of the shareholders (4.1.1.) and the company itself (4.1.2.).

4.1.1. 'OPEN' VOTES; DISTINGUISH THE IMPACT ON PRIVATE/ PUBLIC BC

When the shares of a company are registered on a blockchain, each shareholder will have to register itself on that blockchain[112]. The use of anonymity is, however, limited to the general public. As the original white paper states, "The public can see that someone is sending an amount to someone else, but without information linking the transaction to anyone. This is similar to the level of

[110] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 37.

[111] [https://bitcoin.org/bitcoin.pdf], accessed on 28/08/2018, esp. "10. Privacy".

[112] See supra.

information released by stock exchanges, where the time and size of individual trades, the "tape", is made public, but without telling who the parties were."[113] However, such an "anonymity"[114] has its limits. To enforce the shareholders right, the shareholder must have its identity disclosed at one point of the system, at least to assume its ownership of the shares. The actual system of intermediaries would remain: if a shareholder can add many layers between him and the issuer, which usually protects anonymity, the blockchain system can track him instantaneously by a simple bottom-up check. Same if the true shareholder tries to add its identity under several financial vehicles. If all of them are registered on a blockchain, such effort will be fruitless. Only if, at one point, the chain exits the blockchain system, such stratagem would work. To protect himself, the shareholder will have to use a hidden agent or a front man, at the risk of not being able to enforce his shareholder rights. An intermediary has the duty to comply with the orders of his client, contrary to a shadow agent working outside the legal system.

Is that to say that the rise of shares registered blockchain will destroy anonymity? At some point yes and we can conclude at the end of anonymity of the bearer-shares. But that kind of issue is not so detrimental, as the legal system evolves in a way to hamper this transparency nonetheless. The recent amendment of the shareholder rights directive states the possibility for all public companies relying on this bearer shares to identify their shareholders[115]. All the bearer shares under such a system will become identifiable, unless the member state uses the option to protect the shareholders detaining less than 0.5% of the shares, in other words, the powerless ones inside a company. Blockchain will not protect shareholders from that identification and can also facilitate that process[116].

4.1.2. 'OPEN' ACCESS TO TRANSACTIONS

Usually, company directors cannot hold bearer shares rather nominal shares. Such a legal provision seeks to oversee insider trading. However, unlike in a traditional system where the public cannot clearly see management transa-

[113] *Ibid*.

[114] "There are no real-world identities required to participate in the Bitcoin protocol. Any user can create a pseudonymous key pair at any moment, any number of them", in Narayanan A. e.a., *Bitcoin and cryptocurrencies technology*, Princeton University Press, 2016, De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 38, ad notam 10.

[115] See supra.

[116] Supra.

ction, the public aspect of a blockchain allows it. Investors and other third parties to a company could receive real-time feeds on the activity of the top management, thus misinterpreting shares selling or buying. It could impact the share price dramatically and create unexpected volatility on capitalization, detrimental to the true company value.

4.2. WHAT IF A NEED TO APPEAL TO A NEW THIRD PARTY OCCURS?

It is sometimes deemed necessary for a third party to intervene in the affairs of the company, for instance between shareholders tied by a shareholding. When a shareholder agreement agree to the future selling of shares, as an option for one party or due to a certain event, price of the shares cannot always be based on objective data. It is particularly true when the company is private as there is no capitalization value. It is also true of some agreements in public company, when the selling implies transfer of control, as a premium must then be paid. Therefore, an expert must intervene.

Moreover, it is sometime necessary for a judge to intervene in the functioning of a company when the company itself may face paralysis. It can be for very basic reason as an organ cannot work normally after certain events. For instance, if all the member of the board were to die in a plane crash, a new board would have to be named. Usually, board members are nominated by an AGE. But it is the board itself that must summon such an AGE, which is impossible if there are no more board members… In that case, France has a judiciary system where the court will name a special representative whose mission is to summon the board and take the decision to summon the AGE, such resolving the issue of paralysis. A wide array of case relies on such a human intervene. For instance, if a manager act in a way that harm the interest of the company and its shareholders, but that manager has control over the company, corporate rules cannot allow his revocation. It is then necessary for a judge to intervene and if the activity of that manager is harmful to the company, to demote him.

Finally, many insolvency procedure works in a way where the court demote directors from their position to name a special agent acting as the proxy of the company.

All this human intervention cannot be translated into code. Moreover, for some of them, the human intervention is taken as the consequences of a dispute between shareholders and managers, so the managers who owns the access to take certain decision can refuse such access which will later need prosecution. Until then, paralysis may remain or certain harmful actions can be taken. The only possibility would be to organize the whole judiciary and expertise system into a blockchain, which is utopic, unfeasible and undesirable.

4.3. WHAT IF BC ERRORS OCCUR, FOLLOWED BY INERTIA?

Blockchain is a large decentralized ledger registering all information data made since the beginning. Data stored in a BC cannot be retroactively modified or deleted. Immutable preservation and traceability of operations are therefore two major assets of a BC. However, no technique is 100% reliable. Cryptocurrencies, Ethereum[117] or Bitcoins, can be diverted thanks to a computer fault. The private key may be hacked even though this risk should not be overstated. [118] It is minimal when the company is a knowledgeable professional who will not leave his private key accessible on the web. Another risk could come up from a possible collusion of miners gathered in 'pool' who divert the information.[119] This happened in countries where electricity is cheap (China) or easy cooling (Iceland), in order to pool the computing power of different computers.[120]

On a public BC, the state of the BC can only be updated through consensus so that is unfalsifiable (consensus technique). It is almost impossible to change the contents of a BC[121] because more than 51% of the computing power of all computers participating in the mining is needed to do so. However, a real governance problem in public BC exists because no authority is designed to resolve the difficulties or any key revocation system. This situation raises the issues of liability. Who would then be liable when data are modified or fake information is spread through a BC ledger? The developer who set up the BC - with a protocol of operation - and raised funds to pay minors in cryptocurrencies? Or the start-up of BC, the chaintech, who is an intermediary to the company that uses a BC platform, in particular to register its bylaws, AGM or financial reports, and contractual agreements? Because of the decentralized organization of the BC, neither the developers nor the chaintech can have control on a public BC. Only the communities of miners, developers and users have the power to modify the initial protocol on a decentralized organization with no centralized control.

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[117] A failure in the code of a smartcontract has been exploited on Ethereum BC.Consequently, the consensus was to split the BC ('fork) and initial funders were reimbursed.

[118] On Bitcoin or Ethereum BC, non-professionnals had left their cryptomonney on public addresses and the platform held the private key.

[119] To avoid risks of collusion, other mechanisms have been studied like the proof-of-work scheme. It requires that a potential thief or forger have to alter not only the transaction record they wish to divert, but also all subsequent blocks up to the current one. According to this scheme, altering historical data in a BC prohibitively costly.

[120] D.Legeais, Juris-classeur Comm.Fasc. 534.

[121] Since the hash of the block header is included as an element in the header of the next block, the hash of the next block header will also change, as will the subsequent block headers.

The risk of hacking is even greater in a private BC managed by an administrator, because a hacker can infiltrate the network of this administrator. In addition, in a private BC, the network administrator can modify the operating rules of the BC as well as the content of the BC. The value of the evidence in a private BC cannot be the same as in a public BC.

Failures in the BC technology already happened. These failures may undermine confidence in this new technology. These technological issues should be fixed prior to be used at large scale by companies.

4.4. POTENTIAL CONFLICT OF INTERESTS ISSUES

Conflicts of interests are a major issue in corporate law and governance. Jensen and Meckling, who defended the agency theory, conflicts of interests between managers, as agents, and shareholders, as principals, occur when the former act in their own self- interests, by extracting benefits from the company, all at the detriment of the shareholders' and the company's interests. Such opportunistic behavior results in agency costs, including losses in corporate value, permitted by informational asymmetries at the benefit of managers. The key governance solution to avoid discretionary opportunistic behaviors and make managers behave fairly is brought through greater transparency. Such mechanisms as 'say on pay'[122] or 'related-party transactions'[123] are part of the solution. As shown above, these mechanisms are easy to code as long as their substantial clauses remain quantitative (amount of remuneration or deal). When the clause need be more qualitative, like codifying a 'good faith' situation, code seems of no real help. On BC, greater transparency should therefor prevail, [124] helping limiting conflict of interests. But this is mainly true for forms of 'quantitative' situation. As for more 'qualitative' ones, classical human resources and controls should still be relevant. If not clearly identified, and solve, these differences may impair the companies' activities, trust on the markets and altogether the use of BC as a benefit for corporate governance.

5. CONCLUSION

Our finding is that considering that the main issues with the use of a Blockchain is its transparent and permanent setting, this kind of features comply hardly with the needs of business activity and companies. Therefore, before setting a

[122] See supra.

[123] See supra.

[124] See supra.

blockchain, one must remain conscious of the way he wants to settle it. It can either be public or private. When a register is established on blockchain, the use of a third-party can prove vital.

The governance of such a record will either been made through a central authority or will rely on public transparency and no third-party. A purely decentralized record would cost obviously less as there will be no intermediation cost for the authority overseeing the blockchain. However, such a system could be sensible to fraud and overtaking. If someone manages to obtain more than 50% of the miners computing power, it will be able to alter the blockchain and render void the authenticity of the data stored in it[125]. He would be able to add false information or delete previous information. Trust in the register would then be nullified. Moreover, in such a system, there would be no quality control other than the public. It is unsure that vigilant public overseeing regarding all the companies will work. The amount of work would be enormous when the gains are weak. Moreover, if false information is stored, it is extremely difficult to correct it on a public blockchain. On the contrary, a private blockchain relies on a central authority which oversees the faithfulness of the data and corrects the database if an error occurred[126].

More importantly, a public blockchain will not permit any right to oblivion for former executive officers whose name is bound to the insolvency of their former company. Such right to oblivion can exist in some exceptional cases[127]. Such issues can be addressed with a third-party but can hamper the key features of a blockchain. Arbitrages must be made by legislator.

Finally, no doubt BC technology is not neutral for corporate law. Corporate governance could change in some ways under a BC regime and the balance of power may significantly be upended among actors, i.e. small/large shareholders and managers. Corporate governance may also benefit from it on democratic grounds. However, legal and financial risks may occur for the company and its shareholders. These opportunities and risks should be taken care of. Policy makers should be aware of both of them and bring adapted answers to the issues related to the new technology.

Considering the limits of the article, here are additional thoughts for further potential discussion. Mainly three questions need to be raised and solved: (1) What type of reform: max/minimum changes?; (2) Which level? In Europe:

[125] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 113

[126] De Filippi P., Wright A., *Blockchain and the Law: The Rule of Code*, Harvard University Press, Cambridge Massachusetts, 2018, p. 114.

[127] EUJC, 9 march 2017, aff. C-398/15, Camera di Commercio c/ Salvatore Manni.

Member states reform or EU Directive? (3) Governance OF BC themselves (see introduction).

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THE ECJ'S ERZBERGER RULING: A DOOR WIDELY OPENED TO NATIONAL MODELS OF EMPLOYEE PARTICIPATION?

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ABSTRACT

In the recent decision of the Erzberger case C-566/15, the Court of Justice of the European Union had to address the issue of whether the national rules on employee participation in company management (so-called co-determination) are in line with EU law, in particular whether they do not restrict the free movement of workers within the EU internal market. Although in the present case the judges did not find the existence of restrictions, in their brief ruling they did not give answers to all the questions related to this case and the co-determination in multinational business groups. The article attempts to show for which cases of co-determination we already have clear answers in the current EU law and for which we do not. Overall, however, the analysis shows that the EU Court of Justice decision was pragmatic and therefore wise.

KEYWORDS: *co-determination, EU internal market, free movement of workers, Erzberger vs. TUI, rights of employees*

1. INTRODUCTION

The employee participation or more shortly co-*determination* is defined by the EU sources as „a structure of decision-making within the enterprise whereby employees and their representatives exert influence on decisions, often at a senior level and at a relatively early stage of formulation."[1] It is therefore - in

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[1] [https://www.eurofound.europa.eu/observatories/eurwork/industrial-relations-dictionary/co-determination], entry made on March 11, 2007, accessed on 11/07/2018.

practice - the right of employees to elect their representatives to the supervisory bodies of certain companies, usually those with more staff and the dualistic structure of management (i.e. with the executive and supervisory bodies). This right is regulated in a different way in most EU Member States[2], but not directly by the uniform European Union harmonization legislation (although Article 153(1)f of the Treaty on the functioning of the EU (TFEU) allows for its minimum harmonization through EU directives adopted by unanimity in the Council).[3] Only the related right of employees and their representatives to be informed and consulted by the employer is provided for in several EU secondary law acts.[4]

In this situation, the fundamental freedoms of movement within the EU's internal market may get into conflict with national models of co-determination. EU law holds that even the local legislation that is not subject to EU law harmonization cannot hinder the effectiveness of EU law in the areas where it operates and Member States thus cannot regulate matters that fall under their jurisdiction without respecting EU law. A concrete example of such a conflict affecting national co-determination rules was highlighted by the case of *Konrad Erzberger v. TUI AG* (C-566/15), decided by the Grand Chamber of the

[2] According to different comparisons, certain participation rules exist in 17 EU Member States, but in not all of them employees can directly elect their representatives to company's governing bodies, they can for instance discuss strategic decisions and sometimes co-decide on them. See in Krause, R.*: Acid Test ECJ. The EU Commission´s opinion on the TUI Case – A critical commentary.* Hans-Böckler-Stiftung No 23 Co-Determination Report August 2016. As typical countries of traditionally well-developed co-determination are considered Germany, Austria, the Netherlands and the Scandinavian states. See in Mulder, J.: *The Law Concerning the Election of Employees´ Representatives in Company Bodies. Report in light of he CJEU case Konrad Erzberger* v TUI AG C-566/15. Hans-Böckler-Stiftung Co-Determination No. 29, 01.2017, s. 2-4, Keijzer, T., Oost, O., Van Ginneken, M.: *The ECJ Erzberger Case: An Analysis of German Co-Determination and EU Law.* European Company Law Journal Vol. 14, No. 6 (2017), p. 224.

[3] Since April 2016, the European Trade Union Confederation (ETUC) has been pushing for its own proposal for a directive introducing an obligation to have a system of employee representation in the governing body in transnational companies. See ETUC position paper *Orientation for a new EU framework on information, consultation and board-level representation rights (Part I)*, adopted at the extraordinary ETUC Executive Committee on 13 April 2016 in The Hague. [https://www.etuc.org/en/document/etuc-position-paperorientation-new-eu-framework-information-consultation-and-board-level] , accessed on 11/07/2018.

[4] Directive 98/59/EC on collective redundancies, Directive 2001/23/EC on transfer of undertakings, Directive 2001/86/EC on consultation in European Company (Societas Europaea), Directive 2002/14/EC on information and consultation of employees, Directive 2003/72/EC on employee involvement in European Cooperative Society (SCE), Directive 2009/38/EC on European Works Councils.

EU Court of Justice (CJEU) on July 18, 2017.[5] A shareholder of TUI AG, a multinational company with headquarters in Germany, K. Erzberger, argued that there should be no employees' representatives in the supervisory board, because the German law under which they were elected was contrary to Article 18 TFEU (prohibition of discrimination) and Article 45 TFEU (free movement of workers). The alleged violation of EU rules consisted in the fact that TUI AG employees outside Germany (80 % of all employees) could neither vote nor stand as candidates for the supervisory board and employees of TUI AG establishments in Germany, when transferred to work in TUI AG units in other Member States, lost their right to vote and to be elected.

In Germany, this case was, since its inception, considered to be a landmark one. Leftist forces and trade unions saw in it yet another neo-liberal attempt to further reduce the national model of social and employment rights.[6] Commentators agreed that a possible ruling on incompatibility of the German model of co-determination with EU law would create a precarious state of legal uncertainty as to whether the supervisory boards of hundreds of companies were lawfully constituted and whether their decisions were valid. The judgment handed down by the CJEU did not cause any such earthquake, however, the consequences of what the CJEU said, but also did not say, in the judgment are potentially far-reaching.

This is what the following analysis is about. It has been done with a certain time distance from the decision, and also with the knowledge of the comments that accompanied it.[7] Its aim is therefore not to describe in detail the circumstances and content of the case but to answer the question whether we already have the necessary legal certainty that there is no conflict between national models of co-determination and the freedoms of the EU internal market, or under what conditions it is so.

[5] CJEU C-566/15 *Konrad Erzberger v. TUI AG*, EU:C:2017:347.

[6] See for instance Höpner, M. Weiss, M.: *Co-determination Under Threat: Blocking Social Europe*. *So*cial Europe 12 January 2017, [https://www.socialeurope.eu/co-determination-threat-blocking-social-europe], accessed on 11/07/2018.

[7] See for instance a thorough analysis made by Keijzer T., Oost, O., Van Ginneken, M.: *The ECJ Erzberger Case: An Analysis of German Co-Determination and EU Law.* European Company Law journal, Vol. 14, No. 6 (2017).

2. CROSS-BORDER CO-DETERMINATION AS A LAWFUL OPTION

The preliminary question of the Berlin Higher Regional Court, which the CJEU had to deal with, asked whether: „Is it compatible with Article 18 TFEU… and Article 45 TFEU… for a Member State to grant the right to vote and to stand as a candidate for election as the workers´ representatives in the supervisory body of a company only those workers who are employed in establishments of the company or in affiliated companies that are within the national territory?" (para 21).

Both the Advocate General (AG) Saugmandsgaard Øe in its Opinion (paras 5-11) and after him the Court (paras 3-9) considered necessary to clarify in detail what exactly the German law prohibits since there was not a single act containing an easily detectable ban. The fact that the Law on employee participation (Gesetz über die Mitbestimmung der Arbeitnehmer) from 1976 and the Law on industrial relations (Betriebsverfassungsgesetz) from 2001, do not allow the participation of employees employed by TUI in other Member States, does not follow directly from their provisions but has always been construed by German legal science on the basis of the principle of territoriality which prevents the extra-territorial enforcement of German law in other Member States. (AG para 18, CJEU para 14).

The principle according to which „the competence of the German legislature is limited to German territory, which precludes employees employed in other Member States being included in the German employee participation system" (AG para 88), was defended before the CJEU by the German and Austrian governments. Undoubtedly, it refers to a rule respected both by EU[8] law and international law.[9] It is evident that the German rules of co-determination would be difficult to enforce in case of a dispute in another Member State without its consent, which cannot be easily assumed if the co-determination is governed differently or is not regulated at all in that Member State. It would therefore appear that this objection of territoriality could end the whole dispute, because it is not possible to find in EU law any provision that would oblige the other 27 Member States to follow internally the laws of Germany.

[8] CJEU rulings on territorial limits of applicability of national (tax) rules can be referred to here: C286/90 *Poulsen* a Diva Navigation, EU:C:1992:453, C-379/92 *Peralta*, EU:C:1994:296 and many others.

[9] See for instance in Seidl-Hohenveldern, I. *Mezinárodní právo veřejné (Public international law).* 2. vydání, Praha: ASPI Publishing, 2001, marg. 1504-1517 - „The conflict with international law lies in the boldness of exercising its own state power in the territory of another state without its consent." (marg. 1506).

This conclusion, however, is clear only at the level of abstract legal principles, because the existing practice has developed quite differently. Companies like Daimler or Volkswagen, also seated in Germany, allow their employees in other Member States to participate in the election of their representatives in their supervisory boards operating in German headquarters.[10] The rules governing co-determination in Denmark, Sweden or Norway seem to have no problem with participation of "foreign" employees.[11] The Advocate General himself stated in his Opinion that „some Member States of the EU and the EEA actually grant employees employed in other Member States the right to vote and to stand in elections relating to the administrative and management bodies of national companies." (footnote 72).

An employee working for a „group" seated in another Member State can enjoy the benefit of dual representation: according to the law of his country in the establishment located on its territory and according to the German law in the headquarters of the group on the territory of Germany. The recognition of extra rights to employees - enforceable in another jurisdiction - cannot be considered as a problem from the point of view of their home country. If German law provides that anyone, irrespective of his place of employment, has a certain right enforceable in Germany, it would not be an interference with the sovereignty of another State.[12] For those reasons, perhaps surprisingly, the view of the German-Austrian jurisprudence on the restrictive effects of the principle of territoriality was not recognized as a relevant argument by the Advocate General (para 93) and ultimately also by the Court of Justice, which did not address at all the principle of territoriality in its judgment.

At this point, a generally valid partial conclusion can be made, that EU law does not preclude the national legislation of a Member State from allowing "foreign" employees of a company with a head office in the territory of that Member State to participate in a national system of co-determination. However, this conclusion is only a first step forward, because we still have no answer to the question of whether there is, besides this lawful option, also an obligation to allow such cross-border co-determination in order to avoid discrimination and restrictions on freedom of movement prohibited by EU law.

[10] Keijzer, T., Oost, O., Van Ginneken, M.: op. cit. note 2, p. 217.

[11] Mulder, J.: op. cit. note 2, p. 2.

[12] See reasoning of the General Advocate in his Opinion in the *Erzberger* case, paras 95-96. EU:C:2017:347.

3. CROSS-BORDER CO-DETERMINATION AS A LEGAL OBLIGATION

Probably everyone who wonders whether the representatives elected to the supervisory board by 20% of the employees from Germany would take into account the interests of those who elected them to the same extent as the interests of another 80% of their colleagues abroad, who did do not participate to their election, would feel that something does not fit here. Such system of co-determination creates a situation in which „the interests of German employees are likely to be protected at the expense of their EU colleagues."[13] From the perspective of employees of the same business group, even if they are scattered in places of employment in different EU countries, such a system may appear deeply unfair. The prevention of cross-border co-determination within a multinational business group logically appears to be fundamentally contrary to the principles underpinning the EU internal market: no national protectionism, no discrimination on the basis of country of origin.

Viewed by this optics, the original action brought by the shareholder, K. Erzberger, as well as the preliminary question of the Berlin Higher Regional Courtm, had their merits. Even the European Commission at first had no doubts about it as stated in its written opinion on the case:

> *„It is not compatible with Article 45 for a Member State to grant the right to vote and stand as a candidate for the employees´ representatives in the supervisory board of a company only those workers who are employed in establishments of the company or in affiliated companies within the domestic territory if the Member State structures the co-determination right is such a way that it includes legal situations which, when viewed objectively, could be present both in the same Member State as well as also in another Member State."*[14]

Does compliance with EU law necessitate a Member State to allow a cross-border co-determination in its territory? The answer, summarized only in the conclusion that the Grand Chamber of the CJEU answered this question in the negative, is true but incomplete and fogging a few partial questions for which the answer is not so clear yet.

[13] Keijzer, T., Oost, O., Van Ginneken, M.: op. cit. note 2, p. 221.

[14] Quoted from Krause, R.: op. cit. note 2, p. 2.

4. APPLICATION OF ARTICLE 18 TFEU - PROHIBITION OF DISCRIMINATION

A general prohibition of „any discrimination on grounds of nationality" laid down in Art 18 TFEU was mentioned both in the applicant's arguments and in the preliminary question to the CJEU. As highlighted above, in this case, the feeling that employees subject to the same strategic direction are treated differently seems evident. The Art. 18 also states, however, that the general prohibition of discrimination does not affect the specific provisions of the Treaties which apply the ban on discrimination *in concreto*.

On the basis of this restriction on the application of the general prohibition of discrimination, both the Advocate General and the CJEU quickly dealt with an analysis of the possible conflict of application of the German co-determination provisions with Article 18 TFEU:

> *„It is settled case-law that Article 18 TFEU is intended to apply independently only to situations governed by EU law in respect of which the Treaty lays down no specific prohibition of discrimination. As it is, in respect of freedom of movement for workers, the principle of non-discrimination is given specific effect by Article 45(2) TFEU. There would thus be no need for the Court to give a ruling with regard to Article 18 TFEU if Article 45 TFEU were applicable in the present case."* (AG paras 39-40, CJEU paras 25-26).

The simple elegance of such an argument disappears if the subsequent analysis of a possible breach of Article 45 TFEU results in the conclusion that to those who might feel discriminated against by the established rules of co-determination – i.e. to the employees of a German business group employed outside Germany – the Article 45 TFEU does not apply at all. This Article of the Treaty protects employees who have exercised free movement, that is, they are seeking, exercising, or have been, for a certain period of time, performing dependent work outside the Member State of which they are nationals. This can hardly be the case if an employee, who has never left his home country, is only employed by an employer whose head office is located in another Member State. Under the settled case-law of the CJEU, the Treaty rules on the free movement of persons cannot be applied „to workers who have never exercised their freedom to move within the Union and who do not intend to do so". (CJEU para 28). Therefore, the TUI AG employees outside Germany are not fortunate twice: Article 18 TFEU, which they might want to invoke if they feel discriminated against, will not help them, as priority will be given, due to the cross-border situation of the case, to application of Article 45 TFEU. However, even this *lex specialis* does not offer them anything if their personal situation is found without an "EU element", i.e. without the exercise of free movement.

At this point, apparently, more than one reader perceives that the CJEU got rid of the real problem using a purely formal argument. The Court should have ruled on the question whether, in a situation when the *lex specialis* is not applicable, it does not imply a return to the *lex generalis*, i.e. to the general prohibition of discrimination under Article 18 TFEU, as for instance Mulder argues.[15] Similarly, K. Erzberger insisted before the CJEU that discrimination (within the meaning of Article 18 TFEU) takes place precisely in the case of foreign employees of companies with headquarters in Germany, whereas workers in Germany are, on the contrary, deprived of free movement (within the meaning of Article 45 TFEU).[16] The prohibition of discrimination (in general) is standardly applied in EU law even where there is no element of movement of the allegedly discriminated individuals across the EU's internal borders[17] - of course, except in cases where EU law cannot be applied at all - as it was the case right here, according to the CJEU.

Following such reasoning, another partial conclusion is very difficult to formulate. The CJEU sometimes finds the applicability of EU law where Member States do not expect it[18] and also applies the prohibition of discrimination and the restriction of free movement in cases where all participants are from one Member State and the "EU element" can only be assumed as potentially possible or otherwise distantly present.[19] A firm point for understanding the CJEU decision in the *Erzberger* case may be found in the *ad absurdum* argument, i.e. by pointing to the absurdity of the outcome that the opposite solution would lead to. Finding the applicability of Article 45 TFEU to all employees of companies whose headquarters are located in another EU country would extend the status of EU migrant worker to tens of millions of staff who have never pulled their heels out of their native country. In Member States fully open to foreign investors, large numbers of the domestic population would suddenly be allowed to invoke the protection of EU migrants and the rights guaranteed to them and their family members (including those without EU citizenship) by EU law would be applied preferentially to the law of their home Member State.

[15] Mulder, J.: op. cit. note 2, p. 6.

[16] Hellwig, H.J.: *German Corporate Co-determination of Emloyees and EU Law*. University of Oxford, Faculty of Law Business Law Blog, 24 February 2017, [https://www.law.ox.ac.uk/business-law-blog/blog/2017/02/german-corporate-co-determination-employees-and-eu-law] accessed on 11/07/2018.

[17] For sure, if there is a discrimination case without a cross-border element, it is never based on nationality but on age, sex, religious or political affiliation etc.

[18] Se for instance CJEU C617/10 *Fransson*, EU:C:2013:105.

[19] This is a long series of cases, represented, for example, by an older decision CJEU C-14/83 *Von Colson*, EU:C:1984:153 and a newer decision C-144/04 *Mangold*, EU:C:2005:709 or C-108/09 *Ker-Optika*, EU:C:2010:725.

The CJEU therefore decided pragmatically to exclude those employees from the protection of the rights conferred by Article 45 TFEU.

In spite of that positive assessment, we have no answer to the question of what would have been the solution if the plaintiff in the original case (that is, K. Erzberger) and thereafter the Berlin Higher Regional Court formulating its preliminary question, referred only to an infringement of Article 18 TFEU, i.e. to a general prohibition of discrimination, and not to Article 45 TFEU at the same time. The Advocate-General and the CJEU would have to address the question of the applicability of EU law to non-migrant workers of a multinational enterprise group and could not have escaped it by giving priority to the analysis under Article 45 TFEU. The suggestion of their possible answer can be found in the fact that, although the preliminary question did not distinguish between the employees of subsidiaries and branches of the German company headquarters (it referred in general to 'establishments'), the Advocate General and the CJEU took advantage of the fact that TUI AG was in other Member States always present only through subsidiaries with their own legal personality (under the law of the host country), not through branches without their own legal personality.[20] Employees of foreign subsidiaries of TUI AG, have been subject to the legal order of their home country in all aspects of their individual and collective employee rights, which of course implies that they have not been discriminated against on the ground of their nationality.

However, the CJEU by that narrowing of the scope of the preliminary question did not fully clarify whether its conclusion also applies to the cases of branches deriving their legal personality from the parent company and thus remaining subject in their internal rules (and sometimes through the labor law chosen) to the law of the Member State where the parent company is seated. The CJEU chairman, K. Lenaerts, raised at the oral hearing the question whether there was still no element of free movement of workers in the case of a branch of a foreign company, unlike the case of a local subsidiary whose employees did not actually carry out any free movement[21]. In the ruling, however, the CJEU did not address the issue - because it did not need to answer such question in the specific circumstances of the *Erzberger* case.

This does not mean, of course, that the question should not be answered for the future. The situation of an employee of a branch of a foreign legal person carrying out dependent work on the territory of his home country may be close to

[20] In the Czech law for instance, even the entry of a branch operating on the Czech territory into the Business Register does not give to this branch its own legal personality. See the judgment of the Czech Supreme Administrative Court 9 Afs 289/2015 – 80 from February 11, 2016.

[21] Hellwig, H.J.: op. cit. note 16.

the situation of a "commuting worker" travelling to his employer each day to the other side of the border from his home country where he keeps his permanent residence. If a commuting employee is a migrant worker under EU law, it is entirely possible to ask under what conditions an employee of a branch of a foreign legal entity could and should be a migrant worker either. If he were to become a migrant EU worker, Article 45 TFEU would, of course, be applicable to him. The *ad absurdum* argument used above would not be appropriate here, because employees with this status would be in the order of magnitude much less numerous than employees of foreign companies' subsidiaries. There is no guarantee of a solution here, even after the decision on the *Erzberger* case.

5. APPLICATION OF ARTICLE 45 - PROHIBITION OF OBSTACLES TO THE FREE MOVEMENT OF WORKERS

If a larger group of employees who may feel affected by the impossibility of cross-border co-determination – i.e. "foreign" employees of a business group with headquarters in Germany - is completely out of the EU law scope of application, there remains only the analysis of the violation of Article 45 TFEU to the detriment of those potential or actual members of the supervisory board who might take, as an obstacle to their freedom of movement, the fact that they will have to give up their right if they receive a job offer in an establishment of the group outside of Germany.

In the present case, the issue thus was whether the TUI AG employees in Germany were restricted in their free movement by losing the benefit of co-determination and not whether the TUI AG employees outside Germany were harmed by the fact that they were in the supervisory board of the company represented only by delegates of the minority employed in Germany. It sounds like a paradox that EU law could be helpful to those who, by exercising the right of free movement, have been deprived of a certain "privilege" within the TUI group, while it cannot improve the situation of those who, being part of the same group, cannot achieve the same "privileged" status…

EU does indeed protect those workers who want to migrate and their own Member State relieves them of certain benefits, particularly in the social field, which they are entitled to. Almost exactly one year before the judgment in *Erzberger*, the CJEU replied to the preliminary question in the case *Pöpperl*[22] that a Member State infringes Article 45 TFEU if a civil servant who decides to leave for work in another Member State is retroactively deprived of the pension benefits reserved to civil servants. At the opposite end of the set of similar cases of leav-

[22] CJEU C-187/15 *Joachim Pöpperl*, EU:C:2016:550.

ing for work in another country is the CJEU judgment in the *Graf* case from the year 2000[23], which some of the parties to the *Erzberger* case also invoked. In that case, the CJEU found that the complainant was not prevented from moving freely to work in another Member State by being refused an unemployment benefit by his home State, because the link between that refusal and the freedom to migrate to work was regarded as „too indirect and uncertain". It is possible to ask whether the situation of a TUI AG employee in Germany who, by transferring within the TUI group to work in another Member State, loses the right to vote and to be elected to the Supervisory Board, is closer to Mr Pöppel's situation or Mr Graf's situation. If we find the similarity with *Pöpperl*, the only conclusion would be that there is an obstacle to the free movement of workers, which, if not justified and proportionate, would be contrary to Article 45 TFEU. Adhering to *Graf* on the other hand, there will be no obstacles to free movement, as the freedom of TUI AG employees in Germany to migrate will not be limited.

The Commission has fundamentally departed from its earlier written statement in the same case and at the oral hearing it argued that the obstacle to the free movement of TUI AG workers in Germany was present, but such a restriction could be justified, because the employee participation was „an important public policy objective".[24] The Advocate General advocated an opposite view by concluding that EU law cannot guarantee the migrant worker the complete neutrality of his move to another member country in terms of working conditions, social security benefits etc. The advantages enjoyed by the employee under the law of one Member State simply do not migrate with him if he chooses to be subject to the legislation of another Member State. (para 69). Until there is no harmonized EU legislation in matters of co-determination, the act of labor migration brings the migrating worker to a different legal regime, within which he cannot be discriminated against, but in which he may lose some of the benefits enjoyed in his home country. At the same time, the Advocate General rejected the parallel with the *Graf* judgment, because „the loss of the right to vote and to stand for election as representatives of employees within the supervisory board of the company and, where appropriate, the loss of the seat on that board where the employee is transferred to another Member State cannot in my view be regarded as too indirect and uncertain…" (footnote 59). Anyway, such an argument was not necessary if it were enough to assert that under EU law the migrant worker cannot claim the social and employment neutrality of his transfer between Member States.

Nevertheless, the Advocate General offered also the solution in the event that the CJEU would have shared the Commission's view and found the existence

[23] CJEU C-190/98 *Volker Graf*, EU:C:2000:49.

[24] Commission, Statement 17/141 from January 24, 2017.

of an obstacle to free movement. He therefore proposed a justifiable exemption from the ban to limit the free movement that would be „justified by the objective of ensuring employee participation within the company, in accordance with the national social, economic and cultural particularities." (para 106). He did not go that far as some of the parties recommended and did not suggest to recognize as an acceptable justification either the diversity of national social models for employee participation or the straight reference to Article 4 (2) TEU, according to which national differences in the application of the rules of co-determination would be the component of Member States' national identity respected by EU law. In the end, the CJEU did not need any of such justifications because it very briefly adhered to the line of argument that EU law (in particular Article 45 TFEU) cannot guarantee the neutrality of transfer of a worker to another Member State in terms of the conditions of his work and social advantages. (paras 34-35). The Article 45 TFEU is therefore not infringed even when a TUI AG employee is transferred from Germany to work in another EU Member State and EU law does not prevent Member States from laying down limits on the application of their co-determination rules. (paras 36-39).

The CJEU chose once again the easiest route to the target and avoided dealing with interesting, but complicated questions burdened with risky implications. It did not specify any criteria of (in)direct or (un)certain influence of a State measure over the choice to stay or migrate and did not open the door to attempts of challenging different types of would-be "limitations" of movement resulting from differences in national employment rules. It did not discuss the possibility to either easily justify an obstacle to the free movement by differences between national social systems, or recognize the rules of co-determination as part of a national identity. If that were the case, Pandora box would have been opened and an avalanche of creative justification for all possible national exceptions from EU internal market rules might have followed. Despite the above-mentioned unresolved aspects of the problem, the CJEU sent to national legislators and multinational employers a soothing message: limitation of the application of national rules on co-determination to national territory is not a breach of EU law (certainly in cases where "foreign" employees belong to a "foreign" entity within a group).

6. CONCLUSION

In the *Erzberger* judgment, the CJEU undoubtedly sought to minimize the practical implications and consequent complications that the case with far-reaching legal and non-legal connotations could have caused. Despite certain doubts and lack of answers mentioned in this text, it was basically a decision that avoided the legal confusion which would have arisen if a contradiction were

found between German rules of co-determination and EU law. The ruling also prevented further dismantling of the achievements of a specific model of the welfare state, which should fundamentally be shaped by the debate and consensus of politically relevant forces within the German society, not by the verdicts of a supranational judicial authority. At the same time, the CJEU, by briefness of its reasoning (42 paragraphs only), did not allow to question the degree of integration of the EU internal market through the absolutization of certain differences between Member States.

The fact that the CJEU left some questions to which we would like to know the answer without a solution means, among other things, that the door remained open to further development, whether at the national level (change in the application of German co-determination rules according to the Scandinavian model) or at the EU one (agreement on the harmonization of certain rules on cross-border co-determination). So the ball is now on the politicians' and their voters-employees' side of the playground. If they really worry that employees of multinational companies with headquarters in Germany are not able to vote and be elected to supervisory boards if they are not employed on the territory of Germany, they have to find a political way to change national laws or to harmonize them at EU level.

If many people nowadays complain that the courts are narrowing the room that should remain at the disposal of legislators, the CJEU did not do anything similar in its *Erzberger* decision. The remaining uncertainty about cross-border application of the rules of co-determination is surely worth it. Whoever cannot stand this uncertainty should, in order to be on the safe side, allow all employees of his foreign establishments to vote and be elected to the governing bodies of the company's headquarters.

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THE KEY AUDIT MATTERS AS AN ELEMENT OF THE INDEPENDENT AUDITOR'S REPORT – A BOOSTER TO THE CORPORATE GOVERNANCE

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ABSTRACT

In 2009 the International Auditing and Assurance Standards Board (IAASB) initiated a project entitles 'Auditor reporting' with an objective to appropriately enhance the communicative value and relevance of the audit report. This act of the IAASB can be considered as a starting point in the revision of the International Standards on Auditing related to the structure and content of the audit report. After perennial consultations, dialogs, numerous comments received, on January 2015, the IAASB issued six revised and one new Standard related to the auditors reporting. Revised and new Standards become effective for audits of financial statements for periods ending on or after December 15, 2016. The most significant content change relates to the new Standard ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report. The intention of including new paragraph(s) in the report, related to the key audit matters (KAMs), was to enhance its communication value by providing greater transparency on performed audits, and to give insights to stakeholders to the matters that, in the auditor's professional judgement, were of the most significance. The subject of the paper is to analyse changes in the structure and content of the new audit report, with a focus to the new element - KAMs. Related to the research problem, the objective of the paper will be to investigate improvements of the new audit reports, research an average number of KAMs included in one report, and make conclusions about differences between Croatian statutory auditors in prepar-

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ing the audit report. The research covers audit reports of Croatian listed companies (public interest entities - PIEs) for 2016 and 2017. Research methodology includes using appropriate statistical methods as descriptive statistics, non-parametric tests, principal component analysis, and clustering.

KEYWORDS: *financial statement audit, the International Standards on Auditing, audit report, key audit matters, materiality, listed companies, public interest entities, the IAASB, communication gap, information gap*

1. INTRODUCTION

The objective of the audit report is to provide reasonable assurance that financial statements represent accurate and objective financial position and business performance of a company. "The integrity and credibility of financial statements are sensitive aspects that significantly influence the investors' confidence in the capital market efficiency." (Danescu, T. & Spatacean, O., 2018, p. 111) As a corporate governance mechanism, financial statement audits have an important role in providing reliable and credible information on the truth and fairness of the financial position and business performance of a company. The credibility of financial statement was questioned several times through history, especially related to cases as Enron, HealthSouth, Kmart, Parmalat, Tyco, WorldCom, Waste Management, Sunbeam, Adelphia Communications or Xerox, in the USA, and Parmalat in Italy, Allied Nationwide Finance in New Zealand and others. Danescu & Spatacean (2018) that those happening seriously shaken investor confidence in financial statements. Cordos & Fülöpa (2015) went a step further questioning the auditors' reliability. After the failure of multimillion dollar companies, and as a response to an accounting scandals, numerous measures of legislation restriction have been taken, where the most prominent was new legislation on internal financial controls and financial reporting, aimed to the publicly held corporations, that came into force in 2002 known as the Sarbanes-Oxley Act (The Sarbanes-Oxley Act, *web*). Regarding financial statement audits, continuous efforts are being made to maintain and strengthen accountability, integrity and credibility of statutory auditors and audit reports.

In the context of accountability and integrity of statutory auditors and auditing firms' important role have the International Ethics Standards Board for Accountants (IESBA) that provide appropriate ethics requirements which are compiled in *the Code of Ethics for Professional Accountants*. Fundamental principles in the Code are integrity, objectivity, professional competence and due care, confidentiality, and professional behavior (IESBA, 2016, pp. 9-10). A

professional accountant[1] shall[2] observe and comply with the Code. The obligation of professional accountants is to promote an audit profession, and in that context to gain trust and confidence of all interested parties.

Apart from statutory auditors' accountability and integrity, reliability and credibility of the audit report represents fundamental premise for user of financial statements. The stakeholders are aware of the fact that statutory auditors possess much more information on the audited company than disclosed in the audit report. It can be concluded that lack of available information presented by statutory auditors is one of the major deficiencies of the *former* audit report. The report was strictly standardized with narrowly defined structure. The methods and procedures of the audit process and obtained data on the company is summarized within one page, with no or very little information specific to the audited company. The only paragraph that could be specific to a company is defined by the ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent auditor's report* that was in the domain of auditor's professional judgement, and often not used. The informative power and usefulness of such report was questioned. "Nowadays, the users of audit reports feel that the statutory auditors have more knowledge about their companies than themselves, which in their opinion is frustrating and unsettling. Statutory auditors are being criticised for using a much too standardised language, for not explaining how they have reached the opinion they provide within the audit report, and for not communicating sufficiently with the people whose interest they should protect – shareholders and potential investors." (Cordos G. & Fülöpa M., 2015, p. 149)

The most significant change in the new audit report that could result in narrowing communication gap includes adding new paragraph(s) related to the key audit matters (KAMs). As defined by the new ISA 701 *Communicating Key Audit Matters in the Independent auditor's report* KAMs are "those matter that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period" (IAASB, 2016, p. 776). In accordance with the Standard, statutory auditors select KAMs from matters communicated with TCWG, which result with matters that required significant auditor attention in performing the audit (IAASB, 2016, p. 776). In that context, KAMs are those matters of most significance in the audit of the current period. The new Standard provides statutory auditors with the possibility to provide company-specific information to stakeholders. The future will show

[1] Professional accountant is official term for external auditor in *the Code* and USA practice, and a statutory auditor is a term used in European Union legislation.

[2] Using the word 'shall' indicates a requirement to comply with the specific provision, unless an exception is permitted by the Code (IESBA, 2016, p. 9).

the long-term effects of recent changes, and enhanced value of the audit report, as well as impact on decision making of interested parties. The question is, will those changes bring differences and company-specific information to stakeholders or KAMs will after an adoption period become standardized and insufficiently informative.

2. THE RECENT EVOLUTION OF AUDITOR REPORTING

In 2006 the *International Auditing and Assurance Standards Board* (independent standard-setting board of the International Federation of Accountants – IFAC) and the *Auditing Standards Board* (the senior technical committee designated by the American Institute of Certified Public Accountants – AICPA to issue auditing, attestation, and quality control statements) "commenced a joint initiative to commission academic research to identify, and provide information and insights on user perceptions regarding the financial statement audit and the independent auditor's report among different classes of financial statement users" (IAASB, *web*; project: Auditor Reporting). As it was emphasized in *The Business Times* (2014) the initiation of major reporting standards changes was to deliver more relevant and useful information about the entity, the financial statements and the audit. Several empirical researches that were conducted during the 2009 helped the IAASB to identify key messages regarding users' perception about the audit report. After several meetings that was held from 2010 to middle 2011, in May 2011 the IAASB issued a Consultation Paper, Enhancing the Value of Auditor Reporting: Exploring Options for Change. The objective of the paper was to determine if there are common views of key users about the usefulness and relevance of auditor reporting and to obtain an impression on the expectations and information gaps[3] (IAASB *web*; project: Auditor Reporting).

As a result of identified issues, the Board explored options for changes which they summarized in five parts: format and structure of the standard audit report (part A), other information in documents containing audited financial statements (part B), auditor commentary on matters significant to users' understanding of the audit or the audited financial statements (part C), an enhanced corporate governance reporting model: role of TCWG regarding financial reporting and the external audit (part D), and other assurance or related services

[3] The Board defines the expectations gap as "the difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is", and information gap as "a gap between the information they believe is needed to make informed investment and fiduciary decisions, and what is available to them through the entity's audited financial statements or other publicly available information" (IAASB, May 2011, pp. 7-8)

on information not within the current scope of the financial statement audit (part E) (IAASB, May 2011, pp. 12-24). Next to the structure of the report, use of technical language, and the location of the auditor's opinion, a significant fragment of upcoming change represents an auditor commentary on significant matters. "Users of audited financial statements believe that the auditor possesses a great deal of information about the entity and the audited financial statements that would be of value to them in their decision making. (…) Some have suggested that expanded commentary about topics such as these in the auditor's report on the financial statements would provide greater transparency into the entity, its audited financial statements, and the audit performed." (IAASB, May 2011, p. 16). Furthermore, it has been suggested that statutory auditor should disclose additional information as identified key areas of material misstatement risks, areas of significant auditor judgment, the level of materiality applied by the statutory auditor to perform the audit, the entity's internal controls, including significant internal control deficiencies identified by the statutory auditor during the audit, areas of significant difficulty encountered during the audit and their resolution (IAASB, May 2011, p. 17). A first draft of the new audit report, presented by the Board in the Consultation paper, includes positioning the opinion in the first paragraph, followed by auditor commentary on matters significant to users'. The important questions, in the context of auditor commentary, refers to the possibility of removing paragraph 'Other matter'[4], should paragraph 'Auditor commentary on significant matters' be mandatory for all audited entities, and which information that paragraph should cover. During the four-month period (May 15 – September 15) 82 stakeholders gave feedback on the proposed changes, and at its December 2011 meeting the IAASB approved a project proposal. "Requests for auditor communications in this area stem from the view that the auditor possesses a great deal of information" (IAASB, December 2011, pp. 10-11) In accordance with the received comments, it was clear that significant changes in the structure of the audit report will occur, and additional paragraphs regarding auditor commentary (AC) should be included.

As a result of all researches, consultation paper, commentaries, and meetings, at its June 2012 meeting, the Board approved a consultation document entitled Invitation to Comment: Improving the Auditor's Report (ITC) which clearly illustrates the suggested improvements of the future audit report (IAASB,

[4] In the ISA 706 'Emphasis of Matter' is defined as a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements, and 'Other matter' is defined as a matter other that those presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the audit, the auditor's responsibilities or the audit report (IAASB, 2016, p. 833).

web). At that moment, the IAASB reached general agreement on a number of improvements, where the most significant are adding 'Auditor Commentary' paragraph that will be required for public interest entities (PIEs), and auditor's conclusion on management's use of the going concern assumption (IAASB, 2012, p. 6). "Going concern is one of the fundamental pillars of corporate reporting." (Segal, M., 2017, p. 382)

One of the major questions that arose in the context of including 'Auditor Commentary' in the audit report is related to the necessity of keeping the concepts of 'Emphasis of Matter' and 'Other Matter' paragraphs. In this phase, the IAASB was prone to replace those elements with a comprehensive concept of 'Auditor Commentary' that would provide transparent information about matters relating to the financial statements and the audit itself. "The IAASB will consider this in its standard-setting proposals, but the IAASB's preliminary view is that these concepts should be replaced by the more holistic concept of Auditor Commentary. Views from respondents in this regard would be particularly helpful." (IAASB, 2012, p. 23) In less than four months (June 21 – 08 October) 165 stakeholders submitted their comment letters. The comments they received included supporting and non-supporting opinions on adding 'Auditor Commentary' to the report. Considering the result that the majority of comments supported the concept of adding a new paragraph, the IAASB decided to continue with it (IAASB, Meeting Agenda, 6A, December 2012, p. 11). At the meeting on February 2013, among other matters, the IAASB supported to change the term Auditor Commentary (AC) to **Key Audit Matter (KAM)**. At the June 2013 meeting, the IAASB unanimously approved the following proposed new and revised ISAs for exposure:

- ISA 700 (Revised), Forming an Opinion and Reporting on Financial Statements
- ISA 701 (New), Communicating Key Audit Matters in the Independent Auditor's Report
- ISA 260 (Revised), Communication with Those Charged with Governance
- ISA 570 (Revised), Going Concern
- ISA 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report
- ISA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report. (IAASB, *web*)

The exposure drafts were open for comment from July 25, 2013 through November 22, 2013. Cordos & Fülöpa (2015) conducted an analysis of received comments regarding the KAMs concept. "A number of 138 comment letters

was received, most of them coming from English-speaking countries, like the US, Canada and the UK. (…) For this analysis, we have only selected responses from comment letters issued by organisations, regulating bodies or individuals from within the EU. This counts for a total of 47 responses." (Cordos G. & Fülöpa M., 2015, p. 135) The results of the analysis showed that 32 users (66%) find beneficial inclusion of KAMs in the report and 16 users (34%) finds proposed ISA 701 appropriate and sufficient in determining KAMs. "However, 21% of the replies consider that the framework for assessing KAM are more or less experimental, and should provide further guidance." (Cordos G. & Fülöpa M., 2015, pp. 138-139) "Regarding the possibility for the auditor to not report any KAMs, 70% of the responses argue that this possibility should be allowed, while 9% believe that it should not" (Cordos G. & Fülöpa M., 2015, p. 145). Related to the most prominent question regarding the 'Emphasis of Matter' and 'Other Matter' paragraphs almost half (49%) respondents agree with the IAASB's decision to retain them (Cordos G. & Fülöpa M., 2015, p. 146).

After discussing the feedback on the exposure drafts at the IAASB March 2014 meeting, the agreement is reached at its June 2014 meeting, and at its September 2014 meeting the new and revised statutory auditor reporting standards was approved, which has been released in January 2015, and become effective for audits of financial statements for periods ending on or after December 15, 2016.

3. LITERATURE REVIEW

The most important impact of independent auditors' report improvements should be increase of transparency, disclosed relevant information and to enhance reliability of the report (Reintjes C., 2015; Cordos G. & Fülöpa M., 2015; Botez, D., 2017; Sneller, L., Bode, R. & Klerkx, A., 2017; Tadros, E., 2018). Considering the stakeholders' comments, standard-setters concluded that adequate way of narrowing the communication, information gap is to restructure the report, to emphasize the responsibilities of statutory auditors, and TCWG, and to provide company's specific information through KAMs. "One of the reforms is the transition from a standardised auditor's report without any company-specific information to a report that discloses company-specific information in the so-called key audit matters, significant risks of material misstatement in the company's financial statements." (Sneller, L., Bode, R. & Klerkx, A., 2017, p. 139) Reintjes (2015) concludes that "the overall objective of the new and revised auditor reporting standards is to enhance the value and relevance of the auditor's report". (Reintjes C., 2015, p. 36) "The most prominent change in the auditor's report under the new and revised auditor reporting

standards is the communication of key audit matters (KAM), which provides more entity-specific and audits-specific information to the users of the audited financial statements about the audit that has been performed." (Peyper, T., 2017, p. 53) "Key Audit Matters (KAMs), in the audit report in order to include more information regarding the audit mission, with the aim of improving audit communication. This proposal comes after users perception of audit reporting quality has decreased over time." (Cordos G. & Fülöpa M., 2015, p. 128) "The purpose of communicating key audit aspects is to increase the auditor's report communication value through the transparency of the audit. The communication of key aspects provides users with additional information on those issues considered significant by the auditor." (Botez, D., 2017, p. 74) "The key audit matters section is a positive development for auditors as it lets them highlight to the market their behind-the-scenes work." (Tadros, E., 2018, *web*)

The initiative was launched as a result of four research papers which were considered as a backbone for highlighting the existing disadvantages and reporting problems. Mock, Turner, Gray & Coram (2009) gather information from focus groups and verbal protocol analysis (VPA). Different groups of stakeholders participated in the research, from accountants, bank lenders, non-professional investors, statutory auditors. A total of 53 individuals participated in the focus groups divided by category, and 16 experienced and currently-active financial analysts participated in the verbal protocol analysis. The study identified several specific issues related to user perceptions of the level of assurance provided by unqualified audit reports and the impact of such reports on user decision processes. Those issues include the level of assurance that needs to be clearly communicated to stakeholders, disclosing some aspects of materiality, assumptions made by statutory auditors regarding a going concern assumption, audit reports on internal controls, and the statutory auditor's assessment of fraud risk in regard to the level of assurance (Mock, T. J., Turner, J. L., Gray, . L., Coram, P. J. (2009), pp. 18-19). Following research conducted by Porter, Ó hÓgartaigh & Baskerville (2009) lead to the conclusion stakeholders do not understand auditing and statutory auditors' responsibilities. The research conclusion, obtained by survey in the United Kingdom (UK) and New Zealand (NZ), is that the content of the audit report does not have a significant influence on the messages understood by reasonably knowledgeable users of financial statements, especially regarding the nature of the audit process, the respective roles of the statutory auditor and the directors, and the risk of investing in the reporting entity (Porter, B., Ó hÓgartaigh, C., Baskerville, R., 2009, p. vi). Next relevant research is related to the communication gap in which Asare & Wright (2009) investigated understanding of the objectives and limitations of the audit report ('macro' level) and the extent to which there is congruence in the stakeholders' interpretation of technical language used in the audit report

('micro' level). Authors found "type II gaps in the assurance obtained from the audit for evaluating company management, investment soundness of a company, and whether the company is likely to meet its strategic goals (…) Further, there were prevalent differences in the meaning attached to many of the micro level technical terms studied. For instance, we found type III gaps in the interpretation of 'test basis'. (…) However, most micro level differences were of the type II category, suggesting the need for a more targeted education of particular user groups rather than change in standards. The one type I gap related to the percent of net income that statutory auditor should use for materiality. Users had a much higher percentage suggesting potential misunderstanding of the effect of materiality on audit effort."[5] (Asare, S. K. & Wright, A., 2009, p. 23). The fourth research is conducted by Gold, Gronewold & Pott (2009) who investigated the existence of an audit expectation gap. In addition to that, authors investigated difference between experienced statutory auditors' and financial statement users' perceptions concerning the reliability of audited financial statements (Gold, A., Gronewold, U. & Pott, C., 2009, pp. 1-2). "Results indicate the persistence of an audit expectation gap based on the revised version of ISA 700 with its new wording for the auditor's report. We further investigate the importance of the information provided in the ISA 700 audit report by comparing user perceptions based on the complete long-form versus a short-form opinion-only audit report." (Gold, A., Gronewold, U. & Pott, C., 2009, p. 26) Overall, the authors concluded that "the comprehensive explanations of auditor vs. management responsibilities and of the task and scope of the audit in the new ISA 700 auditor's report are not effective in reducing the audit expectation gap and in part can even have a detrimental effect." (Gold, A., Gronewold, U. & Pott, C., 2009, p. 28)

During the almost eight-year period (2010-2017) of preparation, drafting, issuing proposals, receiving and analyzing comments, two implementation years, and two application years, researchers investigated the role and possible implication report's structure and content changes. Davidson (2015) discusses the role of the audit committee, and will their role be expanded to assessing

[5] The authors „consider between group differences, which we classify as being consistent with one of three patterns: (i) the user groups (investors and lenders) differ from the auditor group (which we define as a "type I communication gap"); (ii) one user group and the auditor group differ from the other user group ("type II" gap); and (iii) the user groups differ from each other as well as from the auditor group ("type III gap"). Arguably, a type I gap is of the greatest concern to standard setters, since it represents a fundamental communication gap between the issuers and users of the SAR and is likely to lead to misinterpretation and potentially litigation. A type II gap potentially represents an opportunistic communication gap, driven by a particular user's context and a type III gap represents a complete absence of shared meaning." (Asare, S. K. & Wright, A., 2009, p. 3)

KAM's. "As the auditor's KAM will highlight certain financial statement disclosures, the knowledge gained from interactions with the auditor will help the audit committee to evaluate whether those disclosures are relevant and sufficient, assisting them in discharging their duties." (Davidson, T., 2015, p. 36) The proposition of KAMs provoked the most questions and doubts regarding changes. "KAM and the reporting thereof is a fundamental shift in the nature of the audit report." (Segal, M., 2017, p. 387) Reintjes (2015) concludes that "the disclosure of entity-specific and audit-specific KAM is intended to increase confidence in the audit and the financial statements, as users will have more relevant information, and communication between various stakeholder will be enhanced. The value of the audit and the auditor report and audit quality will improve. The public interest will be served." (Reintjes C., 2015, p. 38) Inclusion of KAM in the audit report should narrow the information and communication gaps. "By providing a report with more information, in an extended form, it increases its informative value, providing a better understanding of the auditor's position and its importance in the business environment." (Botez, D., 2017, p. 75)

Important question regarding implementation of the KAMs in the audit report includes decision of which and how many matters to include. Cordos & Fülöpa (2015) point out that the statutory auditor needs to apply his professional judgement in communicating KAMs. According to the ISA 701 "the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit" (IAASB, 2016, p. 776). Next to the question which matter should be classified as KAMs, important question underlined by the authors is 'how many' KAMs should be included in the report. The Standard does not determine required number of KAMs and concludes that this is the matter is of professional judgment of the statutory auditor. "While standards provide guidelines for determining whether an audit matter constitutes a KAM, there is relatively little guidance with respect to the number of KAMs that should be reported. Indeed, which and how many KAMs to report is a matter of professional judgment." (Sirois L., Bédard J. & Bera P., 2018, p. 9) "The number of key audit matters to be included in the auditor's report may be affected by the size and complexity of the entity, the nature of its business and environment, and the facts and circumstances of the audit engagement." (IAASB, 2016, p. 788) Cordos & Fülöpa (2015) consider that from two to seven KAMs should be included in the report. Sirois Bédard & Bera (2018) claim that the inclusion of multiple KAMs can add complexity and dilute the statutory auditor's message. Authors concluded that "as the number of matters increases, each KAM signal becomes less salient and users will have less cognitive resources available to process them, thereby reducing their signaling effect." (Sirois L., Bédard J.

& Bera P., 2018, p. 10) The publication prepared by Deloitte (2017) includes the analysis of the new audit report for 50 companies in Switzerland listed at the Swiss Market Index or Swiss Performance Index. Their results show that statutory auditors on average disclosed 2.8 KAMs per group audit and 0.8 KAMs per holding company, and furthermore a quarter of analyzed reports (26%) disclosed only one KAM, maximum number of KAMs reported was 7 (Deloitte, 2017, p. 3). More than half KAMs (62%) are regarding goodwill and intangible assets, and significant proportion take KAMs related to revenue recognition (44%), taxation (38%), provisions (24%) (Deloitte, 2017, p. 4).

In accordance with the ISA 701 the audit may result with three scenarios: (1) inclusion of KAMs in the report, (2) determining KAMs that will not be communicated in the report, and (3) not finding KAMs. "If applicable, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate in the auditor's report." (IAASB, 2016, p. 150) In that case, the statutory auditor shall include a statement on this in a separate section of the report. "It was initially thought that this would be rare, but there were a number of instances where the auditor did not identify a KAM; particularly for smaller listed entities and where reporting of KAM was requested by regulators." (Peyper, T., 2017, p. 54)

Peyper (2017) emphasizes problems which appeared after the first year of application. "It is sometimes also difficult (and time consuming) to engage with management and those charged with governance (TCWG) in order to reach common ground on which matters were of most significance and therefore KAM." (Peyper, T., 2017, p. 54) Additionally, statutory auditors have a problem in articulating KAMs in the report in an understandable way. Sneller, Bode & Klerkx (2017) investigated the audit reports of Dutch companies, as a frontrunner for the implementation of the new audit report regarding KAMs. Within 75 reports authors identified 255 KAMs of which 39 were IT related. The authors questioned whether the inclusion of KAMs helps reduce the audit information gap and expectation gap which a challenging research area, and concluded that is hard to classify and categorize IT-related KAMs in a uniform way (Sneller, L., Bode, R. & Klerkx, A., 2017, p. 148). Sirois, Bédard & Bera (2018) investigated the effect of communicating KAMs, its attention directing role and explore how they impact users' information-acquisition process and, in the end, whether KAMs ultimately influence their decisions. Results obtained by the authors "show that, consistent with the attention directing role of KAMs, participants access KAM-related disclosures more rapidly and devote relatively more attention to them when KAMs are communicated in the auditor's report." (Sirois L., Bédard J. & Bera P., 2018, p. 4) Finally, it can be concluded that "the communication of KAM will evolve over time – the first few reporting periods will have a steep learning curve." (Peyper, T., 2017, p. 55)

Although disclosing information about materiality did not pass as obligatory within the reporting Standards changes, in context of narrowing communication and information gaps, it is interesting to notice that numerous statutory auditors communicate that information in the new audit report. Deloitte (2017) found that 48% of audit reports of 50 Switzerland listed companies have disclosed information about materiality (Deloitte, 2017, p. 15). "In 20 out of 24 reports (84) materiality was determined based on the consolidated profit before tax as a benchmark and with an average percentage of 4.9% (the median was 5%). Profit before tax is considered as one of the most relevant financial indicator for listed companies." (Deloitte, 2017, p. 16)

4. RESEARCH RESULTS

The IAASBs objective of the project entitled '*Auditors reporting*' was to enhance the value of the audit report in context of narrowing communication and information gaps. Six-year-long project resulted with five revised and one new International Standards on Auditing. Today, two years after revised and new Standards become effective, it is possible to investigate main changes. In accordance with the IAASB's objective, the research question is: did recent changes in the audit report resulted with delivering more relevant and useful information about the company, financial statements and audit methodology to stakeholders? The objective of the paper is to investigate if statutory auditors in Croatia respect provisions of revised and new Standards. The most significant change in the report is related to newly introduced ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*. In that context, objective of the paper includes research if the application of ISA 701 show improvements in communicating KAMs in 2017 compared to 2016, and if Croatian statutory auditors managed to adjust to recent changes at once when Standards become effective, or they need a longer period for adjustment. To effectuate research objectives, we developed three research hypotheses: (1) the structure and content of the new audit report (after 2016) is significantly changed compared to the former audit report (prior to 2016); (2) there exists a significant content difference between audit reports prepared by 'big' auditors and 'small' auditors; (3) there exists content and structure improvements in new audit reports of Croatian listed companies in 2017 compared to 2016. In order to test hypotheses, and obtain conclusions, we used appropriate statistics as descriptive statistics, Mann-Whitney U Test, principal component analysis and cluster analysis.

New ISA 701 enforcers are public-interest entities (PIE)[6]. The research covers public interest entities (further in text: PIEs) in Croatia that are listed on the Zagreb Stock Exchange (ZSE). In 2018, 137 PIEs were listed on the ZSE. We manage to gather audit reports for 120 PIEs in 2016 and 116 in 2017. Other PIEs did not disclose the audit report in the annual financial statements, or did not publicly disclosed financial statements at all. 38 different auditing firms (we reciprocally use term audit firms and statutory auditors) performed financial statement audits for those PIEs (Table 1).

Table 1: Structure of audit reports prepared by 'big four' and other statutory auditors

Statutory auditors	2016		2017	
	n	%	n	%
Deloitte	21	*18*	23	*20*
EY	3	*3*	10	*9*
KPMG	12	*10*	11	*9*
PriceWaterhouseCoopers	30	*25*	26	*22*
'Big Four'	**66**	***55***	**70**	***60***
BDO Croatia	9	*8*	8	*7*
Subtotal	**75**	***63***	**78**	***67***
Other statutory auditors	45	*38*	38	*33*
Total	**120**	***100***	**116**	***100***

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Majority of audit firms (58%) are registered in Zagreb. Next to statutory auditors from Zagreb, 10 audit firms are from Mediterranean Croatia (Dubrovnik, Kastav, Pula, Rijeka, Split, Šibenik, Zadar), four from Central Croatia (Čakovec, Varaždin) and two from Eastern Croatia (Osijek). Croatian Register of Audit Firms counts 230 entities, all registered as a limited liability company (LLC) (Hrvatska revizorska komora, *web*). Conducted research includes 16.5% of all registered audit firms.

[6] Public-interest entities are undertakings governed by the law of a Member State and whose transferable securities are admitted to trading on a regulated market, credit institutions, insurance undertakings, and other entities designated as public-interest entities by Member States (The European Parliament and the Council, 2013, Article 2). Public-interest entities in Croatia are defined by Accounting Act.

Table 2: Number of audits, average and total revenues, assets and employee number of PIEs by statutory auditors

	Number of audits		Revenues (Sales) (in million HRK)		Total assets (in million HRK)		Employee number	
	n	%	Mean	Sum	Mean	Sum	Mean	Sum
Deloitte	44	*18.6*	1,026	17,444	3,058	51,985	725	31,887
EY	13	*5.5*	926	40,728	7,548	332,103	3,044	39,575
KPMG	23	*9.7*	4,022	52,281	10,942	142,251	2,267	52,139
PriceWaterhouse-Coopers	56	*23.7*	1,384	31,832	9,302	213,939	1,593	89,227
BDO Croatia	17	*7.2*	1,388	77,751	4,047	226,646	1,882	31,989
Other statutory auditors	83	*35.2*	252	20,883	480	39,859	417	34,570

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

The data in Table 2 show that KPMG performed audits for PIEs with the largest average revenues, total assets and employee number, and BDO Croatia audited the largest market share of PIEs. It is evident that small audit firms preformed audits for smaller PIEs. Conducted analysis gives us information that over 40% of PIEs are registered in the city of Zagreb. The highest proportion of PIEs are registered in the Mediterranean Croatia (43%), and their main business activity is related to tourism (Table 3).

Table 3: PIEs by regions

Number PIEs per region	2016		2017	
	n	%	n	%
Eastern Croatia	13	*10.8*	12	*10.3*
Mediterranean Croatia	50	*41.7*	49	*42.2*
Central Croatia	8	*6.7*	8	*6.9*
The City of Zagreb	49	*40.8*	47	*40.5*
Total	**120**	***100.0***	**116**	***100.0***

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

4.1. CONTENT AND STRUCTURAL CHANGES IN THE AUDIT REPORT

The first hypothesis that the structure and content of the new audit report (after 2016) is significantly changed compared to the former audit report (prior to 2016) will be tested by examining the new audit report structure and content for the listed Croatian PIEs. Former audit report is not investigated considering that their structure and content was strictly standardized and widely known.

First known fact of the former report is that the opinion was placed as the last paragraph in the report, and that the extent of the report was rarely more than one page. All examined new reports begin with the opinion what can be considered as a first signal of new Standards adoption. Next to that, descriptive statistics show that the average page number of the new report is 5.81 pages with a standard deviation of 1.36 pages. Minimum number of pages per report were 3, and in observed two years 10 reports had the minimum page number. Maximum number of pages was 9 (six reports).

Table 4: Descriptive statistics for number of pages in audit reports

	n	Minimum	Maximum	Mean	Std. Deviation
Number of pages	236	3	9	5.81	1.359

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

One of the segments that were highly discussed by the IAASB, and information that would, in stakeholders' opinion, greatly narrow communication gap, is communicating details on auditors' methodology, and related to that, reporting about **materiality**.

Table 5: Structure of audit firms by disclosing information about materiality in the audit report

	2016		2017	
	n	%	n	%
Yes	1	*2.9*	19	*63.3*
No	34	*97.1*	11	*36.7*
Total	35	*100.0*	30	*100.0*

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Former audit report did not include information about materiality. Inclusion of materiality information in the new report is voluntary, although that information could significantly increase the value of the report. "It is considered to be one of the most important decisions of the audit and thus one of the most valuable information for users of the financial statements" (Deloitte, 2017, p. 15). Of 30 audit firms that conducted financial statement audits for 116 listed PIEs for the year 2017, 63% (19) of them communicated materiality details in the audit report (Table 5).

Furthermore, information that needs to be communicated in the audit report for audits conducted after 2017 is information about duration of the continuous engagement period, including the year under review, and date of the first engagement. In accordance with the Auditing Act (127/2017) and Regulation (EU) No 537/2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC, in order to address the familiarity threat and therefore reinforce the independence of statutory auditors and audit firms, a maximum duration of the audit engagement of a statutory auditor in a particular PIE in Croatia is seven years[7] (Official Gazette, Auditing Act, Article 64). Out of 116 examined reports for the year 2017, in three reports information was not published, one report has disclosed information on lasting continuous engagement but not information about first engagement.

[7] Regulation (EU) No 537/2014 in Article 41 regulates transitional provisions that:
"1. As from 17 June 2020, a public-interest entity shall not enter into or renew an audit engagement with a given statutory auditor or audit firm if that statutory auditor or audit firm has been providing audit services to that public-interest entity for 20 and more consecutive years at the date of entry into force of this Regulation.
2. As from 17 June 2023, a public-interest entity shall not enter into or renew an audit engagement with a given statutory auditor or audit firm if that statutory auditor or audit firm has been providing audit services to that public-interest entity for 11 and more but less than 20 consecutive years at the date of entry into force of this Regulation.
3.Without prejudice to paragraphs 1 and 2, the audit engagements that were entered into before 16 June 2014 but which are still in place as at 17 June 2016 may remain applicable until the end of the maximum duration referred to in the second subparagraph of Article 17(1) or in point (b) of Article 17(2). Article 17(4) shall apply."
Croatian Auditing Act (127/2017) prescribes that auditing engagements contracted before 16 June 2014, in accordance with Regulation (EU) No 537/2014, can be applied until the end of the longer period of the audit engagement (10 years). Furthermore, the maximum continuous duration of audit engagements (7 years), appointed before Act enforcement, counts from the day of its appointment (Official Gazette, Auditing Act, Article 123).

Table 6: Information on continuous engagement period including the year under review

Information on continuous engagement period including the year under review	n	%
Appointment of statutory auditor not published	5	*4.3*
Published date of engagement for 2017	92	*79.3*
Published date of first engagement	16	*13.8*
Published information that statutory auditor is engaged from the establishment of a company	2	*1.7*
Published information on year of the first continuous engagement	1	*0.9*
Total	116	*100.0*

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Majority of examined reports has published information about the date of the engagement for year 2017 (79%), or date of the first engagement (14%). According to Auditing Act PIEs must appoint statutory auditors for the current year at least three months before the end of the calendar year (Official Gazette, Auditing Act, Article 41). Conducted analysis shows that nine PIEs appointed statutory auditors within last three months of 2017 (Table 6). Five of those PIEs are part of the Agrokor concern which financial statements had been re-audited in that year. Another four PIEs shall change their practices in future periods.

Table 7: Information on continuous engagement period including the year under review

Information on the continuous engagement period, including the year under review	n	%
Yes	113	*97.4*
No	3	*2.6*
Total	116	*100.0*

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Only 2.6% of 116 audit reports for the year 2017 do not have included information on continuous engagement period, including the year under review (Table 7).

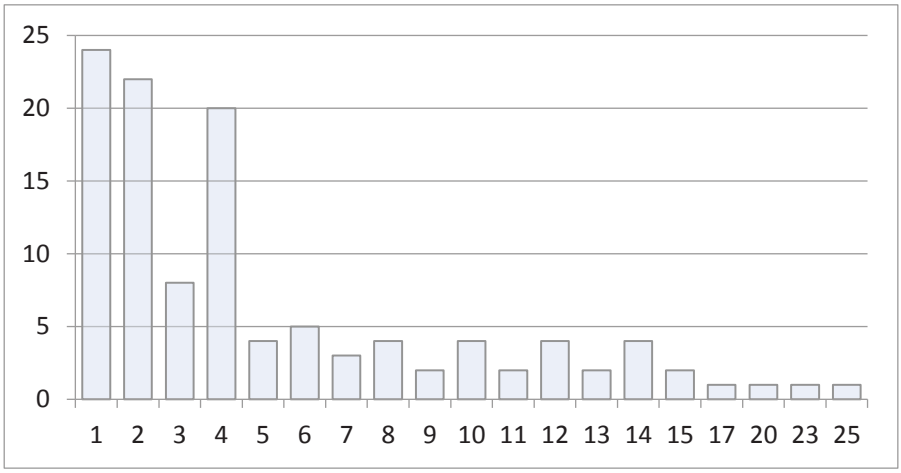
Table 8: Descriptive statistics about continuous engagement period including the year under review

	Continuous engagement period including the year under review						
Year	Count	Mean	Standard Deviation	Median	Mode	Minimum	Maximum
2017	116	5	5	4	1[a]	1	25
a. Multiple modes exist. The smallest value is shown							

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

In Croatian PIEs, average duration of the continuous engagement period was 5 years with standard deviation 5 years (Table 8). For the half of PIEs, engagement lasted 4 years or less, and the other half of PIEs have a continuous engagement 4 years or longer. The most often the engagement duration has been one year, which is at the same time the minimum years of the engagement duration period, while the maximum continuous engagement period was 25 years.

Graph 1: Number of audit reports by continuous engagement period including the year under review



Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Graph 1 shows left-skewed distribution where can be seen that majority of continuous audit engagements lasted from 1 to 4 years. It is important to notice

that 24.6% (28) PIEs did not change statutory auditor for more than 7 years. Moreover, three of them stated that have the same statutory auditor form the PIEs establishment. Six PIEs (5,26%) have the same statutory auditor for more than 14 years, what is double time then allowed by the new provisions of the Act. Three analysed PIEs have the same statutory auditor for 20 years or more.

The majority would agree that the most significant change regarding the new audit report is including KAMs in the report. The new Standard (ISA 701) allows statutory auditors to be more creative and report company-specific information that would deepen the stakeholders' comprehension and cognition of PIEs.

Table 9: Reporting on KAMs

Reporting on KAMs	Number of audit report	%
No paragraph	7	*3.0*
No KAMs	21	*8.9*
Yes	208	*88.1*
Total	236	*100.0*

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Of total examined audit reports seven did not have included section about KAMs, or mention it in any way, what makes 3% of all examined reports (Table 9). Additionally, 21 reports have announcement that '*there are no key audit matters to report*'. The remaining, 208 (88%) audit reports have disclosed from 1 to 4 KAMs. The largest proportion of audit reports has communicated 1 (42%) or 2 (32%) KAMs (Table 10), and only five reports have disclosed four KAMs.

Table 10: Number of KAMs per audit report

Number of KAMs	n	%
0	28	*11.9*
1	99	*41.9*
2	76	*32.2*
3	28	*11.9*
4	5	*2.1*
Total	236	*100.0*

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Considering the results obtained by the analysis, it can be concluded that the first research hypothesis, the structure and content of the new audit report (after 2016) is significantly changed compared to the former audit report (prior to 2016), can be accepted. All reports have positioned the opinion paragraph at the beginning of the report, and all reports have at least three pages. Furthermore, majority of PIEs published information on the continuous engagement duration for 2017, as well as the date of the first or current year engagement. Over 95% of the audit report applied ISA 701, and communicated KAMs.

4.2. DIFFERENCES BETWEEN 'BIG' AND 'SMALL' AUDITORS

Second research hypothesis includes investigating are there a significant content difference between audit reports prepared by 'big' auditors and 'small' auditors. For the research purposes, we grouped audit firms, i.e. statutory auditors, with regard to the number of conducted audits and the size of PIEs measured by total assets, revenues and employee number. In order to classify audit firms as 'big' or 'small' auditors, we used k-means cluster analysis. Clustering process includes two classifying variables, number of conducted audits per statutory auditor and the average size of the PIE. The average size of the PIE is measured by total assets, revenues and employee number. Size proxy is determined by applying principal component analysis. After obtaining new variable, we calculated average value of the proxy per statutory auditor. Variables are standardized for using in cluster analysis. The analysis resulted with two clusters: first cluster includes five cases (Deloitte, EY, KPMG, PriceWaterhouseCoopers, BDO Croatia), and second 33 cases (all other audit firms included in the research) (Table 11).

Table 11: Number of Cases in each Cluster

Number of Cases in each Cluster		
Cluster	1	5.000
	2	33.000

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Final cluster centres show the mean for each variable within each cluster, and in accordance with obtained values, it can be concluded that cases in the first cluster include audit firms that conducted more audits of bigger PIEs (Table 12).

Table 12: Final Cluster Centres and Distances between Final Cluster Centres

Final Cluster Centres	Cluster	
	1	2
Zscore(AuditNumber)	2.12189	-0.32150
Zscore(AvgPCA)	1.95996	-0.29696

Distances between Final Cluster Centres		
Cluster	1	2
1		3.326
2	3.326	

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

ANOVA table shows that both variables are important for cluster analysis (p-value < 0.05). The higher F-value for the first variable suggests that the number of conducted audits had higher impact on determining clusters than size proxy (Table 13).

Table 13: ANOVA table for the cluster analysis

ANOVA						
	Cluster		Error			
	Mean Square	df	Mean Square	df	F	Sig.
Zscore(AuditNumber)	25,923	1	0,308	36	84,250	0,000
Zscore(AvgPCA)	22,118	1	0,413	36	53,501	0,000
The F tests should be used only for descriptive purposes because the clusters have been chosen to maximize the differences among cases in different clusters. The observed significance levels are not corrected for this and thus cannot be interpreted as tests of the hypothesis that the cluster means are equal.						

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Out of 38 audit firms, five can be classified as 'big' auditors that conducted majority financial statement audits of Croatian listed PIEs (63% in 2016 and 67% in 2017). Onwards, other audit firms are classified as 'small' auditors. Financial statement audits of listed PIEs in Croatia in 2016 were conducted by 30, and in 2017 by 25 'small' auditors (Table 14).

Table 14: Number of audit firms classified by size

	2016	2017
Number of audit firms	**35**	**30**
'Big' auditors	5	5
'Small' auditors	30	25

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Table 15 shows that 'small' auditors conducted 83 (35%) financial statement audits of PIEs in Croatia. The average revenues, total assets and employee number for PIEs audited by 'small' auditors is significantly lower than for PIEs audited by 'big' auditors.

The analysis of differences between audit reports prepared by 'big' and 'small' auditors is performed by testing characteristic of the reports for the both groups of audit firms. In order to determine differences, we choose to examine six elements of the audit report that will be the foundation for our conclusion. Those elements are: (1) number of pages, (2) opinion, (3) going concern assumption, (4) 'Other matter' paragraph, (5) materiality and (6) reported number of KAMs.

Regarding the number of pages for reports prepared by 'big' and 'small' auditors, Table 15 shows that reports of 'big' auditors on average have 6.25 pages with a standard deviation of 1.23 pages, i.e. the most often number of pages in the audit report is 6. As opposed to that, reports prepared by 'small' auditors on average have 5.01 pages with a standard deviation of 1.22 pages, i.e. 'small' auditors most often prepared reports 5 pages long. Performed Mann-Whitney U test shows that there exists statistically significant difference in page numbers distributions for 'big' and 'small' auditors.

Table 15: Number of pages in audit report by audit firms' size

Number of pages	Count	Mean	Standard Deviation	Median	Mode
'Big' auditors	153	6.25	1.23	6.00	6.00
'Small' auditors	83	5.01	1.22	5.00	5.00

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Interesting in determining differences between 'big' and 'small' auditors is a tendency to report modified opinion. On average 28% of examined audit reports have '*Qualified Opinion*', and the rest of reports have '*Unmodified Opinion*' (Table 16). Over 31% of 'small' auditors published report with modified opinion compared to 26% of modified reports prepared by 'big' auditors. More detailed analysis shows us that Deloitte most often reported modified opinion (36%), and KPMG had the lowest proportion of modified opinion (13%). Nevertheless, Mann-Whitney U test shows that there is no statistically significant difference between opinion distribution of 'big' and 'small' auditors (empirical p-value .398 that is higher than the significance level of .05).

Table 16: Structure of qualified opinion, significant going concern disclosure, other matter paragraph, and materiality for 'big' and 'small' auditors

	Qualified Opinion		Significant going concern disclosure		Other matter paragraph		Materiality	
	n	%	n	%	n	%	n	%
'Big' auditors	40	*26.1*	26	*17.0*	26	*17.0*	64	*27.1*
'Small' auditors	26	*31.3*	12	*14.5*	35	*42.2*	27	*11.4*
Subtotal	66	*28.0*	38	*16.1*	61	*25.8*	91	*38.6*

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Another variable that could make the differences between 'big' and 'small' auditors is communicating going concern assumption. Out of 236 examined audit reports, 16% (38) had paragraph significant going concern disclosure, 19 per each observed year. The assumption was reported in 17% of reports prepared by 'big' auditors, and in 14.5% of reports prepared by 'small' auditors. According to the results of Mann-Whitney U test there is no statistically significant difference in the distributions of 'big' and 'small' auditors regarding going concern assumption (p-value .614). 'Big' auditor with the highest percentage of significant going concern disclosure is PriceWaterhouseCoopers (28.6%), followed by BDO Croatia (23.5%), while Deloitte and KPMG had 9% reports with the disclosure, and opposed to that EY did not have report with included going concern assumption.

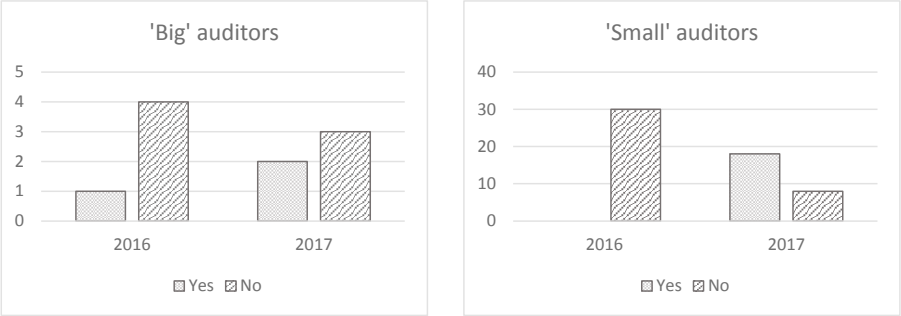
A quarter (25.8%) of examined audit reports has 'Other matter'[8] paragraph. Mann-Whitney U test shows that there exists statistically significant difference in reporting 'Other matter' between 'big' and 'small' auditors. The higher proportion of reports with included the paragraph issued 'small' auditors (42.2%) compared to 'big' auditors (17.0%). In the case of five 'big' auditors, 'Other matter' is communicated in almost half reports issued by BDO Croatia (47.1%) and EY (46.2%). Opposed to that, only 1.8% of reports issued by PriceWaterhouseCoopers have included 'Other matter' paragraph. The content of the paragraph is diverse and the most common reason of including paragraph in the report is to announce the change of statutory auditor (7; 11.5%). Additionally, six reports with included paragraph 'Other matter', reported about the change of statutory auditor in separate section entitled 'Other questions' (6; 9.8%), and three reports of PIEs that changed the statutory auditor for the cur-

[8] For the research purposes, 'Emphasis of matter' and 'Other matter' paragraphs are complied.

rent year, does not have that announcement. Other common announcements included in the 'Other matter' paragraph are related to the active lawsuits uncertainties regarding land ownerships (tourism PIEs), uncertainties about account receivables, liabilities, revaluation of assets and others.

Information about materiality is disclosed in 39% of all examined reports (Graph 2), and although 27% of the reports prepared by 'big' auditors compared to 11% of the reports prepared by 'small' auditors have included materiality details, existing difference is not statistically significant (p-value .162).

Graph 2: Information about communicating materiality for 'big' and 'small' auditors



Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

The most commonly used materiality base is revenue, which is used in 61.5% audits. The average materiality percentage is 1.35% of revenues with standard deviation 0.68%. Minimum percentage was 0.5%, maximum 3.0%, and most common was 1% of revenues (Table 17).

Table 17: Materiality base and percentage

Materiality base	Materiality percentage							
	n	%	Mean	Standard Deviation	Median	Mode	Minimum	Maximum
Assets	12	13.2	0.97	0.38	1.00	1.00	0.50	2.00
Earnings	22	24.2	5.57	2.16	5.00	5.00	2.50	10.00
Equity	1	1.1	4.50		4.50	4.50	4.50	4.50
Revenues	56	61.5	1.35	0.68	1.00	1.00	0.50	3.00
	91	100.0						

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Statutory auditors apply the materiality concept in planning and performing audit engagements, and in evaluating the effect of identified and uncorrected misstatements. "Misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statement." (IAASB, 2017, ISA 200, p. 81) In accordance with the Standards (ISA 200), the statutory auditor is responsible for the detection of misstatements that are not material. In simple words, for the amounts that exceed materiality level is considered that can influence the economic decisions of stakeholders, and on the other side, it is possible that the financial statements as whole have misstatements up to the materiality level and auditor's opinion will not be modified in respect of that. Considering that, it is understandable why materiality represents an important question to users of financial statements.

Table 18: Descriptive statistics for materiality amount by materiality base

Materiality base	Materiality amount						
	Count	Mean	Standard Deviation	Median	Mode	Minimum	Maximum
Assets	12	3,059,583	2,897,681	1,700,000	5,000[a]	5,000	8,200,000
Earnings	22	18,269,545	23,085,669	8,700,000	330,000[a]	330,000	75,000,000
Equity	1	7,550,000		7,550,000	7,550,000	7,550,000	7,550,000
Revenues	56	9,378,696	11,408,905	4,750,000	1,300,000	6,000	54,000,000
a. Multiple modes exist. The smallest value is shown							

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

The highest materiality level is present in audit reports for PIEs in which statutory auditors used earnings as a materiality base (Table 18). The average materiality level for the financial statements of those PIEs was 18.3 million HRK with a standard deviation of 23 million HRK. The minimum materiality level was 330 thousand HRK, and it was for the financial statements of the PIE that had 121.4 million HRK of total assets, and 43 million HRK of revenues (sea transport). The highest materiality level is determined in amount of 75 million HRK, and refers to the PIE with 15.7 billion HRK of total assets, and 7.9 billion HRK of revenues (telecommunication services). As it was stated earlier, the largest number of reports has revenue as materiality base, with most common materiality level of 1.3 million HRK.

Table 19: Descriptive statistics for number of KAMs for 'big' and 'small' auditors

Number of KAMs	Count	Mean	Standard Deviation	Median	Mode
'Big' auditors	153.0	1.7	0.9	2.0	1.0
'Small' auditors	83.0	1.1	0.9	1.0	1.0
a. Multiple modes exist. The smallest value is shown					

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

'Big' and 'small' auditors most commonly issued reports with included only one KAM, but half of 'big' auditors issued reports with 2 or more KAMs (Table 19). On average, 'big' auditors, disclosed 1.7 KAMs with a standard deviation of 0.9 KAMs, and 'small' auditors disclosed 1.1 KAMs with a standard deviation of 0.9 KAMs. Mann-Whitney U test shows that the difference between 'big' and 'small' auditors is statistically significant. The PriceWaterhouseCoopers reported the highest number of KAMs, on average 1.9 per report.

Table 20: KAMs structure

KAMs structure	**1**	**2**	**3**	**4**
Revenue recognition	42	4	3	/
Capitalization	5	3		/
Estimates	14	8	2	/
Impairments	39	28	5	/
Valuation	39	15	9	2
Property, plant and equipment	7	2	/	/
Collectability of receivables	/	4	/	/
Before bankruptcy settlement	4	1	/	/
Contingent liabilities and litigation settlements	7	8	1	/
Provisions	12	4	2	1
Construction contracts	4	/	/	/
Accumulated depreciation	1	4	2	/
Going concern assumption	1	/	2	/
Other	35	24	7	2
Total	210	105	33	5

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

As it can be seen from the Table 20, the most common first KAM is about revenue recognition (20%), impairments (18.6%), and valuation (18.6%). Significant proportion makes matters about estimates (6.7%) and provisions (5.7%).

Table 21: Structure of impairments, valuation, estimates and provisions reported as KAMs

Impairments	Valuation	Estimates	Provisions
– assets – assets held for sale – assets, factoring gain – brands and goodwill – goodwill – granted loans to subsidiaries – intangible assets – investments in subsidiaries – non-current assets – property, plant and equipment – receivables – related parties – ships – test for equity instrument – tourist facilities	– biological assets – public partner receivables - Arena lessee – liabilities – long-term liabilities – tourist facilities – intangible assets – inventories – land and buildings – non-financial financial instruments – granted loans to subsidiaries and unrelated third parties – related parties' receivables – account receivables – property, plant and equipment – liabilities from the insurance contract and the adequacy test of liabilities – ships recoverable amount – technical reserves – related parties' investment – technological oil	– technical reserves – real estate – tourist facilities – unlimited useful life of brands and licenses – lawsuit and claims – useful life of the property, plant and equipment – hydrocarbon reserves	– loan losses – litigation settlements and contingent liabilities – leaving the field estimation – warranty obligations – contingent liabilities

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

As it can be seen in the Table 21, disclosures related to valuation are the most diverse, followed by impairments disclosures. Reports include total 28 KAMs related to the granted loan impairments (1/19; 2/9; 3/0; 4/0), 15 KAMs related to the valuation of land, buildings and tourist facilities (1/11; 2/3; 3/1; 4/0). Provisions are most often related to warranty obligations (1/6; 2/3; 3/1; 4/0), and 13 KAMs about estimates is related to estimates of the useful life of the property, plant and equipment (1/10; 2/3; 3/0; 4/0).

Table 22: Results of Mann-Whitney U Test

	Variable	Null Hypothesis	Test	Sig.	Decision
1	**Number of pages**	The distribution of Number of pages is the same across categories of Auditor size	Independent-Samples Mann-Whitney U Test	.000	Reject the null hypothesis
2	Opinion	The distribution of Opinion is the same across categories of Auditor size	Independent-Samples Mann-Whitney U Test	.398	Retain the null hypothesis
3	Going concern assumption	The distribution of Going concern assumption is the same across categories of Auditor size	Independent-Samples Mann-Whitney U Test	.614	Retain the null hypothesis
4	'Other matter' paragraph	The distribution of 'Other matter' paragraph is the same across categories of Auditor size	Independent-Samples Mann-Whitney U Test	.000	Reject the null hypothesis
5	**Materiality**	The distribution of Materiality is the same across categories of Auditor size	Independent-Samples Mann-Whitney U Test	.162	Retain the null hypothesis
6	**Number of KAMs**	The distribution of Number of KAMs is the same across categories of Auditor size	Independent-Samples Mann-Whitney U Test	.000	Reject the null hypothesis
Asymptotic significances are displayed. The significance level is .05.					

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

As it can be seen from the results, out of six observed variables, three of them have the same distribution for 'big' and 'small' auditors, and three of them show different distributions. Considering results, it is hard to make conclusions about the differences between 'big' and 'small' auditors without assignment of the weight to every included variable by using our professional judgement. In that context, as the most important variables we would outline KAMs, then variability, and number of pages. Those variables are chosen because their content is independent of PIEs business operations. If we apply that assumption, we may confirm second research hypothesis that there is a significant difference between reports prepared by 'big' auditors and 'small' auditors.

4.3. IMPROVEMENTS IN THE NEW AUDIT REPORTS

Existence of content and structure improvements in new audit reports of Croatian listed companies in 2017 compared to 2016 is tested by analysing elements of audit reports in 2016 and 2017, and testing differences by using appropriate statistical tests. We selected three variables that, in our opinion, are the best improvement measurements of the audit report: (1) number of pages, (2) reporting on materiality, and (3) number of reported KAMs.

As it was stated earlier, average number of the audit report pages, observed all together, was 5.81 with a standard deviation 1.4 pages, i.e. the minimum number was 3 pages, and maximum 9 pages.

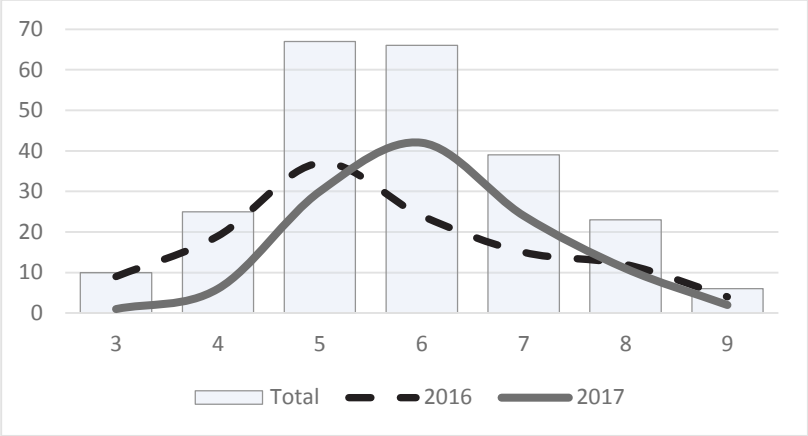
Table 23: Descriptive statistics for number of pages in audit reports by years

Year	Mean	Standard Deviation	Median	Mode	Minimum	Maximum
2016	5.58	1.51	5.00	5.00	3.00	9.00
2017	6.06	1.14	6.00	6.00	3.00	9.00

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Observations analyzed per year show that minimum and maximum number of pages is the same in both years, however, in 2017 the average number of pages per report is over 6 with standard deviation 1.14 pages. Considering the results that mean, median and mode are almost the same in 2017, the data distribution in that year was normalized, compared to 2016 when it was left skewed, meaning that in 2016 were more reports with fewer pages.

Graph 3: Distributions of number of pages in audit reports by years



Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Graph 3 shows normalized and distribution shifted to the right in 2017 compared to 2016. The question is, are those changes statistically significant what is tested by Mann-Whitney U Test. Considering that empirical p-value is .002, and its lower than significance level .05 the null hypothesis that the distributions are the same should be rejected.

As it was shown earlier, there exists increased trend in communicating the **materiality** in 2017 compared to 2016. In 2016 only one statutory auditor reported detailed information about materiality, and in 2017 19 statutory auditors had materiality announcement, what means that 18 statutory auditors changed their approach of preparing the audit report (Table 24). Out of 18 statutory auditors that started reporting materiality details in 2017, one of them conducted two audits in that year, of which one report consist statement on materiality, and other does not. In 2016 only one of five statutory auditors classified as 'big' announces details on applied materiality and in 2017 one more statutory auditor joined him in communicating that information. It can be concluded that the increase of statutory auditors that communicates information about materiality is the result of changes in reporting of 'small' auditors. Those results may lead us to the conclusion that 'small' auditors need more adoption time compared to 'big' auditors that possesses more financial and human resources.

Table 24: Reporting information about materiality

Materiality	No		Yes		Total
	n	%	n	%	
2016	90	*75.0*	30	*25.0*	120
2017	55	*47.4*	61	*52.6*	116
Total	145	*61.4*	91	*38.6*	**236**

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Out of total reports included in the analysis 38.6% have announced information on materiality, and 61.4% does not have disclosed that information. As it was emphasized earlier, disclosure of information about materiality is voluntary and represents a direct increase of the informative value of the audit report, and can be an excellent mechanism for communication and information gap reduction. Changes in 2017 compared to 2016 shows us positive trend. Proportion of reports that have included details about applied materiality increased from 25% to 52.6%. We tested the statistical significance of increase, i.e. improvement of information and communication value, by using appropriate non-parametric Mann-Whitney U Test. Considering that the empirical p-value is .000, and its lower that significance level of .05 it can be concluded that distributions for 2016 and 2017 are different.

The majority of audit reports has disclosed one (41.9%) or two (32.2%) KAMs. In 2016 18% of audit reports did not disclose KAMs. For the year 2017, that proportion decreased to 5% (Table 25). It is undoubtedly that almost all analysed reports in 2017 have disclosed at least one KAM, but the question is, if that increase in 2017 compared to 2016 is statistically significant. The results of non-parametric Mann-Whitney U Test shows that distributions for years 2016 and 2017 are not the same, so it can be concluded that audit reports for the year 2017 have disclosed more information on PIEs, and by that it can be considered that the value of the report is improved.

Table 25: Reporting information about KAMs

	2016		2017	
	n	%	n	%
No	22	*18.3*	6	*5.2*
Yes	98	*81.7*	110	*94.8*
Total	120	*100.0*	116	*100.0*

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Although the number of reports that disclose information regarding KAMs significantly increased in 2017 compared to 2016, that increase is dominantly related to the announcement of one matter (Table 26).

Table 26: Number of KAMs included in the audit reports

Number of KAMs	**0**	**1**	**2**	**3**	**4**
2016	22	38	40	17	3
2017	6	61	36	11	2

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Related to reporting two, three or four KAMs per report, decrease for the year 2017 compared to 2016 can be noted. Considering that, the conclusion is that PIEs, which for the year 2016 had more than one KAMs, in 2017 had disclosed only one. That can be interpreted as a decrease of the informative value of the audit report. However, Mann-Whitney U Test shows that the distribution of a number of KAMs is the same across categories of year because the empirical p-value is .867, and it is higher than the significance level .05. The conclusion is in favour of the enhanced value of the audit report.

Table 27: Results of Mann-Whitney U Test

	Variables	Null Hypothesis	Test	Sig.	Decision
1	Number of pages	The distribution of Number of pages is the same across categories of Year	Independent-Samples Mann-Whitney U Test	.002	Reject the null hypothesis
2	Materiality	The distribution of Materiality is the same across categories of Year	Independent-Samples Mann-Whitney U Test	.000	Reject the null hypothesis
3	Inclusion of KAMs	The distribution of KAMsCode is the same across categories of Years	Independent-Samples Mann-Whitney U Test	.002	Reject the null hypothesis
4	Number of KAMs	The distribution of Number of KAMs is the same across categories of Year	Independent-Samples Mann-Whitney U Test	.867	Retain the null hypothesis
Asymptotic significances are displayed. The significance level is .05.					

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/07/2018.

Considering the results obtained for all improvement measurements, statistically significant differences show that statutory auditors follow new Standards, and they are improving their practices in second compared to first implementation year. The third research hypothesis that there are significant content and structure improvements in new audit reports of Croatian listed companies in 2017 compared to 2016, can be accepted. The results are also the sign that is very hard to implement and adjust to such a significant Standards change overnight. Considering that, it can be predicted that few following reporting years will be adoption period, and additional certain changes in reports' content can be expected. That represents an interesting direction for a future research. Nevertheless, we can conclude that statutory auditors are putting effort in delivering more informative audit report, what can be noted especially regarding disclosures on materiality.

5. CONCLUSION

Recent changes of the International Standards on Auditing regarding statutory auditors reporting resulted with significant structure and content enhancements of the audit report. Align with these changes, the research question is: did recent changes in the audit report resulted with delivering more relevant and useful information about the company, financial statements and audit methodology to stakeholders? The objective of the paper is to investigate if statutory auditors in Croatia respect provisions of revised and new Standards. The results of conducted research show that Croatian statutory auditors adjusted their reporting process to the revised and new Standards. In that context, the information value of the reports is undoubtedly enhanced. Also, the results indicate that 'small' auditors, compared to 'big', need more adjustment time to completely adopt Standards changes, but it is encouraging that reports prepared for the year 2017 are improved compared to the reports for the year 2016. The most outstanding difference between 'big' and 'small' auditors is linked to reporting the KAMs and reports' number of pages, where 'big' auditors are prone to announce more KAMs and their reports are more extensive. As a KAM, statutory auditors most frequently reported about revenue recognition, granted loan impairments, valuation of land, buildings and tourist facilities, provisions regarding warranty obligations and estimates of the useful life of the property, plant and equipment. Creditable improvement of the audit report for the year 2017 compared to 2016 is the statutory auditors' decision to voluntary announce detail information regarding applied materiality. Generally, materiality concept is one of the most important segments of audit engagements, and considering that, as very important information for stakeholders in making economic decisions using information from audited

financial statements. Research results show that Croatian statutory auditors most commonly use 1% of revenues as materiality base, followed by 5% of earnings. It is interesting to emphasize that audit engagements based on earnings have almost two times greater misstatements thresholds than in case of revenues as materiality base. The conducted research shows that the value of the new audit report is significantly improved, and by that, communication and information gaps narrowed. Nevertheless, future research should be aimed to conduct a survey that will include stakeholders by which it would be possible to investigate their opinion regarding the audit report improvements and enhanced value. Besides, considering that additional adjustments of the report are expected within following few years, it would be beneficial to expand this research in the future, in order to gain comprehensive results about the revised and new Standards implementation phases and adjustment duration.

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SHAREHOLDER POWER AS AN ACCOUNTABILITY MECHANISM: THE 2017 SHAREHOLDER RIGHTS DIRECTIVE AND THE CHALLENGES TOWARDS ENHANCING SHAREHOLDER RIGHTS

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ABSTRACT

The 2017 Shareholder Rights Directive has paved the way towards adopting a model where shareholder power can be used as an accountability mechanism in European corporate governance by amending the 2007 Shareholder Rights Directive to encourage active shareholder participation. This model can ensure good governance practices, but practical implications can challenge its effectiveness. This paper seeks to outline the merits and the challenges this model must overcome to be effective. The Directive manifests EU corporate law's adoption of a model where shareholders power is used to confer accountability in corporate governance. Despite the model's merits, there are implications that may impede its effectiveness. Firstly, several problems related to agency capitalism and the establishment of collective action, such as participation costs, disclosure of information; free-riding and incentives of exercising shareholder rights can significantly affect proper shareholder engagement. Secondly, another implication is found on shareholder short-termism and the basis on which shareholder power is to be exercised to confer accountability. Though the Directive addresses these issues to some extent, the appropriate consideration of all issues of these implications is paramount. As such, the Directive is only the starting point towards the facilitation of shareholder power act as an accountability mechanism.

KEYWORDS: *European Corporate Law, Corporate Governance, Shareholder Rights, Shareholder Power, Accountability*

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1. INTRODUCTION

The 2008 financial crisis highlighted serious flaws in corporate governance and accountability and has questioned the extent European and National corporate governance regulation was adequate to prevent these misconducts. As a reaction to the economic crisis, legal regulators reiterated a long-standing position of the European Union that shareholders must play a more responsible role in upholding accountability in corporate governance.[1] This led to the introduction of the 2017 Shareholder Rights Directive.[2] The 2017 Directive seeks to amend the 2007 Shareholder Rights Directive[3] in order to strengthen shareholder monitoring; enhance transparency between companies and its investors and encourage active shareholder engagement for the long-term benefit of the company.[4] In line then with an international upsurge in enhancing shareholder rights, European corporate law through the 2017 Shareholder Rights Directive paves the way towards adopting a corporate governance model where shareholders act as an accountability body in corporate governance to prevent managerial inefficiencies through the exercise of their respective rights.

This model of corporate governance has undoubtedly its merits. An effective shareholder engagement is cornerstone to upholding good corporate governance; and can enhance the checks and balances between different organs of the company.[5] Furthermore, the active exercise of shareholder rights can improve corporate performance, by taking into account issues related to the company's stakeholders or upholding public interest.[6] Despite the merits of this model however, several implications can impede the exercise of shareholder power as an effective accountability mechanism; and can challenge the mod-

[1] Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions: Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies (COM/2012/0740, 2012)

[2] 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 (Shareholder Rights Directive 2017) (OJ L 132, 20.5.2017)

[3] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies (Shareholder Rights Directive 2007) (OJ L 184, 14.7.2007)

[4] Shareholder Rights Directive 2017, [3]

[5] ibid [14]

[6] On stakeholder considerations in the company see Parkinson, J.E.: *Corporate Power and Responsibility: Issues in the Theory of Company Law*, Oxford/ Oxford University Press, 2002; Dodd E. M.: *For whom are corporate managers trustees*, Harvard Law Review, 45 1932, p.1145

el's adequateness and effectiveness for securing good corporate governance practices for the company's sustainable growth.

This paper then seeks to highlight the merits of the model the 2017 Shareholder Rights Directive seeks to introduce, as well as the challenges that European corporate law must address to ensure its effectiveness. Section 2 will state that the 2017 Shareholder Rights Directive contributes in the adoption of a corporate governance model where shareholders exercise their power to enhance accountability. Sections 3 and 4 will highlight several implications that can impede the model's effectiveness should they are not addressed effectively. Section 3 will argue that implications arising from the director-shareholder agency problem that are related to the establishment of collective action and the practice of agency capitalism may affect shareholder power to confer accountability effectively. Though the Directive deals to some extent with these issues; the challenges arising because of the costs of participation, free-riding, information quality and intermediary incentives to exercise shareholder rights need to be addressed more effectively. Section 4 will argue that another implication is found on the basis on which shareholder power is to be exercised. This is because shareholder power may be abused as a means of securing abnormal short-term returns. The security then of a corporate objective that ensures that shareholder power is exercised for conferring accountability for the company's sustainable growth is paramount. Section 5 will conclude that the 2017 Shareholder Rights Directive is only the starting point towards the facilitation of a model where shareholders act as an accountability body. As such, European company law should take these practical implications into account as well to ensure the model's effectiveness.

2. THE 2017 SHAREHOLDER RIGHTS DIRECTIVE: TOWARDS ADOPTING A DEVELOPING MODEL FOR CORPORATE GOVERNANCE

The 2017 Shareholder Rights Directive seeks to amend the 2007 Shareholder Rights Directive and encourage more active shareholder engagement to enhance accountability in corporate governance. The first of the changes regard the enhancement of shareholder voting power. The Directive acknowledges that directors' remuneration should contribute to the company's advancement of accountability to achieve sustainability in corporate governance using performance criteria related both to financial and stakeholder factors.[7] In light of this, Article 9a of the 2007 Directive will state that Member States will en-

[7] Shareholder Rights Directive 2017, [35]

sure that companies will establish a remuneration policy for its directors that will be subject to shareholder approval.[8] However, Member States may provide rules for the vote to be advisory; on which case remuneration will be paid to directors only in accordance with a remuneration policy that has been submitted for shareholder consideration.[9] In addition to that, the 2017 Directive seeks to enhance accountability for a number of transactions that may cause prejudice to the company.[10] Article 9c of the 2007 Directive then will require Member States to ensure that companies will publicly announce a number of key related-party transactions, which shall be subject to shareholder approval or to an approval by the administrative or the supervisory body of the company.[11]

The 2017 Directive further seeks to contribute to the enhancement of transparency between the company and its respective shareholders. The identification of shareholders then becomes a prerequisite to facilitate communication between shareholders and the company to encourage better shareholder engagement.[12] Based on this premise, Article 3a of the 2007 Directive will state that Member States will ensure that national corporate law will allow companies to identify its respective shareholders,[13] and establish a requirement for shareholder intermediaries to contribute towards such identification,[14] subject to compliance with all necessary data protection legislation.[15] Furthermore, the 2007 Directive will compel such identification when the shareholding percentage exceeds 0,5% of the company's shareholding.[16] In addition to the identification requirements, the 2017 Directive seeks to enhance transparency by implementing rules for the effective transmission of information between companies and shareholders. Article 3b then seeks to achieve this by requiring Member States to ensure that shareholder intermediaries are required to trans-

[8] Shareholder Rights Directive 2007 (as amended by the Shareholder Rights Directive 2017), Art. 9a

[9] ibid

[10] Shareholder Rights Directive 2017, [45]

[11] Shareholder Rights Directive 2007 (as amended by the Shareholder Rights Directive 2017), Art. 9c

[12] Shareholder Rights Directive 2017, [4]-[6]

[13] Shareholder Rights Directive 2007 (as amended by the Shareholder Rights Directive 2017), Art. 3a

[14] ibid

[15] 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 (OJ L 119, 4.5.2016)

[16] Shareholder Rights Directive 2007 (as amended by the Shareholder Rights Directive 2017), Art. 3a (1)

mit all necessary information required for the shareholder to be able to exercise its rights effectively; or give notice of the availability of such information in case they are available online.[17]

In addition, the 2017 Directive acknowledges that the active exercise of shareholder power by institutional shareholders and shareholder intermediaries is significant to facilitate accountability for corporate governance.[18] The importance of the existence of such intermediaries and institutional shareholders is undoubted. Institutional shareholders and intermediaries can reduce significantly issues related to the inability of shareholders to exercise their power efficiently as a result of the wide dispersion in shareholding ownership that was noted in public corporations.[19] Furthermore, shareholder intermediaries and institutional shareholders can utilise their expertise to actively exercise shareholding rights. In light of this, Article 3c of the 2007 Directive will state that all intermediaries and institutional investors' asset managers will engage with exercising shareholder rights.[20]

In addition, Article 3g will impose an obligation on institutional shareholders to disclose their engagement policy on a comply-or-explain basis; which will entail details related to the monitoring of the investee company or outline the engagement of shareholder rights for relevant matters including investment strategy and the corporate financial performance and risk.[21] Article 3i of the 2007 Directive will require asset managers to disclose on an annual basis the means the investment strategy is being implemented for the medium to long-

[17] Shareholder Rights Directive 2007 (as amended by the Shareholder Rights Directive 2017), Art. 3b

[18] Shareholder Rights Directive 2017, [9], [14], [15]

[19] Mallin C.*: Institutional investors: the vote as a tool of governance*, Journal of Management Governance, 16 2012, p.180; Gillan, S. L., Starks, L.T.: *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, Journal of Finance and Economics, 57 2000, pp. 278–79; Rose, P.: *The Corporate Governance Industry*, Journal of Corporate Law, 32 2007, p. 887. On the history of the dispersion of shareholding ownership in the US and Europe see in general Morck R. (ed): *A History of Corporate Governance Around the World: Family Business Groups to Professional Managers*, University of Chicago Press, 2007; Wells, H.: *A Long View Of Shareholder Power: From The Antebellum Corporation To The Twenty-First Century*, Florida Law Review, 67 2015; Berle A.A; Means, G.G.: *The Modern Corporation and Private Property, revised ed*., New Jersey, 1991; Davies, P.: *Shareholders in the United Kingdom* in Hill, J.G. and Thomas, R.S. (eds.): *Research Handbook on Shareholder Power*, Cheltenham, 2015; Cheffins, B. R.: *Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies*, Oxford Journal of Legal Studies, 23 2003

[20] Shareholder Rights Directive 2007 (as amended by the Shareholder Rights Directive 2017), Art. 3c

[21] ibid Art.3g

term performance of the assets of the institutional investor, which will include, among other information, how the investment strategy will affect the medium to long-term financial and non-financial performance of the company.[22] Moreover, Member States under Article 3j will be responsible for ensuring that proxy advisors will apply, on a comply-or-explain basis, a code of conduct which shall be disclosed to shareholders; and are required to publicly disclose on an annual basis how they are undertaking their duties for shareholders with regards to the preparation of research, advice and voting recommendations.[23] Moreover, to facilitate further engagement, the 2007 Directive will further require Member States to ensure that there is no discrimination in the incurrence of costs for shareholders on cross-border voting, unless justified where such costs will reflect the variation of actual costs on the implementation or provision of the services as a means of mitigating costs and encourage further engagement.[24]

The 2017 Directive manifests the EU regulators' attempts to conform with an international set of thinking in corporate governance that seeks to adopt a corporate governance model where shareholders exercise their power to provide accountability in corporate governance. The emergence of this idea is not new. The beginning of the 21st century came with the emergence of several corporate scandals, both in the US and Europe,[25] that led to the reconsideration of the prevailing model of absolute managerial control; and the suggestion of more active shareholder participation to counter managerial indiscretion.[26] Based on this model, shareholders can utilise their power to improve the decision-making process through monitoring the executive management for the long-term interests of the company. This model sees shareholders as being more responsible for the affairs of the company, whose active exercise of their rights will mitigate corporate inefficiencies by signalling managerial irregularities or malperformance.[27] Shareholders then with their expertise and power will have a responsibility towards the company they invested in to keep

[22] ibid Art.3i

[23] ibid Art. 3j

[24] ibid Art 3d

[25] See in general Fox, L.: *Enron: Rise and Fall*, Hoboken, 2003; Bava, F.; Devalle, A.: *Corporate governance and best practices: the Parmalat case*, GSTF Business Review, 2 2012; Eriksson, K.: *Corporate Governance in the European Union post-Enron*, Business Law Review, 15 2003.

[26] ibid; see also Armour, J. *et al*.: *Shareholder Primacy and the Trajectory of UK Corporate Governance*, British Journal of Industrial Relations, 41 2003, p.542

[27] Bebchuck, L. B.: *The Case for Increasing Shareholder Power,* Harvard Law Review, 118 2005, p. 892

the management accountable. It must be noted that this model does not seek to inhibit the ability of the management to take decisions. On the contrary, this model seeks to provide the ability to shareholders to raise their concerns and pursuit changes only when the management's actions affect the company adversely.[28] On this premise then, shareholder power enables certain questionable managerial actions to be subject to shareholder consent or control to ensure that responsible governance is at all times upheld.

The merits of this model are numerous. An effective shareholder engagement is cornerstone to upholding good corporate governance; and can enhance the checks and balances between the different organs of the company.[29] This is because shareholders, through the exercise of their rights, can contribute to the advancement of accountability in corporate governance by using of their rights to monitor questionable managerial actions or actions that may significantly deter corporate performance. In this way, shareholders can significantly counter managerial opportunism or inefficient performance;[30] and thus act as a corrective mechanism in corporate governance which contributes to the enhancement of accountability internally.[31] Furthermore, the active exercise of shareholder rights can improve corporate performance, by taking as well into account issues related to the company's stakeholders and its responsibility towards the society in general.[32] Shareholder power then can be used not only for the furtherance of shareholder interests, but also for furthering the company's sustainable growth, which will secure their interests as well through the pursuit of good corporate governance. The combination of both will further contribute to the efficient operation of European capital markets; which will increase confidence in the undertaking of cross-border business that will enhance both the Internal Market and the national economies of European Member States as well. An effective exercise then of shareholder rights as an accountability mechanism will enable shareholders to assess the company's relative performance and sustainable growth.[33]

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[28] Hill, J.: *Visions and Revisions of the Shareholder*, The American Journal of Comparative Law, 48 2000, p.60

[29] Fama, E.F.; Jensen, M.C.: *Separation of Ownership and Control*, Journal of Law and Economics, 26 1983, pp. 301-310

[30] Moore, M.; Petrin, M.: *Corporate Governance: Law, Regulation and Theory*, London, 2017, pp. 90-93

[31] ibid

[32] ibid

[33] On the meaning of sustainable growth for a company see Keay, A.: *The Corporate Objective*, Cheltenham, 2011

Nevertheless, the efforts made for the adoption of this model via the 2017 Directive bear a number of material implications that need to be addressed by European and national corporate law more effectively to ensure that shareholders will actually contribute to the enhancement of accountability in corporate governance under this model.

3. THE MULTIDIMENSIONAL SHAREHOLDER-DIRECTOR AGENCY PROBLEM: COLLECTIVE ACTION AND AGENCY CAPITALISM

The multidimensional shareholder-director agency problem creates a number of practical implications that can impede the effectiveness of shareholder power as an accountability mechanism should they are not addressed effectively by corporate governance regulation to facilitate such a model for corporate governance. When the management falls short of their responsibility to secure the company's sustainable coverage of its liabilities,[34] the need for shareholder monitoring generates a number of agency costs.[35] In theory, the single owner of all shareholding of a company will try to keep the management accountable regardless of the costs, as the sustainable running of the company is of paramount concern to the sole shareholder.[36] In the context of public companies though, the costs of keeping directors accountable may exceed the advantage shareholders will have to keep directors accountable, thus making them dis-interested or unable to monitor directors by themselves.[37] For this reason, shareholders are required to undertake a collective action as a means to mitigate agency costs incurred from the need to keep the management accountable.

Collective action though poses a number of additional agency problems,[38] as additional costs are required to be incurred to co-ordinate shareholder incen-

[34] Bainbridge, S. M.: *Why a Board? Group Decisionmaking in Corporate Governance*, Vanderbilt Law Review, 55 2002, p.10

[35] Fama, E.G.; Jensen, M.C.; *Agency Problems and Residual Claims*, The Journal of Law & Economics, 26 (2) 1983, pp. 330-334

[36] ibid

[37] Black, B.S.: *Shareholder Passivity Re-examined*, Michigan Law Review, 89 1990, p. 566. Corporate Governance systems with an administrative body or supervisory board bear additional agency problems and costs as a result of the need to co-ordinate the administrative body or supervisory board to correct managerial inefficiencies. For the dimension of such problems in Germany see in general Schulz, M.; Wasmeier, O.: *The Law of Business Organizations: A Concise Overview of German Corporate Law*, Berlin, 2012, pp. 40-53; du Plessis, J. *et al*.: *German Corporate Governance in International and European Context* (2nd edn), Berlin, 2012, p. 159

[38] Rock, E.B.: *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, The Georgetown Law Journal, 79 1990, p. 453

tives and ensure the action's success.[39] The incentives of shareholders then to engage in a collective action become material. The traditional logic behind shareholder collective action typically sees shareholders finding it difficult to engage in a collective action. This idea is attributed to Olson's fundamental work, the "Logic of Collective Action".[40] To Olson, individuals in a large group driven by their self-interest and economic rationality will typically engage in a collective action only when the advantage provided from the collective action is greater than the costs incurred to undertake such a collective action.[41] Thus, any group to which the advantage conferred on each individual is outweighed by the costs or the advantage conferred is zero will be latent. For Olson though, individuals of a large group will find it difficult to engage in a collective action given the group's size; and will thus be latent.[42] This is because individuals in a large group may find it difficult or less rational to engage in a collective action with each abstention of an individual from the collective action. The amount of the advantage conferred to each shareholder will be minimised with each abstention of a shareholder, as fewer members will have to bear the costs of the collective action, and thus be less rational for the bearers of the cost to engage as the advantage for them will be continuously minimised.[43]

The traditional idea of collective action problems reflects a fraction of the practical implications shareholders face when there is a need to take a collective action to exercise their rights. A shareholder who is primarily incentivised by its own self-interest or engage in a collective action based on what is considered economically rational may engage in a collective action when it determines that managerial accountability will confer significant advantages, especially if the action will be engaged by a good number of shareholders that can reduce agency costs incurred per individual shareholder.[44] Based on Olson's understanding though, shareholders may not find collective action to be in their best interests,[45] since the need for a collective action in a large group of shareholders makes co-ordination of interests difficult.[46]

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[39] ibid

[40] Olson, M.: *The Logic of Collective Action*, London, 1971

[41] Ibid pp. 37; 61-63; 174

[42] Ibid p. 48

[43] Ibid p. 53

[44] Sharfman, B.S.: *Activist Hedge Funds In A World Of Board Independence: Creators Or Destroyers Of Long-Term Value?*, Columbia Business Law Review, 2015, pp. 824-825

[45] Coffee, J.C.: *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, Columbia Law Review, 91 1991, pp. 1310-1318

[46] Bainbridge, S.M.: *Corporate Governance after the Financial Crisis,* Oxford, 2012, pp. 240- 245; Wachter, BW.: *The Case Against Shareholder Empowerment*, University of Pennsylvania Law Review, 158 2009, p. 653

The parallel implication of free-riding though further impedes the fruition of collective action. If a number of shareholders will choose not to engage in the collective action,[47] they may still enjoy the fraction of all advantages produced by that collective action should it is initiated.[48] The costs of intervention can be incurred by the participants in the collective action, but the benefit will still be shared, even at a smaller fraction. Thus, a shareholder may find free-riding an advantageous alternative than participation.[49] But should a collective action arises, free-riding acts to the detriment of shareholders participating in the collective action because of the provision of fewer advantages to them as a result of incurring more costs, thus making it costlier to be engaged.[50] Since shareholders under this logic will engage only when the advantage is significant enough to outweigh the costs, the element of free riding can significantly impede the extent collective action will be undertaken, as it can influence shareholders not to engage given the growing number of costs and the minimised advantage conferred to them.[51]

The traditional logic of collective action correctly identifies several material problems in establishing shareholder collective action. This includes the material issue of costs, free-riding and the limited incentives in engaging in such an action in the absence of a significant advantage. However, the traditional logic of collective action does not entirely resonate with all material considerations in need to be taken when considering collective action in the corporate context. Firstly, collective action can be as beneficial as any other alternative course of action in terms of choices available to each individual in a group.[52] This is because the only way an individual can get any advantage or most of the advantage conferred from a collective action will be to refrain from free-riding or not participating at all.[53] In the corporate context then, shareholders will have to consider whether collective action is advantageous enough in comparison with alternative courses of action.

Secondly, the extent of latency for shareholders in the corporate context does not depend much on the number of shareholders, but on the degree of concen-

[47] Moore, Petrin (n 30), p. 118

[48] Grossman, S.J.; Hart, O.J.: *Takeover Bids, The Free-Rider Problem, And The Theory Of The Corporation*, The Bell Journal of Economics, 11 1980, p. 42

[49] Rock (n 38) pp. 454; 461

[50] ibid

[51] Schelling, T.C.: *Micromotives And Macrobehaviour*, New York, 1978, pp. 213-243

[52] Hirschman, A.O.: *Shifting Involvements: Private Interest And Public Action*, Princeton, 1982, pp. 77-82

[53] ibid

tration of shareholding ownership.[54] Latency then for a shareholder collective action depends on the smallest efficacious group of shareholders that has the incentives and voting power to engage in a collective action. The smallest efficacious group is based on the degree of concentration of shareholding ownership and the extent shareholder voting power and influence of the efficacious group can be sufficient in engaging in a collective action.[55] This means that the larger the concentration is in a company, the easier the smallest efficacious group can be found to engage in a collective action.[56] If the advantage from a collective action to keep the management accountable will not be provided unless the full costs of engagement are being paid; and provided that each shareholder holds information about the number of shareholders that can form an efficacious group to undertake that collective action; an effective efficacious group can be created to hold such collective action as a means to provide the advantage to the whole of the group.[57]

Because of this, a shareholder must decide the best course of action for itself based on the information the shareholder holds about the existence of an efficacious group capable of undertaking that very collective action effectively to confer the advantage to shareholders.[58] Should the information indicates that an advantage is capable of being conferrable to shareholders, the choice for shareholders to engage in a collective action becomes a matter of the best course of action available compared to alternative courses of action. Free riding for example will affect shareholder collective action only when the free-riding behaviour will disable the ease or the ability to form an efficacious group.[59]If high concentration though renders collective action feasible, free-riding becomes less favourable, as the probability of not getting any advantage is increasing with the increase in probability of not forming an efficacious group, since its abstention will increase the possibility of rendering collective action unachievable and the shareholder not getting any advantage.[60] The same applies to considerations regarding exiting the company.[61] If other

[54] Hardin, R.: *Collective Action*, Baltimore, 1983, pp. 25-26

[55] Rasmussen, E.: *Games And Information: An Introduction To Game Theory*, Oxford, 1981, pp. 43-53

[56] ibid

[57] Rock (n 38) p. 458

[58] ibid

[59] Ibid p. 460

[60] Hirschman, A.: *Exit, Voice, And Loyalty: Responses To Decline In Firms, Organizations, And States*, London, 1970, Chapters 2 and 3

[61] Rock (n 38) p. 461

factors do not contribute to render exiting the company a feasible option;[62] the provision of the advantage from the collective action for each individual shareholder increases with the rate of concentration of the company.[63] Shareholders then will engage in a collective action even when the advantage provided is actually zero, to the extent the rest of the alternative courses of action are not more beneficial than engagement in a collective action.

Thirdly, shareholders tend to be incentivised by other axioms to those of self-interest and economic rationality as well.[64] In trying to explain how latent groups can still engage in a collective action, Olson identified that individuals may be compelled to engage in a collective action to mitigate any further losses in advantages;[65] or possess selective incentives arising from potential advantages privately to each individual should a collective action is undertaken.[66] In addition to these, other axioms may incentivise shareholders to engage in a collective action.[67] Such axioms include convention arising from the frequent exercise of shareholder rights;[68] incentives with regards to fairness and responsibility to correct corporate wrongs to this extent;[69] economically extrarational behaviour that drives them into such an engagement,[70] such as actions accruing from moralistic pursuits;[71] sentiment arising from the shareholders' relationship and attachment to the company;[72] and the idea of social responsibility as a means to correct corporate wrongs affecting the society in general.[73]

These axioms are capable of further bolstering the feasibility of shareholders engaging in a collective action. If a collective action is undertaken from shareholders that have different axioms, shareholders can keep the management accountable as a by-product of the relative incentives to contribute into a col-

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62 Ibid p. 462

63 ibid

64 Woidtke, T.: *Agents watching agents?: evidence from pension fund ownership and firm value*, Journal of Finance and Economics. 63 2002, p. 104

65 Olson (n 39) p. 91

66 Reisman, D.A.: *Theories Of Collective Action*, Basingstoke, 1990, pp.156; 164

67 Ibid

68 ibid

69 Ibid p. 169

70 Ibid

71 Marshall, A.: *Principles of Economics*, New York, 1920, p. 253

72 Reisman (n 66) p. 171

73 Sommer, A. A. Jr.: *Whom Should the Corporation Serve--The Berle-Dodd Debate Revisted Sixty Years*
Later, Delaware Journal of Corporate Law, 16 1991, p.35

lective action.[74] Based on the level of concentration of shareholding ownership and the availability of information, shareholders have the ability to convert or utilise their power based on their incentives to keep the management accountable as a means to gain their desired advantage that managerial accountability will provide it.[75] Thus, if a shareholder or an efficacious group determines that it may be irrational for shareholders to engage in a collective action because of the limited availability of an advantage or the collective action stands as less advantageous from other alternative courses of action; shareholders may determine rational to organise shareholders incentivised from different axioms to ensure that the advantage is to be provided through the common goal of achieving managerial accountability.[76]

Therefore, subject to the existence of other axioms that may require accountability by shareholders important, shareholders will engage in a collective action if concentration in shareholding ownership will allow shareholders gaining an advantage high enough in comparison to any alternative courses of action. At this point, it must be noted that several parameters determine the extent shareholder collective action is a feasible option to shareholders. The first of the parameters concern the amount of costs. The 2017 Directive has made its efforts to alleviate costs through the introduction of rules for non-discrimination in costs between national and cross-border exercise of shareholder rights. The introduction of these rules will definitely assist in the encouragement of shareholders exercising their rights more frequently, especially at a cross-border level.[77] In addition, the transparency laws introduced by the Directive will further mitigate costs and thus contribute to better engagement.[78] Nevertheless, internal agency costs vary to a significant extent from company to company and depends much on the action in need to be taken and the company's internal controls.[79] This is because, active shareholder participation requires the assessment and adoption of a number of strategies, in addition to the need to align such strategies with the various shareholder interests to minimise the

[74] Fama, E. F.: *Agency Problems And The Theory Of The Firm*, Journal of Political Economy, 88 1980, pp. 292-295

[75] ibid

[76] Hardin (n 54) p. 31

[77] Belcredi, M.; Ferrarini, G.: *Corporate boards, incentive pay and shareholder activism in Europe: main issues and policy perspectives* in Belcredi, M.; Ferrarini, G. (eds): *Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms*, Cambridge, 2013, p.13

[78] Berglöf, E.:*Reforming Corporate Governance: Redirecting the European Agenda*, Economic Policy, 12 1997, p. 91

[79] Katelouzou, D.: *Myths And Realities Of Hedge Fund Activism: Some Empirical Evidence*, Virginia Law & Business Review, 7 2013, p.578

risk of failure.[80] Such costs can be further mitigated if shareholders are more readily encouraged to use electronic means to exercise their rights or assess the likeliness of engaging in a collective action. While European corporate law has encouraged the introduction of electronic voting for shareholders as a means to alleviate further the costs of participation,[81] the rigorous and active encouragement of shareholders to use electronic means or the better administration of the disclosure of information using online public records will assist in further mitigating costs.

The second parameter is the information available to shareholders. If the information about the efficacious group capable of undertaking the collective action is enough for a shareholder to consider that it is needed to engage in collective action, a shareholder will require to use that information and assess the viability of engaging in such an action. Similarly, the engagement of a collective action much relies not only on the information each shareholder has for each shareholder, but also on information related to the company as well, which is subject to managerial control.[82] The 2017 Directive's rules on the disclosure of information and the achievement of transparency by disclosing the shareholder engagement policy publicly will materially contribute to easier access to information, which will assist in more active shareholder participation. Notwithstanding, the quality of information remains an issue. While the transmission of such information will readily make shareholders capable of engaging in a collective action to keep the management accountable more effectively, the extent they will engage in such an action relies much not only on the quantity and accessibility of information, but also on its quality. If the information submitted bears practical inaccuracies, shareholders may find themselves not only in a difficult position to engage in a collective action regardless of the availability of information, but also find themselves as poor accountability monitors for corporate governance.[83] Though corporate information quality has gone up over the recent years,[84] the need for ensuring the standard of quality remains of paramount importance as well.

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[80] Gilson, R.J.; Gordon, J.N.: *The Agency Costs Of Agency Capitalism: Activist Investors And The Revaluation Of Governance Rights*, Columbia Law Review, 113 2013, p. 874

[81] Shareholder Rights Directive 2007 (as amended by the Shareholder Rights Directive 2017), Art. 8

[82] Galbraith, J.K.: *The new industrial state (Reprint)*, Princeton, 2007, p.96

[83] Berglöf, E.;Pajuste, A.: *What Do Firms Disclose and Why? Enforcing Corporate Governance and Transparency in Central and Eastern Europe*, EFA 2005 Moscow Meeting, 2005, pp. 9-11

[84] Vincke, F., Heimann, F. (ed.): *Fighting corruption A Corporate Practices Manual*, ICC, 2003, p. 135

The final parameter lies in the introduction of shareholder intermediaries and the rise of institutional shareholders. This is because the effective exercise of shareholder rights now relies much on the extent asset managers of institutional shareholders or other intermediaries will have the incentives to use the information available to exercise their shareholder rights effectively.[85] To many asset managers of private funds or hedge funds or other shareholder intermediaries, the exercise of shareholder rights must be cost-effective to be rendered as a feasible solution for them in terms of their engagement; or selective incentives must require their exercise important.[86] The existence of alternative courses of action though may be regarded more beneficial to them.[87] Regardless of the fact that collective action will provide an advantage to shareholders that can be more beneficial than alternative courses of action, institutional shareholders typically hold diversified portfolios of shareholding in various companies as a means of ensuring the beneficiaries' interests.[88]

Asset managers however, because of this diversification, may not consider engagement in the collective action of a company beneficial, irrespective of the fact that the exercise of shareholder rights can provide advantages that are in the best interests of such beneficiaries should the action is successful.[89] The reason behind this rests on the fact that asset managers typically act based on the information they hold to make their portfolio more competitive or attractive for their current and future beneficiaries. Asset managers then may be concerned to use the information to engage in alternative courses of action to ensure that current beneficiaries' funds are maintained instead of exercising shareholder rights and engage in a collective action, which bears a sufficient element of risk of failure.[90] This means though that asset managers may be more predominantly concerned with the advancement of the competitiveness of their portfolio instead of them conferring accountability in the investee company.[91] The same applies to shareholders that are not incentivised primarily from profit, such as pension funds and/or other groups holding shares or in-

[85] Gilson, R.J.; Gordon, J.N.: 'Agency Capitalism: Further implications of equity intermediation' in Hill, J.G. and Thomas, R.S. (eds.): *Research Handbook on Shareholder Power*, Cheltenham, 2015; p. 42

[86] ibid

[87] ibid

[88] ibid

[89] ibid

[90] Kahan, M.; Rock. E.B.; *Hedge Funds in Corporate Governance and Corporate Control*, University of Pennsylvania. Law Review, 155 2007, pp. 1070-1075

[91] Gilson, Gordon (n 85) pp. 39-43

dividual shareholders,[92] as they may face the same disincentives as asset managers in private equity funds and hedge funds.[93] To the extent fiduciary duties do not apply to the manager of such funds that render participation important or mandatory,[94] managers of such groups or individuals may be reluctant to undertake an engagement in a collective action, especially if funding for such intervention is minimal or if the management is closely tied with the company and/or its beneficiary groups.[95] Free-riding therefore, because of the existence of such intermediaries and their incentives can surface as a result of a possible abstention from the collective action, that can impede the development of an efficacious group to undertake the collective action and thus the conferring of any advantage at all to shareholders or the provision of accountability.

An effective corporate governance model therefore requires the consideration of two key factors to counter intermediary disincentives to exercise shareholder rights.[96] The first is the encouragement of shareholders to exercise their rights to keep the management accountable. The encouragement of shareholders exercising their rights can have its basis on facilitating more power and influence within the corporate structure to monitor the management effectively. This is something that the Directive provides to some extent through the introduction of voting on the remuneration policy and the approval of material related-party transactions. Both powers can surely contribute to the facilitation of more active engagement and greater accountability. The voting on the remuneration policy gives the ability to shareholders to raise their concerns about excesses in remuneration when such remuneration does not crystallize corporate performance.[97] Similarly, the voting on related-party transactions will give shareholders the ability to take an advisory role in the affairs of the company, especially when there are significant changes in its construction, thus rendering them an adequate voice in bringing changes to the company for its sustainable growth.[98]

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92 ibid

93 Gilson, Gordon (n 80) p. 874

94 Mccormack, G.: *Sexy but not sleazy: trustee investments and ethical considerations (United Kingdom)*, The Company Lawyer, 19(2) 1998, p. 40

95 Thomas, R.S.: *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, Cornell Law Faculty Publications. Paper 530, available at http://scholarship.law.cornell.edu/facpub/530

96 Chiu, I.; Katelouzou; D.: *From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?*, Nordic & European Company Law LSN Research Paper Series no 18-10, 2017, p. 143

97 Thomas, R.S.: *Say on Pay Around the World*, Washington University Law Review, 92 2015, p.711

98 Roth, M.: *Related Party Transactions*, 2016, Available at SSRN at http://dx.doi.org/10.2139/ssrn.2710128

Despite their significance, both powers can be subject to a number of implications that may tamper their usefulness or effectiveness. The use of voting on the remuneration policy may be of limited use to shareholders in Continental Europe where shareholders hold enough concentration and can thus keep the management accountable without relying on their remuneration to exert discipline.[99] Nevertheless, if shareholder dispersion in Continental Europe continues to disperse because of the continuing convergence of ideals and the internationalization of equity capital markets, the voting on remuneration policy can become an adequate tool in shareholders upholding accountability.[100] On the same premise, the approval of related-party transactions much depend on the definition of related-party transactions; the boundaries each Member State has on such related-party transactions; and the extent such transactions are determined to be either subject to approval or falling within self-dealing.[101] Even if these implications do not stand as an impediment of shareholders taking an adequate vote on such matters, national legal barriers which may preclude either intra-shareholder communication. Similarly, the agenda setting of the general meeting for such voting becomes subject to national law regulation, which may not provide ample time for shareholder to reflect on the matters available for them effectively.[102] Such barriers however can hinder substantially the extent these rights are to be exercised efficiently, thus discouraging active shareholder engagement. A legal framework that assists further in the facilitation of active voice apart from the provision of such powers becomes mandatory as well for the facilitation of such model by European company law.

The second factor is the establishment of requiring the exercise or engagement of shareholder rights. Such a duty has been introduced over the years in several jurisdictions in the EU on a voluntary basis through the introduction of national soft-law of stewardship that define asset managers' responsibilities.[103] The creation of a soft law notion of stewardship though may not be enough in compelling shareholders to engage in keeping the management accountable

[99] Milbourn, T.T.: *Financial Systems and Corporate Governance*, Journal of Institutional & Theoretical Economics, 154 1998, p. 174

[100] Bratton, W.W.; McCahery, J.A.: *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, Columbia Journal of Transnational Law, 38 1999, p.234

[101] Moscariello, N.: *Related Party Transactions in Continental European Countries: Evidence from Italy*, International Journal of Disclosure and Governance, 2011, p. 130

[102] Masouros, P. E.: *Is the EU Taking Shareholder Rights Seriously? An Essay on the Impotence of Shareholdership in Corporate Europe*, European Company Law, 7 2010, p.200

[103] Financial Reporting Council (FRC), The UK Stewardship Code 2010, 2012, see https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx.

effectively.[104] This is because, in the absence of hard-law compelling shareholders to exercise their rights, shareholders may as well provide justification for not exercising such rights. As such, stewardship soft-laws may stand unable to change many of institutional shareholders' current practices or induce them to be more active participants in corporate governance.[105]

On the same premise, the 2017 Directive requires shareholder engagement through the requirement of exercising shareholder rights and the disclosure of shareholder engagement policy and its exercise on a comply-or-explain basis.[106] Though it seems that the 2017 Directive's introduction of law will bear the same issues as national stewardship laws so far, Katelouzou and Chiu argue that the difference of the now 2017 Directive lies in the expectation from shareholders to at least engage with the exercise of shareholder rights.[107] If an institutional shareholder chooses not to exercise its rights and provide an explanation to this extent, the Directive's introduction of laws will assume at least a duty of engagement with the company's corporate governance or the exercise of shareholder rights based on the requirement of the disclosure of the engagement policy and the means such policy is exercised.[108] While this is a significant step towards the facilitation of the model of seeing shareholders as a credible accountability body, the introduction of an explicit duty for shareholders to exercise their rights could have introduced more active shareholder participation. Nevertheless, the introduction of such a duty requires the careful consideration of a number of related issues, both at a national and European level. Such issues include the consideration of the legal interpretation of shareholder fiduciary duties at a national level, the extent the introduction of such duties conform with the practices and realities of each national corporate legal system, the basis on which shareholders should exercise their rights and the purpose of exercising such rights and the position of shareholders in the company.

4. THE BASIS OF EXERCISING SHAREHOLDER RIGHTS

One of the key factors that determine materially the effectiveness of shareholder power as an accountability mechanism is the extent shareholder rights will

[104] Cheffins, B.R., *The Stewardship Code's Achilles' Heel*, University of Cambridge Faculty of Law Research Paper No. 28/2011, 2011, p. 17

[105] ibid

[106] Chiu, Katelouzou (n 96), p. 144

[107] ibid

[108] ibid p.145

actually be exercised to confer accountability to the company for its sustainable growth.[109] This is because of the possible abuse of power by shareholders to secure short-term profits.[110] As shareholder rights are costly to be exercised, shareholders may seek short-term returns to cover the costs of exercising their rights and accumulate as much returns as possible, irrespective of the fact that such course of action will be to the detriment of the company.[111] Shareholder rights then can be used to exercise accountability not for the company's best functioning and performance, but for the security of more returns to its shareholders through the exercise of their rights. Such behavior though may worsen because of the limited investment horizon of shareholders in modern companies.[112] As many shareholders now hold their shares for a limited amount of time, a number of shareholders may exercise their rights to secure more profits prior to their departure from the company.[113] This resonates with another impediment of agency capitalism. Asset managers are prone to using shareholder power to secure more residual returns that will confer better returns for their beneficiaries; or increase share market value as a means of advancing the portfolio's competitiveness in the equity capital market.[114] Similarly, shareholder intermediaries may follow shareholder demands or choose the best course of action for the interests of shareholder, which may not entail achieving accountability in corporate governance.[115]

The extent then shareholder power can be used as an accountability mechanism is contested by the very fact that shareholder power can be used for adverse purposes as well.[116] Though shareholders have the capability to confer accountability in corporate governance should their agency problems are alleviated, they can as well compel the board to undertake myopic actions to

[109] ibid

[110] Bebchuk, L.: *The Myth that Insulating Boards Serves Long-Term Value*, Columbia Law Review, 113 2013, p.1658

[111] Easterbrook, F.H.; Fischel, D.R.; *Voting in Corporate Law*, Journal of Law & Economics, 26 1983, p.403

[112] ibid

[113] Lipton, M.; Savitt, W.; *The Many Myths of Lucian Bebchuk*, Virginia Law Review, 93 2007, p.746

[114] Black, B.S.: *Agents Watching Agents: The Promise of Institutional Investor Voice,* UCLA Law Review, 39 1992, p. 835; Hazen, T.L.: *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, North Carolina Law Review, 70 1991, p. 140

[115] Anabtawi, I.: *Some Skepticism About Increasing Shareholder Power*, UCLA Law Review, 53 2006, p.561

[116] Bainbridge (n 46) p.234; Anabtawi, I.; Stout, L.: *Fiduciary Duties for Activist Shareholders* Stanford Law Review, 60 2008, p. 1291

secure short-term profits; with catastrophic consequences for the company.[117] This is bolstered by the fact that the capital market's inevitable short-termism influences shareholders to have short-term horizons in each company, and as such penalize directors should they undertake a corporate policy that does not crystallize on share value.[118] This means though that accountability in corporate governance through the exercise of shareholder power can become a secondary obligation for shareholders, if it can be an obligation at all.

EU company law then requires the establishment of a corporate objective upon which shareholders will exercise their rights to adequately confer accountability for advancing corporate performance and sustainability. The 2017 Directive acknowledges this and seeks to provide a solution by requiring asset managers to disclose in their engagement policy how their policy will contribute to the medium to long-term performance of their assets, which will include the evaluation of the medium to long-term financial and non-financial performance of the company. Through this orientation, the Directive seeks to provide a benchmark for an optimal behavior for shareholders when exercising their rights. By calling shareholders to engage in corporate governance with a medium to long-term orientation of asset performance which will include medium to long-term financial and non-financial corporate performance, the Directive attempts to set a standard for the exercise of shareholder rights by requiring the consideration of the performance of shareholding assets, which can regard corporate performance as a means of regarding public interest objectives as well.[119]

The extent this orientation will contribute to mitigating short-termism though is contestable. The medium to long-term orientation of the pursuit of shareholder power based on asset performance seems to conform with an international set of thinking that shareholder power can contribute to the advancement of the share's long-term value.[120] This orientation has its basis on the principle of shareholder primacy, which set share value and its wealth maximization as the prime determinants of the medium to long-term performance of the shareholders' assets.[121] These metrics however cannot ensure that good governance

[117] Anderson, R.: *The Long and Short of Corporate Governance*, Georgetown Mason Law Review, 23 2015), p. 29

[118] Grossman, N.: *Turning a Short-Term Fling into a Long-Term Commitment: Board Duties in A New Era*, University of Michigan Journal of Legal Reform, 43 2010, pp. 923-31

[119] Chiu, Katelouzou (n 96), p. 146

[120] Bebchuck (n 27) p. 892

[121] On the rise of shareholder primacy see Friedman, M.: *The Social Responsibility of Business Is to Increase Its Profits*, New York Times Magazine, 13 September 1970; Jensen, M.C.; Meckling, W.C.: *Theory of the firm: Managerial behavior, agency costs and ownership struc-*

practices are adopted, irrespective of the medium to long-term orientation.[122]

Firstly, the medium to long-term orientation on asset performance seems to lie partly on the rationale that asset performance based on the share's value in the capital market is indicative of the company's performance,[123] since the capital market is stated to be efficient enough to determine such good or bad governance practices because of changes in share value.[124] Behavioral economics studies though show that investor biases, such as short-term overvaluation as medium to long-term value,[125] or acknowledging increases of a company's value as indicative of medium to long-term sustainable development,[126] render shareholders unable to configure whether good governance practices are adopted based on value so as to exercise their rights to confer accountability based on it.[127] This is because the extent shareholders choose between short-term or medium to long-term asset performance based on value can be dubious; as both estimates tend to cancel each other out. For short-term value to differ significantly from medium to long-term value so as for shareholders to pursue the latter based on the Directive's wording and rationale, there is a need for a capital market that is efficient enough so as to indicate that the shareholders' exercise of rights to accumulate short-term profit will confer substantially greater returns than the price of long-term share value.[128] The abovementioned biases however; and shareholders' possible inclinations for short-term returns because of these biases; may be offset by what is determined to be long-term value of the company, thus making the difference between the two limited and incapable of showing good governance practices.[129] To add to that, the information available must be of such quality that must crystallize great devia-

ture, Journal of Financial Economics, 3 (1976), p. 312. On the convergence of corporate goverance systems on shareholder primacy Hansmann, H.; Kraakman, K: *The end of history for corporate law*, Georgetown Law Journal, 89(2) 2001, p. 439.

Jansson, A.: *No Exit!: The Logic of Defensive Shareholder Activism*, Corporate Board: Role, Duties & Composition, 10 (2014), pp. 16-17; Romano, R.: *Less is More: Making Institutional Investor Activism A Valuable Mechanism of Corporate Governance*, Yale Journal of Regulation, 18 2001, pp. 222-240

122 ibid

123 Moore, Petrin (n 30) p. 119

124 Martin, R.: *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL*, Boston, 2011, pp. 12–13;

125 Moore, Petrin (n 30) p.121

126 Stout, L.A.: *The Shareholder Value Myth*, Oakland, 2013, pp. 63-64

127 Moore, Petrin (n 30) p.120

128 Anderson (n 117) pp. 30-41

129 ibid

tion between the company's actual value to determine short-term or long-term value. Nevertheless, several issues related to the quality of information, such as inaccuracies on the value of the share or accounting frauds may tamper the extent short-term or medium to long-term value will differ or the extent the pursuit of either value will lead to the deterioration or the advancement of governance practices within the company.[130]

Such asymmetry then in configuring short-term and medium to long-term value cannot not configure the extent shareholder power will advance corporate governance practices to uphold accountability based on asset performance.[131] The share value does not relatively make shareholders to keep the management accountable for the company's performance or to uphold good governance practices, but compels them to act based on what is expected in terms of value to them on the belief that value is representative of such performance or good governance practices.[132] Given however that the difference between what is considered short-term or medium to long-term value will be often thin; and the fact that information provided in the market bears the possibility to be inaccurate; shareholder power exercised on an objective based on value performance may not achieve the responsibility required by the Directive in exercising shareholder rights responsibly to confer accountability, as the corporate objective shareholder power is sought to be exercised primarily sees towards the share's best expectation of value performance rather than correcting actual governance practices.

Secondly, the medium to long-term orientation on asset performance adopted by the 2017 Directive disregards the implications of considering asset performance through maximizing returns as a metric of accountability.[133] It is undoubted that the medium to long-term approach seeks to crystallize the need of conferring accountability to achieve more residual returns without impeding the interests of stakeholders.[134] But if the difference between short-term and medium to long-term value is difficult to be identified and thus incapable of determining good governance practices, the introduction of the medium to long-term orientation on enhancing asset performance by maximizing returns

[130] Joerg, P. *et al*.: *The Purpose of the Corporation : Shareholder value Maximization?*, European Corporate Governance Institute Finance Working Paper No. 95/2005, 2006, p. 13

[131] Quiggen, J.: *Zombie Economics: How Dead Ideas Still Walk among Us*, Princeton, 2010

[132] Martin (n 124) pp. 12, 21, 23, 193

[133] Anderson (n 117) pp. 40

[134] Harper Ho, V.: *Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide*, Journal of Corporate Law, 36 2010, p.62. This is also a theme adopted in UK company law under s.172 of the Companies Act 2006. See Keay, A.: *The Enlightened Shareholder Value Principle and Corporate Governance*, Abingdon, 2012, p.70

is equally not helpful. Since shareholder incentives and the investment horizon for each shareholder differ, a shareholder's pursuit of a medium to long-term maximization of wealth to enhance asset performance accordingly depends on such incentives and investment horizon, regardless of the Directive's legislative text.[135] Thus, the medium to long-term orientation in exercising shareholder rights becomes a rather relative term for each shareholder, thus making again the difference of long-term or short-term rather thin. As with value orientation, the exercise of shareholder rights to ensure wealth maximization to improve asset performance bear the risk of adopting practices that may not ensure the company's sustainability or its controlled sustainable growth. If shareholder rights are exercised to keep the management accountable for maximizing wealth in the long-term as per the Directive's wording, accountability will be conferred for securing such wealth maximization that is expected to be long-term performance of assets from the shareholder's own end, which is subject to its investment horizon and their incentives when exercising their rights.[136] Given however that the difference of long-term and short-term maximization of returns is a dubious metric because of its relativity; an orientation of exercising shareholder rights based on asset performance through maximizing wealth does not assist in any meaningful way in configuring whether good governance practices are actually adopted through the exercise of shareholder rights.

The foregoing arguments resonate with another impediment of placing an orientation based on asset performance as a primary concern for shareholders. Even if the orientation of such asset performance is in the medium to the long-term, the primary focus of exercising shareholder power based on it is capable of inducing shareholders in engaging in activities that do not regard good governance practices, irrespective of the fact that financial or non-financial performance of the company is stated to be included as an assessment consideration. If shareholders are incentivized by their own self-interest and calculative rationality, then the pursuit of shareholder power for profit may lead to short-term activities if the basis on which shareholders will exercise their rights depends on either value or return maximization, which stand incapable of considering good governance practices. At the same time though, it must be noted that shareholders driven by the same axioms or incentivized by other axioms can as well exercise their rights even if the advantage conferred to them is zero, as they may seek good governance practices or determine that alternative courses of action are of no assistance.[137]

[135] Stout (n 126) p. 70;

[136] Bainbridge (n 46) p. 234

[137] Stout, L: *Cultivating Conscience: How Good Laws Make Good People*, Princeton, 2011, pp. 98

This means that the course of action that shareholders may undertake rely much on shareholders' systemic behavior. Like every person, shareholders or its asset managers or other intermediaries are pro-social and responsible individuals,[138] but they are susceptible to biases that can affect their pro-sociality.[139] The real deal then for corporate law is to provide shareholders a basis that incentivizes them to act responsibly and use their powers to uphold accountability in corporate governance. The Directive's medium to long-term orientation on asset performance will find difficulty in achieving that. According to Stout, any orientation based on shareholder primacy, and given shareholders' susceptibility to investor biases and informational asymmetries, can incentivize shareholders to determine that optimal corporate governance is adopted only through facilitating greater shareholder returns and the increase of share value.[140] An orientation as such though does not assist in creating incentives to achieve better accountability; nor encourages pro-social shareholders in exercising their rights for accountability purposes.[141] If a shareholder wishes to further good corporate governance practices, the exercise of shareholder power to pursuit such practices may be outweighed by the furtherance of achieving accountability based on maximizing shareholder wealth or increase share value.[142] Having this in mind though, and considering that neither metrics are indicative of good corporate governance practices, shareholder incentives of achieving good governance practices may fail because of their efforts to maximize value instead of actually considering the adoption of good governance practices for the company's sustainable growth.

At this point, it must be acknowledged that the inclusion of considering medium to long-term performance of the company in the engagement policy that will regard non-financial performance of the company as well can provide the incentives to shareholders to regard good governance practices. Though this may be true, the inclusion and consideration of governance practices still exists as a secondary consideration when exercising shareholder rights. The primary obligation of shareholders remains the performance of their assets in the medium to long-term, which assumes the exercise of shareholder rights to enhance its value and confer more residual returns. Given though that both metrics cannot measure good governance practices, the possibility for regarding good governance practices while adopting a pursuit of exercising shareholder rights based on asset performance will be outweighed by the very pursuit of maximizing asset performance itself.

[138] Stout (n 126) pp. 98

[139] ibid

[140] ibid

[141] ibid

[142] Anderson (n 117) p. 58

Following this then, European company law must seek the establishment of a corporate objective for shareholders that does not seek the enhancement of asset performance, but the actual pursuit of good governance practices by shareholders for the company's sustainable growth. If it can be readily agreed that shareholders can successfully keep the management accountable in the sense that they can bring changes to the company should agency problems related to collective action and agency capitalism are alleviated; then the primary basis on which shareholders must pursue their power lies in the adoption of good governance practices for the company's financial and non-financial performance. While the Directive insists on the consideration of asset performance as a metric of good governance, the extent shareholders will contribute to enhancing accountability in corporate governance under it remains thin.

5. CONCLUSION

The changes the Directive introduces is definitely a step towards the effective facilitation of a model where shareholder power is used as an accountability mechanism in corporate governance. This is being undertaken through the enhancement of shareholder power, the encouragement of better engagement; the transparency of information; and the alleviation of cross-border costs. Nevertheless, a number of material implications need to be addressed more effectively by European and national corporate law to ensure the model's effectiveness. Firstly, the issues related to the establishment of collective action in the corporate context, such as the availability and quality of information, the incurrence of costs to exercise shareholder rights, the incentives of asset managers to exercise shareholder rights and the element of free-riding can significantly affect the extent shareholders will be able to exercise their rights effectively. Though the Directive deals to some extent with these issues, the possibility of disclosure of inaccurate information, the incurrence of costly engagements for corporate governance and the extent shareholder rights will be exercised by asset managers or shareholder intermediaries requires better regulation and consideration. Similarly, the basis on which shareholder power is sought by the Directive equally needs further consideration. This is because the prime orientation put on shareholders to regard asset performance will not ensure that shareholders will not exercise their rights for short-term purposes; nor will assist them in exercising their rights to confer accountability effectively in corporate governance.

The abovementioned implications lead to considerations on whether shareholders should exercise their rights to influence the control of the company. One however should not forget the merits of having shareholders acting as

monitors of corporate governance. Shareholders can have the incentives and the power because of their position to make material changes to the company as a means of upholding accountability. Such advancement of accountability can definitely assist in the development of corporate governance regulation, but also in the adoption of appropriate corporate practices that will mitigate the possibility of having further corporate scandals and economic crises. The issue therefore for EU corporate law is not whether it is appropriate to adopt a model where shareholders act as an accountability body; but consider the extent the implications discussed in this Article can be alleviated by corporate law to make such a model effective. The Directive then should not be regarded as a failed attempt to regulate shareholder rights to be exercised for accountability purposes. On the contrary, the 2017 Directive should be regarded as the starting point towards the facilitation of a model where shareholders act as an accountability body. European company law then should take the implications discussed in this paper into account as well to ensure the model's effectiveness.

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THE CONCEPT OF LIMITED LIABILITY AND THE PLIGHT OF CREDITORS WITHIN CORPORATE GOVERNANCE AND COMPANY LAW: A UK PERSPECTIVE

Eneless Nyoni *
Tina Hart **

ABSTRACT

The focus of this paper is to analyze the effects of shareholder primacy governance on creditors, the characteristics of the firm, and how creditors can protect themselves. The governance of the firm is legally vested on directors and the law places on them specific duties requiring them to act in a certain way to promote the success of the company. The governance of the firm has evolved to be known as corporate governance. The mode of corporate governance such as the shareholder oriented governance and the characteristics that come with the firm (legal personality and limited liability) have negative implications on creditors. Shareholder primacy model of corporate governance seems to find its support from the Companies Act so does limited liability which limits the liability of the Members to the subscribed shares. Legal personality of the firm means that the firm is a juristic person with rights and obligations of a natural person in that it can own its own property. The presence of limited liability brings about the shareholder primacy model of governance. The problem is not the shareholders but the foundation on which they find there protection which is the law. With the presence of the above concepts, the implication on creditors is higher risk. This paper argues that if creditors' interests are taken into account from inception, creditors will be better protected as they would be an ongoing concern for the company. Although the law provides circumstances when the corporate veil can be pierced as a mechanism to protect creditors, it is argued in this paper that clear and concise rules must be put in place as to when the veil can be pieced.

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This paper contributes to literature on the protection of creditors in light of limited liability and within corporate governance. It also makes recommendations to change the law thereby contributing to policy makers to include creditors when governing the firm.

The article uses the doctrinal approach to analyze the law on the protection of creditors by a critical examination of the section 172(1) and section 830 of the Companies Act.

KEYWORDS: *Limited Liability, Creditors, Directors, Shareholders, Financial Distress, dividends, Company Law and Corporate Governance*

1. INTRODUCTION

To begin with, it is important to state that this paper uses some of the propositions that were made by Professor Christopher J. Cowton in his article entitled: 'Putting Creditors in Their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability' which was published in the Journal of Business Ethics in 2011. His article was not focused on the protection of creditors per se but rather their position within issues of corporate governance and company law and the implications for this. Although Cowton did use some legal materials to emphasize the legal position of creditors created by law, his article is not a legal analysis a fact which he clearly states in the paper.[1] Nevertheless, he did raise very interesting propositions such as the shareholder primacy model of corporate governance and mechanisms creditors could use for protection. These mechanisms include capital maintenance, restriction of dividend and requirements for financial reporting. This article adopts some of these propositions and expands on them using a legal analysis.

The lack of effective control, and lack of accountability including the misuse of corporate assets by directors led to a number of corporate failures in the UK which is what led to the development of the corporate governance Codes.[2] Although the UK is generally acknowledged as the leading country in corporate governance because of its enlarging interests within corporate governance, this does not mean that there is no need for reform within corporate governance in the UK.[3] On the contrary, as the corporate world is developing, so is the need to review and improve governance practices. Although corporate

[1] Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability , Journal of Business Ethics, 102(1), 2011, pp. 22

[2] Cuomo F, Mallin C& Zattoni A, Corporate Governance Codes: A Review and Research Agenda, Corporate Governance: An International Review, 24(3) 2016, p. 222.

[3] Solomon J, Corporate Governance and Accountability, 3rd ed. Chichester, 2010, p.45.

governance was practiced in the UK as long as corporate entities existed, its growth began in the twentieth century.[4] Corporate governance lacks a globally accepted definition however, the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) in 1992 defined it as 'the system by which companies are directed and controlled.'[5] This article adopts the above definition even though several definitions have been written overtime. The law has always protected shareholders and has placed on directors fiduciary duties to the company except were in financial difficulties, directors are required to take into account creditors' interests.[6] While authors have been clearly divided on whether directors should perform their duties with the interests of the shareholders or the company, the law has been clear on the position of creditors which supersedes the shareholders when a company is financially distressed.[7]

Cowton explained that there are two modes of governance in which the corporation with limited liability is managed namely when a company is financially stable and the interests of the shareholders are paramount and when it is distressed and the interests of creditors become paramount.[8] Cowton called the former as the 'normal mode' and the latter as the 'distressed mode'. Whereas Cowton is correct on the point of law concerning the modes of governance, this paper argues that if creditors' interests are taken into consideration even at the time when a company is solvent, this could reduce substantial risk on creditors. This is not to say that the company will not go into financial difficulty, but even though it does, because measures have been taken to protect creditors' interest from the time of financial stability such as withholding dividends, the risk on creditors would be reduced.

However, corporate governance in the UK is centered on the idea of shareholder value management with companies run principally for the benefit of the shareholders.[9] Armor and others argued that in the UK the shareholders' interests are paramount and tends to neglect other stakeholders.[10] That being the case, this model of governance in its current state has negative implications on

[4] Tricker B, Corporate Governance: principles, policies & practices, Oxford, 2012, p. 7.

[5] http://www.ecgi.org/codes/documents/cadbury.pdf

[6] Keay A, Directors' duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors, The Modern Law Review, 66(5), 2003, p.665.

[7] Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability , Journal of Business Ethics, 102(1) (2011), pp. 22.

[8] Ibid

[9] Gamble A and Kelly G, Shareholder Value and the Stakeholder Debate in the UK, Corporate Governance: An International Review, 2001, 9(2), p. 110.

[10] Armour J, Deakin S & Konzelmann S. J, Shareholder Primacy & the Trajectory of UK corporate Governance, British Journal of Industrial Relations, 41(3), 2003, p. 531.

creditors. Nonetheless, Company law was the foundation feature of corporate governance,[11] and it is a body of statutes, supporting rules and regulations that regulate corporate activities.[12] Understanding corporate governance needs the understanding of a 'corporate' itself as an entity.

A company has been known to be a juristic person since the landmark case of *Salomon v A. Salomon & Co Ltd*.[13] Since the inception of the concept of limited liability in the mid-19th century, doing business with incorporated companies meant that creditors risk was increased.[14] The introduction of limited liability meant that creditors' claims could not extend to shareholders but was limited to company property.[15] The nature of a company in law comes with two major characteristic namely limited liability and legal personality.[16] The Member's liability is limited to the subscribed shares only and the legal personality of the company entails that a company is separate from its members and has its own rights and obligations. Limited liability entails that creditors' claims could no longer extend to the shareholders personal property but limited to company assets as the company owns property in its own name.[17] The shareholders are protected by what is known as the corporate veil of incorporation as a result of limited liability and legal personality.[18] Consequently, although this is a known risk to creditors, it is harmful to their business.

However, there are certain instances in which the courts have lifted or pierced the veil to hold the shareholders liable for the actions of the company but this is a rare occurrence surrounded by irregularities. Although this can be seen as a mechanism to protect creditors, there are other mechanisms that creditors could use for their protection in the face of limited liability.

This article has three sections. The first section focuses on the modes of corporate governance in the UK and how this implicates creditors based on section 172 of the Companies Act 2006. The second section analyses the concept of limited liability and the legal personality of a corporation and the third section analyses the law on dividends and followed by conclusions on the article.

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[11] Tricker B, Re-Invention the Limited Liability Company, Corporate Governance An International Review, 19(4), 2011, p. 386.

[12] Tricker B, Corporate Governance: principles, policies & practices, Oxford, 2012, p. 8.

[13] [1897] AC 22 (House of Lords)

[14] Tricker B, Re-Invention the Limited Liability Company, Corporate Governance An International Review, 19(4), 2011, p. 385.

[15] Hansmann H, Law and the Rise of the Firm, Harvard Law Review,, 119(5) 2006, p. 1334.

[16] Sealy L & Worthington S, Cases and Materials in Company Law, Oxford, 2013, p.33.

[17] Smith B, Legal Personality, Yale Law Journal, 37(3), 1928, P. 283.

[18] Ibid

2. SHAREHOLDER PRIMACY MODEL OF CORPORATE GOVERNANCE

Clearly corporate governance deals with the governance of the firm but this beg the question as to what the objective of the firm is. What is it that directors must work towards in order to ensure that they achieve this ultimate objective? Keay stated that determining the corporate objective is vital because it underpins the type of corporate governance to be implemented as well as inform the kind of responsibilities to impose on directors.[19] Monks and Minow stated that a company is established by law to allow different parties to contribute capital, expertise, and labor for the maximum benefit of all of them.[20] To answer the question of the objective of the law, the first place to look is the law. What exactly does the law provide for as the objective of the firm? The law states that:

'A director of a company must act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole……'[21] To start with, directors are required to promote the success of the company for the benefit of its members as a whole which arguably has an implication that shareholders are the ultimate beneficiaries. The duty placed on directors to promote the success of the company is the main objective but eventually it is for the ultimate benefits of the shareholders hence directors taking their interests as paramount.

However, this is not an absolute duty at all times because when the company is in financial difficulties, the law requires that the directors take the interests of the creditors as paramount. This evidently neglects creditors as they are only considered when the company is financially struggling and there is a possibility of them losing their funds. Nevertheless, while shareholder primacy is founded on the law, the legal characteristics of a company make it clear that they cannot own the company because it is a separate entity with its own rights. Therefore they argue that by virtue of owning equity interest in the firm, they hold residual rights which entitle them (arguably) to be owners. Constantly Hansmann et al referred to shareholders as owners of the firm because it is a legal entity simply protecting or shielding its owners from liability.[22] Also it was argued that shareholders possess the greatest incentives to maximize the

[19] Keay A, Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model, 71(5), 2008, p. 663.

[20] Monks R. A. G and Minow N, Corporate Governance, Chichester, 2011, p.4.

[21] Section 172(1) UK Companies Act, 2006

[22] Hansmann H, Kraakman and Squire R, Law and the Rise of the Firm, Harvard Law Review, 119(5), 2006, p.1333.

wealth of the company because of their investment.[23] Easterbrook and Fischel argue that residual bearers have contracted for a promise to maximize profits for a long term which maximizes the value of the stock.[24] They went further to contend that maximizing profits for equity investors automatically assures the rest of the stakeholders including creditors that their fixed claims would be successful.[25] Nonetheless, this cannot be asserted to be true in all instances because in cases of insolvency where unsecured creditors are much more than company assets, they certainly become bearers of residual risk. Cowton wrote that this argument might seem ethical considering the nature of their residual position although when the company has no assets to settle unsecured creditors, the shareholders will not be bearers of risk.[26] Despite the debates surrounding the ownership of the company, the law is clear on its intention to impose legal personality on the company which means that the assets of the company are independent of its members.

3. THE LEGAL PERSONALITY OF AN ENTITY, THE CONCEPT OF LIMITED LIABILITY AND CREDITORS

The concept of the company being a legal person in its own right whereby it can sue and be sued in its own name is what gives the company the legal personality. The company as a juristic person was illustrated in *Salomon v A. Salomon & Co Ltd*[27] where Lord Macnaughten stated that: *"the company is at law a different person altogether from the subscribers …..; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor the subscribers liable, in any shape or form, except to the extent and in the manner provided by the Act*".[28] The important thing to ascertain is the existence of the legal attributes of the company. Salomon's case illustrated that a company is a separate legal entity which permits the corporation to own property. This is argued to be for functions which tend to ignore the individuals in

[23] Yan M, Agency theory Re-examined: an agency relationship and residual claimant, International Company and Commercial Law Review, 26(4), 2015, P. 139.

[24] Easterbrook F. H and Daniel F, The Economic Structure of Corporate Law, Harvard, 1991, p. 187.

[25] Ibid

[26] Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability, Journal of Business Ethics, 102(1), 2011, p. 22.

[27] [1897] AC 22 (House of Lords)

[28] Ibid

the corporate group but foster functions for responsible corporate activities.[29] It has been argued that the intention is to impose or accord certain attributes on the company that enable it to create legal relations just like a natural person.[30] These legal relations relate to the abstractions of legal science like title, possession, rights and duties which links to title or ownership of property.[31] This means that the property belongs to the company and not to its members. Neither a member nor a creditor unless secured has an incurable interest in the assets of the company.[32]

It seems correct to assume that the restriction of company assets from the shareholders is a mechanism to protect creditors and an illustration of this was in the case of ***Prest v Petrodel***[33] where it was stated that having more control of the company or owning a lot of shares in it is not an equitable interest in relation to company assets.[34] It must be understood that the shareholders equitable interest is in the shares of the stock that they subscribe to but does not extend to company property. However, this has not been an effective means of enhancing creditor protection because of the concept of limited liability. The purpose of incorporating companies with limited liability was to promote corporate activities for the shareholders and in the process protect them from liability.[35] Tricker argued that the invention of limited liability was a significant concession of the society which promoted economical activities with clear objectives but today the concept has become besmirched.[36] This was fuelled by the desire to accelerate business activity which was inspired and generated by the industrial revolution and it has been argued that this concept was very successful and precise as to the purpose until later when it started being exploited to the detriment of creditors.[37] This was a period of economic growth and there was a reasonable need for external capital in order to expand businesses faster and yield profits.[38]

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29 Smith B, Legal Personality, Yale Law Journal, 37(3), 1928, P. 283.

30 Ibid

31 Ibid

32 Sealy L & Worthington S, Cases and Materials in Company Law, Oxford, 2013, p.41.

33 [2013] UKSC 34

34 Ibid

35 Tricker B, Re-Invention the Limited Liability Company, Corporate Governance An International Review, 19(4), 2011, p. 386.

36 Ibid

37 Ibid

38 Tricker B, Corporate Governance: principles, policies & practices, Oxford, 2012, p. 38.

However, the law provides for exceptions in which the veil of incorporation can be pierced so as to protect creditors. Cowton suggested that when creditors request the directors to sign guarantees against a loan, this could be piercing the veil to the extent, perhaps, if the company is small with some of the shareholders as directors. Clearly piercing the corporate veil in the legal sense is removing the limitation of the liability from the shareholders in order to hold them responsible for the activities of the company. The directors are not protected by the veil unless they are also shareholders of the same corporation. It is quite interesting how the law protects shareholders with the corporate veil yet it allows directors who do not participate in any profits of the company to put their own personal property on the line for the company. Although it is an enforceable agreement, this could be argued to be another loophole created by law to yet again expose creditors to more risk. Directors might be induced into signing guarantees just to secure the loan and it so happens that at the time when the company goes into insolvency, the personal property is not enough to settle the debts. Perhaps the law should allow the shareholders to sign personal guarantees to secure a debt in that way they will still be protected by the veil but there would a contractual obligation against their property in case the company goes under. The question is whether shareholders will still be willing to embark on risky business ventures if they had their personal property at risk. Clearly this concept of limited liability is a legal way of expropriation from creditors.

However, some economists have claimed that limited liability is not absolute because the veil of incorporation can be pierced and shareholders held liable for actions of the company. Easterbrook argued that this makes limited liability not an absolute concept for redirection of risk and argues that the manner in which it happens is unprincipled.[39] He argued that it is done like lightning and it is severe which causes confusion within corporate law.[40] On the contrary, literature has indicated a lot of difficulties when it comes to lifting the veil as the judiciary faces an uncertainty. Lifting the veil has been argued to lack definite methods a burden which the courts have not yet resolved.[41] Supporting this view Bainbridge describes it as unjustifiable and arbitrary in the sense that it is vague and only creates uncertainty as it leaves the judges with great discretion instead of achieving its purpose which is an effective policy outcome which

[39] Easterbrook F. H and Fischel D, Limited liability and the Corporation, University of Chicago Law Review, 52(1), 1985, pp. 89.

[40] Ibid

[41] Mujih, E. C, Piercing the Corporate Veil as a Remedy of Last Resort after Prest v Petrodel Resources Ltd: Inching Towards Abolition: Limited Liability, Company Lawyer, 37(2) 2016, p. 39.

can protect businesses.[42] Others have advocated for its abolition because it exists as an exception to the general rule of limited liability and almost impossible to be used effectively.[43] Precedence has indicated that there is no straight forward route to be followed hence the courts have adopted a tendency to use metaphysical terms such as 'mere fraud' 'sham', 'dummy', or 'alter ego' in their judgements which indicates the challenges they are facing.[44]

Although the courts have made several attempts to explain the circumstances in which the veil can be lifted, Digman argues that none of them has been satisfactory, a view which was also taken by Griffin.[45] Cases such as fraud, tax evasion or where a company acts as an agent for another are examples of the scenarios in which the courts can lift the veil of incorporation notwithstanding that in certain similar circumstances they have refused to do so. It is submitted that piercing the veil is supposed to be a mechanism to help creditors but on the contrary, it leaves them in a wavering position which still leaves them searching for better protection from risks they face as a result of limited liability.

However to enhance the protection of creditors in the face of limited liability, the law must give directors duties that include creditors from the time of financial stability. And if any company goes into insolvency with unsettled creditors, then the corporate veil must be pierced to recover the outstanding debts for the creditors as a class. This will put the directors in a position where before embarking on risky ventures, they have to consider the implications of a failed project and put in place mitigating factors for creditors. That will provide better protection to creditors as there interests will be an ongoing concern of the company thereby ensuring that there is a relationship that must be natured for purposes of business in order to promote the success of the company.

Nonetheless, Cowton suggested that creditors are protected by other mechanisms found in company and commercial law.[46] These include capital maintenance and restriction of dividend payouts as well as the use of information in the financial reports. Cowton writes that that capital maintenance measures have been made to avoid inappropriate reduction of company assets to the ad-

[42] Bainbridge S. M, Abolishing Veil Piercing, Journal of Corporate Law, 2000, 26, p. 479.

[43] Mujih, E. C, Piercing the Corporate Veil as a Remedy of Last Resort after Prest v Petrodel Resources Ltd: Inching Towards Abolition: Limited Liability, Company Lawyer, 37(2) 2016, p. 39.

[44] Gallagher L and Ziegler P, Lifting the Corporate Veil in the Pursuit of Justice, Journal of Business Law, 1990, p. 292.

[45] Griffin S, Company Law: Fundamental Principles, Pearson, 2006, p. 15.

[46] Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability , Journal of Business Ethics, 102(1) (2011), pp. 22

vantage of creditors. For instance, to safeguard creditors' rights, re-purchasing of company shares has been restricted to prescribed rules. The law provides that a limited company may not purchase its own shares unless they are fully paid and the shares must be paid for on purchase.[47] Any repurchases of own shares must be financed from distributable profits or from the proceeds of a fresh issue of shares made specifically for financing the purchase.[48] The re-purchasing of own shares has a negative implication on the capital of the company in that it will be reducing the capital and by this, the leverage ratio of the company would be increased which represents more risk for both current and potential creditors. Nonetheless, Cowton went further to argue that this mechanism is not free from challenges of implementation because of the difficulty in the definitions of profit, capital and insolvency.[49] The law has also restricted the payment of dividends to be done from profits only and Cowton suggested that although this helps creditors to an extent as well as the shareholders so that they are not misled to thinking that the company is performing well when in fact it is not. The law provides that:

> *'A company may only make a distribution out of profits available for the purpose. A company's profits available for distribution are its accumulated, realized profits, so far as not previously utilized by distribution or capitalization, less its accumulated, realized losses, so far as not previously written off in a reduction or reorganization of capital duly made'*.[50]

Any distribution that is made contrary to the provisions of the law is an unlawful dividend and the shareholder is to pay it back if at the time of the distribution, he had knowledge or reasonable grounds for knowing that it was made unlawful. Although it is the rights of the shareholders to receive a dividend for stokes, where external finance is involved, creditors should have more rights to have greater influence on the dividend pay-out policy. They must be able to demand that firms pay lower dividends as their position is legally weak or they are in a weak position in terms of legal protection.

It can be submitted in this study that if creditors have legal standing to alter dividend policy, that could be a form of protection. In that way, the shareholders are aware that if the interests of creditors are not taken into consideration, they will not be receiving their dividends. This is still not sufficient protection for creditors because if the firm makes a loss and fails to settle its obligations,

[47] Section 691, Companies Act, 2006

[48] Section 692, Companies Act, 2006

[49] Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability , Journal of Business Ethics, 102(1) (2011), pp. 22

[50] Section 830, UK Companies Act, 2006

the shareholders will have nothing to lose as compared to creditors. La Porta, Lopezi-de-Silanes, Shleifer and Vishny[51] Easterbrook,[52] Byrne and O'Connor,[53] have all argued that the dividend has been highly influenced by the corporate need to strengthen the protection of providers of capital. Literature has indicated that one of the ways in which the shareholders can handle the agency problem is by way of dividends and debt.[54] Jensen contends that using the distribution of dividends as a mitigating factor is not effective but rather debt be used to substitute large dividends.[55] Jensen further argues that by so doing the creditors will have the right to take the firm to court if they do not pay back the principle and the interests promised by the managers. In order to prevent the harm creditors are exposed to, it was established that weak creditor rights only enhances the possibility of the managers to make dividends.[56] Creditors need to demand stronger control rights because with inadequate legal protection, they continue to bear the risk of doing business with incorporated companies.

4. CONCLUSION

The first conclusion is that the shareholder primacy model of corporate governance is harmful to creditors. Directors who by law are responsible for governing the company have specific duties in law. It is from these duties that the shareholder primacy model of governance starts from as they carry out their duties to promote the success of the company for the benefit of the shareholders. However in financial difficulties this duty is suspended by the fact that creditors' interests become paramount. This establishes a place for creditors in law and yet they are not adequately recognized in the mode of governance until the firm is in financial difficulties. It is submitted that if creditors' interests are recognized from the very beginning, the amount of risk would ultimately be reduced.

[51] La Porta R, Lopez-de Silanes F, Shleifer A, & Vishny R, Investor Protection and Corporate Governance, Journal of Corporate Finance 58(1), 2000, p. 1.

[52] Easterbrook F. H and Fischel D. R, Limited Liability and the Corporation University of Chicago Law Review, 52(1), 1985, p.89.

[53] Byrne J and O'Connor T, Creditor Rights and Outcome Model Dividends, Quarterly Review of Economics and Finance, 52(1), 2012, P. 227.

[54] Ibid

[55] Jensen M. C, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers (1986) The American Economic Review, 76(2), 1986,p. 323.

[56] Brockman P and Unle E, Dividend Policy, Creditor Rights, and the Agency Costs of Debt, Journal of Financial Economics, 92(1), 2009, p. 276.

The second conclusion is that the law must be revised on directors signing personal guarantees for company debts. It must be for the partakers of dividends to put their personal property at risk for the company they claim to be theirs? If the law cannot allow this, alternatively there should be more clear and straight forward rules on lifting the veil of incorporation to protect creditors such as every company that goes in to insolvency with less assets and more debt to have the veil pierced for purposes of the outstanding debt. This is because although limited liability is an advantage of incorporation and backed for purposes of economic development at the time of inception in the UK, it is a burden for creditors who ensure that there is corporate finance for business activities. While it works perfectly as a safe haven for the shareholders, it is an impediment for creditors although they already know this but should they stop doing business? There will be no source of external finance. This is why it is submitted that even dividend rights must be restricted in order to protect creditors. It is also submitted that the law must impose on directors' duties that incorporate creditors' interest from the time of financial stability so as to reduce the amount of risk when the company goes into insolvency. This will ensure that financial risk is not externalized on creditors without adequate protection.

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UPCOMING CHALLENGES ON REGULATING REMUNERATION OF THE DIRECTORS AND IMPLEMENTING REMUNERATION POLICIES

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ABSTRACT

The European Parliament adopted the Directive 2017/828 as regards the encouragement of long-term shareholder engagement that grants shareholders to hold the right to vote on the remuneration policy for employees and directors. Following the collapse of large companies in the USA and common agency problem, the intent of regulators on capital markets was to ensure preconditions for stable companies, so remuneration policies were prescribed by the recommendations and through corporate governance mechanisms, such as is say on pay. In order to align interests of the companies and their directors, remuneration policy was recognized as one of the key instruments introduced by the EU legislator for financial institutions, primarily investment funds and banks. The implementation of the Directive into national legislation is mandatory, so for the first time the regulator gives shareholders the right to decide on the remuneration of directors, it gives them the option of setting the framework within the pay of directors is to be held and proposing public disclosure of remuneration policy. One of the major issues that will be imposed by the new Directive will be how and to what extent the decision on the remuneration of directors, will be left to the shareholders to vote at the general meeting. The authors in this paper analyze new system on remuneration policies, opportunities and obstacles that companies may face, as well as the challenges imposed to directors, in the implementation of the Directive in national legislation and practice.

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1. INTRODUCTION

The remuneration of members of supervisory, administrative, and management bodies and workers in companies has a particular significance, both for the performance in the best interest of the company and for strategic decision making to achieve the long-term objectives of the company. One of the fundamental conflicts of interest in most companies is the conflict between the personal interests of directors in the form of fixed and variable remuneration and the interests of shareholders and other stakeholders concerning the long-term development and prosperity of the company.[1] The basic principle - the failure is not to be rewarded – consequently causes remuneration to be one of the key instruments that make directors apt to taking greater risk in the management of the company.

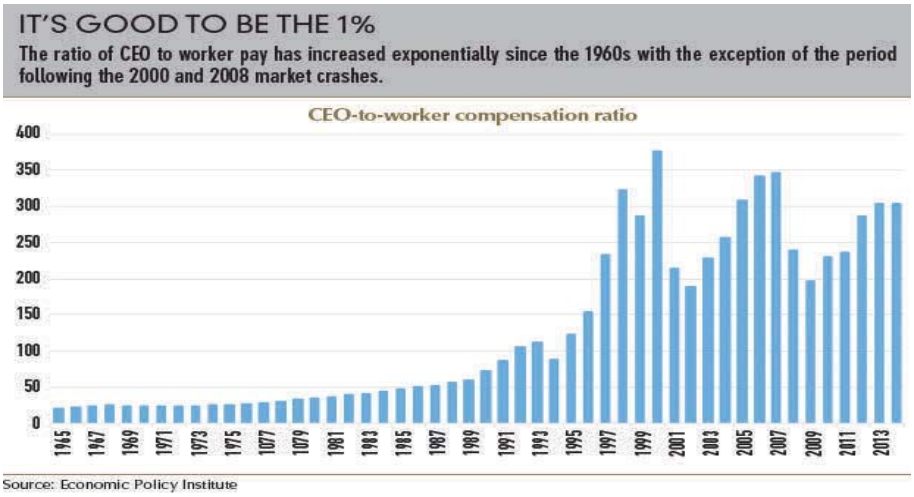
2. HISTORICAL REVIEW OF THE ISSUE CONCERNING REMUNERATION OF DIRECTORS

The big financial crisis and the accompanying media scandals have detected directors' remunerations as one of the major triggers to take excessive risk. Based on the experience of the failed markets and companies, legal regulations have been developed over the years, which contribute to a clear, simple and transparent process of rewarding the directors and enable shareholders to actively participate in determining directors' remuneration.

Due to the development of the capital market, the trend of tracking directors' remuneration and additional rewarding has begun in the United States. Over the last 50 years, the ratio of CEO to worker compensation in companies has increased by up to 380%, with a particularly significant increase recorded in the past 30 years.

[1] Conflict of Interest in the Professions (Practical and Professional Ethics) Davis, Michael, Stark Andrew, Oxford 2001,p. 137

Chart 1: CEO to worker compensation ratio[2]



The above graph clearly reflects the correlation between the growth in the turnover and value of companies on stock exchanges during the 1990s and the increase in CEO remunerations. Economic crises, in particular the latest one of 2008, have also pointed to serious failures concerning the wrong Directors' remuneration system - primarily in terms of lack of transparency, absence of a provision concerning bonus deferral or reclaiming of the already paid bonus. Directors' decisions are predominantly short-term in nature, motivated by accompanying bonuses, thus jeopardizing the company's long-term objectives and sustainability.

2.1. PRACTICE AND REGULATIONS FROM THE UNITED STATES OF AMERICA

Regulations limiting Directors' remuneration have started after bankruptcy of large companies during the collapse of the "Dot-com bubble" (bladder caused by the growth in the value of internet companies). US companies' total indebtedness in 2002 amounted to $ 4.5 billion, with an average loan of $ 11 million. There was no interest paid for approximately 50% of the loans granted to directors, whereas a large number of interest rates were below the market rate, and the loans themselves were written off entirely on a regular basis.

[2] Economic Policy Institute http://www.futuresmag.com/2016/07/16/ceo-compensation-rational (24.09.2018)

One of the most illustrative examples is WorldCom, which, either directly or indirectly, provided loans worth hundreds of millions of dollars, or about 20% of cash on the company's balance sheet, to its CEO Bernard Ebbers, for the purpose of profit payment in his personal brokerage account. Loans, which were to be collected by brokers' companies, had no collateral security. WorldCom filed for bankruptcy several months after the last loans had been granted.[3]

The perhaps most famous example in the media is the case of Enron. From 1996 to 2000, the energy giant Enron paid to their five executives the amount of more than $ 500 million[4]. While according to the company accounting records the revenue had increased by nearly six times, and the share price had been increasing continuously, the subsequent study found that Enron "had systematically annulled the shareholder value ... the company debt had been increasing and margins had been decreasing". In the period from 1999 to 2001, Enron's CEO's had sold out shares worth $ 17.3 million for a total of $ 1.1 billion of their market value. It was as late as in September 2001, when shares began to fall, that one of the shareholders, Executive Director Ken Lay, convinced their employees that according to his "personal belief Enron's share was an incredible deal at current prices." Two months later, Enron's share was worthless.[5]

In order to prevent market collapse and restore investor confidence, the US legislator has adopted the Sarbanes Oxley Act already in 2002, which, in addition to the transparent financial reporting measures, introduction of the Corporate Governance Code and the prevention of accounting frauds, was the beginning of limiting the Director's remuneration. Companies were prohibited by the law to take loans to be subsequently used for loans to directors. A "Clawback" clause was also introduced, allowing for the company to reclaim the bonus already paid if proven that it had been acquired for risks undertaken that have not yielded results or have otherwise deceived the investors.[6] The Sarbanes Oxley Act was applicable not only to companies in the United States, but also to any other companies listed on the US stock exchanges. In this way, the law was binding upon a large number of companies from the European Union as well.

Another crisis followed in 2008 after the collapse of the "housing bubble" (caused by the collapse of the real estate market). That year, as evident from Chart 1, showed a significant increase in compensations and bonuses. However, a drastic decline followed shortly after the crisis.

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[3] http://www.law.harvard.edu/faculty/bebchuk/pdfs/Performance-Part2.pdf (24.09.2018)

[4] https://www.forbes.com/2002/03/22/0322enronpay.html#3f6f63eb7a6d (24.09.2018)

[5] https://www.forbes.com/2002/03/22/0322enronpay.html#3f6f63eb7a6d (24.09.2018)

[6] http://www.law.harvard.edu/faculty/bebchuk/pdfs/Performance-Part2.pdf

Once again, the answer was stricter regulations. In 2010, the Dodd-Frank Act was passed, which prescribed a provision called "say on pay". The provision guarantees shareholders a regular opportunity to declare themselves and vote on Director' remuneration packages at the general meeting.[7]

Based on US regulatory experience and driven by the economic crisis that had affected the European capital markets as well, provisions were introduced by the European Union into its legislative framework that encourage more active engagement of shareholders in the performance of company activities, including the issue of declaring themselves and deciding on the remuneration of directors.

3. DIRECTIVE 2007/36/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 11 JULY 2007 ON THE EXERCISE OF CERTAIN RIGHTS OF SHAREHOLDERS IN LISTED COMPANIES

Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies (hereinafter: Directive 2007/36)[8], applies to companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State.

Directive 2007/36 was intended to influence the role of corporate governance, in particular the so-called mixed corporate governance, which implies "legal regulation of the obligation of financial reporting and transparency of the operations of joint stock companies and auditing of financial statements",[9] which has been increasingly important to day-to-day operations in the capital market, both for shareholders (shareholders), and for all stakeholders - investors, workers, suppliers and others (stakeholders).

To keep all corporate stakeholders timely informed is one of the basic principles of corporate governance and the prerequisite for more active engagement of shareholders, especially in terms of their influence on the remuneration pol-

[7] https://www.ilr.cornell.edu/sites/ilr.cornell.edu/files/workspan/09-11-research-for-the-real-world_0.pdf

[8] Directive 2007/36/EC of the European Parliamenta and of the Council of 11 July 2007 on the exercise of certain rights of shareholders of listed companies, available at - https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32007L0036

[9] Jurić Dionis, „Pojam i značenje korporacijskog upravljanja u dioničkim društvima", Proceedings from the Second International Conference „Aktualnosti građanskog i trgovačkog zakonodavstva i pravne prakse" The University of Mostar Faculty of Law, 2004, p. 337-349

icy. If financial reporting is clear and transparent, the possibility of misuse is reduced to a minimum. Until the adoption of Directive 2007/36 on the exercise of certain rights of shareholders of listed companies, as of 11 July 2007 (hereinafter: Directive 2007/36), the EU Member States have differently regulated areas related to financial reporting procedures and, indirectly, shareholder participation in the remuneration policy making.

Pursuant to Directive 2007/36, companies are required to ensure equal treatment of all shareholders in the same position as regards the participation and exercise of voting rights at the general meeting.[10]

Equal treatment of the shareholders is one of the basic premises of Directive 2007/36, which is aimed at empowering shareholder rights during their participation in the general meeting. This has been ensured by extending the transparency rules which enable shareholders to effectively supervise the decision making procedure that affects, among others, the price of their shares as well. In this regard, Directive 2007/36 provides for full and timely informing of shareholders with regard to their participation in the general meeting, the exercise of voting rights by proxy, the right to attend the general meeting via electronic means (using modern technology, with the only limitation concerning identity verification and electronic communication security) and the right to cross-border participation and voting.

4. DIRECTIVE (EU) 2017/828 AMENDING DIRECTIVE 2007/36/EC AS REGARDS THE ENCOURAGEMENT OF LONG-TERM SHAREHOLDER ENGAGEMENT

4.1. RATIONALE OF NEW REGULATIONS

However, Directive 2007/36 did not adequately respond to market requirements in terms of ensuring transparent conditions for encouraging more active engagement of shareholders.

The need for amendments has its reasoning in emphasizing the long-term development of companies, while addressing the main shortcomings identified in the implementation practice of Directive 2007/36:

- Short-term objectives of administrative bodies
- Disadvantages in supervising remunerations of board members

[10] Art. 4. Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ.L. 184, 14.7.2007 available at http://data.europe.eu/eli/dir/2007/36/oj (15.6.2018)

- Disadvantages in supervising transactions of related parties
- Shortcomings in the exercise of cross-border shareholder rights

The main objections were directed at the lack of mechanisms to prevent the administration's action aimed at short-term repayment, leading to inefficient corporate governance and adverse outcomes for strategic objectives and long-term sustainability of the company.[11]

Almost all texts and debates, before and after the adoption of the new 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 (hereinafter: Directive 2017/828)[12], have put the emphasis on the same issue - the importance of long-term objectives of a company as the basis of sustainability of the economy.[13]

4.2. FIELD OF APPLICATION OF THE NEW DIRECTIVE 2017/828

For reasons mentioned above, on 17 May 2017, the European legislator adopted Directive 2017/828 amending Directive 2007/36/EC. The aim of Directive 2017/828 is to further motivate shareholders and to facilitate their engagement in the corporate governance of companies that have their registered offices in a Member State and whose shares are listed for trading on a regulated market located or operating in a Member State.

As Directive 2017/828 has added new chapters and has significantly broadened the scope of regulation in relation to the original Directive 2007/36, it has introduced and defined in detail certain terms (e.g. institutional investor, asset managers, directors, shareholder identity information, etc.).

Apart from the widespread influence of shareholders on adopting the company remuneration policy, regulated by the provisions of Articles 9a and 9b (see *infra*), the basic areas of regulation of Directive 2017/828 are as follows:

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[11] Action Plan of the European Commission to the European Parliament and the Council of 12.12.2012; available at - https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX-%3A52012DC0740

[12] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2107 amending Directive 2997/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, available at http://data.europe.eu/eli/dir/2017/828/oj (15.6.2018)

[13] http://data.consilium.europa.eu/doc/document/ST-7526-2017-ADD-1/en/pdf;
http://blogs.uab.cat/dretmercantil/2017/06/22/directive-2017828-on-the-encourgament-of-long-term-shareholders-engagement/;
http://progresomicrofinanzas.org/en/12223/
https://companylawandgovernance.com/2017/05/28/the-amended-shareholder-rights-directive/

1. Identification of shareholders[14], transmission of information[15] and facilitation of the exercise of shareholder rights[16] - in terms of more direct communication of the company with its shareholders, obtaining of timely information on shareholder identification and processing of the said data; in addition to improving the transmission of information along the intermediary chain to facilitate the exercise of the rights by the shareholder, particularly in the cross-border context, a high level transparency regarding the cost of intermediaries and a ban on discrimination in terms of charges levied for domestic and cross-border exercise of shareholder rights; a more modern shareholder voting procedure in terms of shareholder rights to know whether their votes have been properly taken into account, to be provided with an electronic confirmation of receipt of the votes in the case of votes cast electronically and the possibility of obtaining confirmation that their votes have been validly recorded and counted by the company.
2. Transparency of institutional investors, asset managers and proxy advisors[17] – with the aim to secure long-term results and existence of the company.
3. Transactions with related parties[18] – in terms of providing adequate protection in transactions with related parties, publicly announcing material transactions, providing information on the identity of the related party and providing restrictions for directors or shareholders to participate in decision making in capacity of related parties.[19]

Taken as a whole, all the above mentioned is of utmost importance for the establishment of the necessary prerequisites for shareholders' participation in decision making in respect of the remuneration policy for directors, as provided for in Article 9a: The right to vote on the remuneration policy and Article 9.b: Information to be provided in the remuneration report and the right to vote on the remuneration report.

[14] Directive 2017/828, art. 3.a

[15] Directive 2017/828, art. 3.b

[16] Directive 2017/828, art. 3.c - 3.f

[17] Directive 2017/828, art. 3.g - 3.k

[18] Directive 2017/828, art. 9.c

[19] Apart from greater risk assumption and transactions with related parties, these transactions have been recognized as one of the elements that can contribute to the lessening of the company assets and cause potential conflicts of interest and it is therefore very important for them to be timely recognized and submitted to the shareholders for approval - as a prevention of so-called tunneling. 'Tunneling occurs either in the form of transactions that the holding company undertakes and manipulates the property of a subsidiary company ...'
See more in Jurić, Dionis, Pravo manjinskih dioničara na podnošenje tužbe u ime dioničkog društva protiv članova uprave i nadzornog odbora; Collection of Papers of the University of Rijeka Faculty of Law (1991) v. 28.no.1.541-586 (2007)

4.3. REMUNERATION POLICY - SHAREHOLDER (ACTIVE) ENGAGEMENT

Having in mind the shortcomings of the current remuneration regulations, as one of the key instruments for harmonizing the interests of the company with the interests of the company directors, appropriate mechanisms have been introduced by the European Union through Directive 2017/828 concerning shareholder participation in the company remuneration policy making process. Using the so-called 'push approach', it highlights the importance of an active shareholder and, by establishing a clear, understandable and comprehensive review of the company remuneration policy, it seeks to encourage and awaken them in the direction of taking over social corporate responsibilities with the aim to contribute to the long-term sustainability of the company.

In the preamble to Directive 2017/828, Clauses 28 to 49, guidance has been introduced with regard to remunerations, for each Member State to introduce in their national legislation. Directive 2017/828 respects the diversity of corporate governance systems of the EU Member States related to the determination of responsible bodies within companies for the determination of the remuneration policy and on the remuneration of individual directors. The importance is emphasized of the remuneration policy of companies to be determined in an appropriate manner and the right is introduced of shareholders to express their views regarding the remuneration policy of the company.

The latest financial crisis of 2008 showed that shareholders, for personal reasons, had supported the management in excessive short-term risk undertakings. Having recognized the issue of short-term objectives, linked to high premiums that had been contracted and paid, in the preamble to Directive 2017/828 the legislator explicitly stipulates for the first time that the remuneration policy must be based on long-term interests and sustainability of the company and should not be linked entirely or mainly to short-term objectives. In addition to the financial performance criteria, the remuneration policy should also be based on non-financial performance criteria, such as environmental, social and governance factors. It also prescribes the possibility of introducing and describing the different components of directors' pay through the remuneration policy as well as the range of their relative proportions, i.e. the variable part that directors can achieve. There has been a possibility left for a frame to be designed by the remuneration policy within which the pay of directors is to be held. It is not prescribed as an obligation but only as a possibility and leaves each Member State free will to decide in which way the provisions in question will be incorporated into their national legislations. Specifically, transparency in terms of directors' total remuneration greatly contributes to the high level corporate governance, but at the same time affects the competence of the su-

pervisory board and limits the scope for contracting remunerations with board members.

In order to prevent the circumvention of the requirements laid down by this Directive 2017/828 by the company, Member States are obliged to provide for the disclosure of the remuneration awarded or due to individual directors not only from the company itself, but also from any undertaking belonging to the same group. Otherwise, there would be a risk that companies try to provide directors with hidden remuneration via a controlled undertaking. In such a case, shareholders would not have a full and reliable picture of the remuneration granted to the directors by the company and the objectives pursued by Directive 2017/828 would not be achieved.

Directive 2017/828 introduces two new articles: Article 9a Right to vote on remuneration policy and Article 9.b Information to be provided in the remuneration report and the right to vote on the remuneration report.

Under the aforementioned provisions, shareholders will have the right to express their views on the remuneration policy twice – for the first time (*ex ante*) when voting (binding or advisory) on the remuneration policy and for the second time (*ex post*) when voting on the remuneration report in respect of the most recent financial year.

4.4. RIGHT TO VOTE ON REMUNERATION POLICY

The main objective in regulating the voting rights consists in the obligation of the company to determine the remuneration policy applying to the directors and to provide the shareholders with the right to vote at the general meeting on the subject remuneration policy. [20]

Vote by a shareholder may have a binding or advisory character.[21] It is interesting in this regard to see which approach will be applied by the Croatian legislator, i.e. in the case of an alternative legal solution offer (either-or) [22], how transparent and socially responsible the reaction of national companies will be. It is yet to be seen whether the Croatian legislator will avail themselves of

[20] Directive 2017/828, Art. 9.a, para 1

[21] Directive 2017/828, Art. 9.a, para 2 - 3

[22] A similar solution was selected when the Company Law was amended in 2007, when the option was introduced for a choice to be made between the monistic and dualistic structure of the management as a body of a joint-stock company.
See more: Academician J. Barbić Pregled odredaba Zakona o trgovačkim društvima o monističkom ustroju organa dioničkog društva, Croatian Law Review, 7 (2007), p. 44-53

legal solutions from the German legislation or will conduct an independent public debate with a view to obtaining the bottom-up feedback from national economic entities (e.g. Irish approach[23]).

In any event, the aim of Directive 2017/828 is to have directors' remunerations paid by companies exclusively in accordance with their remuneration policy adopted at the general meeting, no matter whether the decision of the shareholders is binding or advisory.

Provided the binding nature of the vote by the shareholders' at the general meeting on the remuneration policy, where no remuneration policy has been approved and the general meeting does not approve the proposed policy, the company may continue to pay remuneration to its directors in accordance with its existing practices and shall submit a revised policy for approval at the following general meeting.

Where an approved remuneration policy exists and the general meeting does not approve the proposed new policy, the company shall continue to pay remuneration to its directors in accordance with the existing approved policy and shall submit a revised policy for approval at the following general meeting.[24]

In the case of an advisory nature of the vote of shareholders at the general meeting on the remuneration policy, companies shall pay remuneration to their directors only in accordance with a remuneration policy that has been submitted to such a vote at the general meeting. Where the general meeting rejects the proposed remuneration policy, the company shall submit a revised remuneration policy to a vote at the following general meeting. [25]

Member States may allow companies, in exceptional circumstances, to temporarily derogate from the remuneration policy. Derogation from the adopted policy is allowed exceptionally (i) temporarily, (ii) in exceptional circumstances, (iii) if it is necessary to serve the long-term interests and sustainability of the company as a whole or to assure its viability, and (iv) provided that the

[23] The public debate procedure was launched by the Republic of Ireland competent Ministry for Business, Enterprise and Innovation on the occasion of mandatory incorporation of Directive 2017/828 in the Irish legislation as early as in December 2017 (see more at - https://dbei.gov.ie/en/Consultations/Consultations-files/Consultation-on-the-Transposition-of-Directive-EU-2017-828.pdf
https://www.computershare.com/News/Irish%20SRD%20Consultation%20-%20CPU%20Response%20FINAL%202018.pdf). The public debate, with a detailed and broad spectrum of questions, was going on until and including 9.2.2018.

[24] Directive 2017/828, Art. 9.a, para 2

[25] Directive 2017/828, Art. 9.a, para 3

policy contains the procedural conditions under which such derogation may apply and the precise elements of the policy it may derogate from. [26]

The possibility of temporary derogation from the remuneration policy by the company has been provided only as a possibility, not the obligation, for the Member State. The way the Croatian legislator is going to react with regard to this issue is an open question as yet.

An analogy may be drawn here with the current legal solution within the Croatian law whereby the supervisory board is authorized to reduce remunerations to members of the board if the circumstances within the company have aggravated to the extent that any further payments of such remunerations would represent a serious injustice to the company (see *supra*). However, Directive 2017/828 does not explicitly provide for the possibility of derogation only in the form of remuneration reduction. As an *argumentum a contrario*, according to the cited provision it is also possible for remunerations of the members of the administration to be temporarily increased. In addition, the term 'temporary' derogation opens up space for arbitrary decision-making on the time the derogation from the adopted policy is to apply and the emergence of different practices within individual Member States may be easily presumed.

The remuneration policy is to be submitted to a vote by the general meeting at every material change and in any case at least every four years. [27]

Regarding the content, the remuneration policy must be: (i) clear and understandable and shall explain how the pay and employment conditions of employees of the company were taken into account when establishing the policy; (ii) contain the information of its contributing to the company's business strategy and long-term interests and sustainability and shall explain how it does so; and (iii) contain different components of fixed and variable remuneration, including all bonuses and other benefits in whatever form, which can be awarded to directors and indicate their relative proportion.

Where a company awards variable remuneration, the remuneration policy shall set clear, comprehensive and varied criteria for the award of the variable remuneration. It shall indicate the financial and non-financial performance criteria, including, where appropriate, criteria relating to corporate social responsibility and explain how they contribute to the objectives set out. It shall specify information on any deferral periods and on the possibility for the company to reclaim variable remuneration (clawback).

[26] Directive 2017/828, Art. 9.a, para 4

[27] Directive 2017/828, Art. 9.a, para 5

The remuneration policy shall indicate the duration of the contracts or arrangements with directors and the applicable notice periods, the main characteristics of supplementary pension or early retirement schemes and the terms of the termination and payments linked to termination. The remuneration policy shall explain the decision-making process followed for its determination, review and implementation, including measures to avoid or manage conflicts of interests and, where applicable, the role of the remuneration committee or other committees concerned. Where the policy is revised, it shall describe and explain all significant changes and how it takes into account the votes and views of shareholders on the policy and reports since the most recent vote on the remuneration policy by the general meeting of shareholders.[28]

Apart from providing for the transparency of the voting procedure, Directive 2017/828 provides for the policy together with the date and the results of the vote to be made public without delay on the website of the company and to remain publicly available, free of charge, at least as long as it is applicable.[29]

4.5. INFORMATION TO BE PROVIDED IN AND RIGHT TO VOTE ON THE REMUNERATION POLICY

In addition to ensuring the company shareholder right to vote, it is of utmost importance to control the implementation of the remuneration policy. In this connection, the companies shall draw up (i) a clear and understandable remuneration report containing (ii) a comprehensive overview of the remuneration, including all benefits in whatever form, awarded or due during the most recent financial year to individual directors, including to newly recruited and to former directors. The aim of such a detailed and broadly ranged regulation is to reduce the possibility of manipulation in reporting.[30]

Where applicable, the remuneration report shall contain the following information regarding each individual director's remuneration:

1. The total remuneration split out by component, the relative proportion of fixed and variable remuneration, an explanation of how the total remuneration complies with the adopted remuneration policy, including how it contributes to the long-term performance of the company, and information on how the performance criteria were applied.

[28] Ibid.

[29] Directive 2017/828, Art. 9.a, para 7

[30] Directive 2017/828, Art. 9.b, para 1

2. The annual change of remuneration, of the performance of the company, and of average remuneration on a full-time equivalent basis of employees of the company other than directors over at least the five most recent financial years, presented together in a manner which permits comparison;
3. Any remuneration from any undertaking belonging to the same group as defined in point (11) of Art. 2 of Directive 2013/34/EU[31], in order to minimize the space for mismanagement, and to enable shareholders to have a full and reliable picture of total remunerations paid to directors.
4. The number of shares and share options granted or offered, and the main conditions for the exercise of rights including the exercise price and date and any change thereof;
5. Information on the use of the possibility to reclaim variable remuneration;
6. Information on any deviations from the procedure for the implementation of the remuneration policy and on any derogation applied, including the explanation of the nature of the exceptional circumstances and the indication of the specific elements derogated from.[32]

According to the preamble to Directive 2017/828, directors remain on a company board for a period of six years on average (although in some Member States that period exceeds eight years).[33] In this connection, it is of crucial importance to evaluate the remuneration and the results of directors' performance not only on an annual basis but also during the relevant period. Thereby, the shareholders, as well as other stakeholders are provided with a mechanism to correctly assess the link between the remuneration and the long-term results. In most cases it is only possible after a period of several years to evaluate whether the awarded remuneration was in line with the long-term interests of the company.

The remuneration report should be clear and understandable and should provide a comprehensive overview of the remuneration of individual directors during the most recent financial year. Shareholders should be granted the right to vote on the company' remuneration report, in order to ensure compliance between the implementation of the remuneration policy and the policy itself. Where the shareholders vote against the remuneration report at the general meeting, the company should explain, in the following remuneration report, how the vote of the shareholders was taken into account.[34]

[31] According to Art.2, para 11 of Directive 2013/34, „group" is defined as 'parent undertaking and all its subsidiary undertakings'

[32] Ibid.

[33] Directive 2017/828, preamble, para (39)

[34] Directive 2017/828, preamble, para (31)

Shareholders have the right to hold an advisory vote at the annual general meeting[35]on the remuneration report of the most recent financial year and the company shall explain in the following remuneration report how the vote by the general meeting has been taken into account.

For small and medium-sized companies[36] exception has been provided for, as an alternative to a vote, whereby the remuneration report of the most recent financial year is to be submitted for discussion in the annual general meeting as a separate item of the agenda. The respective Member States are to ensure for such an exception to be included in their national legislation and to prescribe that in such cases companies should explain in the following remuneration report how the discussion in the general meeting has been taken into account.[37]

There are exceptions provided for in respect of the disclosure of the data regulated by Regulation (EU) 2016/679 (GDPR Regulation)[38] and personal data relating to the family situation of individual directors.[39] Specifically, in relation to Regulation 2016/679, data relating to the family situation of directors are considered to be particularly sensitive.

Since pursuant to Directive 2017/828, and in order to provide a full review of the directors' remunerations, the remuneration report should reveal the amounts of remuneration received on the basis of the family situation of individual directors (e.g. family allowance or child allowance), it should be noted here that in accordance with the applicable regulations in Croatia, the variable remuneration means any remuneration other than the pay or any remuneration that has not been provided for by the company internal act to apply to all employees.

Talking about director's family situations, variable remuneration is considered to refer to child tuition fee as well as to other expenses that directors are entitled to under "bonus packages". Therefore, pursuant to Regulation (EU)

[35] Directive 2017/828, Art. 9.b, para 4

[36] Small and medium-sized undertakings are defined in Art. 3, para 2 and 3 of Directive 2013/34/EU and they correspond to small and medium-sized entrepreneurs, in compliance with Art. 5 of the Accountancy Act. Small companies meet 2 out of 3 criteria as a minimum: (i) balance sheet total: EUR 4.000.000; (ii) net turnover: EUR 8.000.000; (iii) average number of employees duringthe financial yer: 50. Medium-sized undertakings meet 2 out of 3 criteria as a minimum: (i) balance sheet total: EUR 20.000.000; (ii) net turnover: EUR 20.000.000; (iii) average number of employees duringthe financial year: 250.

[37] Ibid.

[38] Regulation 2016/679 of the European Parliament and of the Council, available at - https://eur-lex.europa.eu/legal-content/hr/TXT/?uri=CELEX:32016R0679

[39] Directive 2017/828, Art. 9.b, para 2

2016/679, such data enjoy special protection and it is proposed that only the remuneration reports are only entered the remuneration amounts without specifying the basis on which it was awarded to the director.

The purpose of processing personal data of the directors by the company and their inclusion in the remuneration reports is to enhance corporate transparency and directors' accountability as well as to improve shareholder oversight over directors' remuneration. These personal data are made publicly available in accordance with Directive 2017/828 for a period of 10 years from the publication of the remuneration report.[40]

After the general meeting, the companies shall make the remuneration report publicly available on their website, free of charge, for a period of 10 years, and may choose to keep it available for a longer period provided it no longer contains the personal data of directors. The statutory auditor or audit firm shall check that the information so required has been provided.[41]

According to Directive 2017/828, to directors of the company is imposed collective responsibility for ensuring that the remuneration report is drawn up and published in accordance with the requirements of that Directive. Member States shall ensure that their statutory measures apply to the directors of the company for breach of the duties.[42]

4.6. APPLICABLE REGULATIONS IN CROATIA REGARDING DIRECTORS' REMUNERATION

According to positive legislation in Croatia, the principles for deciding on the remuneration of the directors of the company fall within the competence of the supervisory board. Pursuant to Article 247 of the Companies Act, the supervisory board determines the criteria for the total remuneration of directors (fixed and variable remuneration). It is limited by two criteria, i.e. by the adequacy of the work performed by the individual director and by the financial standing of the company.[43] The basic assumption for the company's successful determination of the remuneration policy for the directors is the independence of the supervisory board.

[40] Directive 2017/828, Art. 9.b, para 5

[41] Ibid.

[42] Ibid.

[43] Companies Act (NN 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), Art. 247

The shareholders of the company, except in electing the members of the supervisory board, have no influence on the creation of the remuneration policy for the directors. Independence is defined here as the absence of any material conflict of interest, as one of the basic assumptions for reducing or completely eliminating the possibility of mismanagement of the company.[44] Members of the supervisory board are required to determine all the essential components for determining all the awards (rewards, reimbursement of expenses and special benefits, and the content of basic and additional rewards). When deciding on the essential elements of contracts of remuneration of directors, the decision of the members of the supervisory board should not be negative, having particularly in mind the duty to determine severance payments, if the member of the supervisory board is acting within the scope of the applicable recommendations.

However, in German law, for example, the determination of the severance payment in an inappropriate or unjustifiable amount for a director who withdraws from duty draws the civil liability of a member of the supervisory board and possibly even criminal liability for embezzlement. The German Supreme Court explicitly stated in the Mannesmann case that the subsequent granting of special payments to directors which had not been determined by the employment contract constituted a violation of the loyalty and caused damage to the company assets, since that remuneration had the character of the reward only and does not provide any future benefit for the company. In Croatian legislation, such crimes are determined by the Criminal Code (economic criminal crimes) and by the Capital Markets Criminal Law and the Companies Act.[45]

The supervisory board is authorized to reduce the remuneration to the directors if the company's circumstances are significantly aggravated so that further payment of such remunerations would constitute a serious injustice. However, there have been no simple, quick and clear mechanisms established in this case either of shareholder participation in deciding on the remuneration of directors.

4.7. REMUNERATION POLICY AS PRACTICED BY CREDIT INSTITUTIONS IN CROATIA

Financial institutions are highly regulated as industry everywhere in the world, including in Croatia. Therefore, the obligation concerning the remuneration policy already applies to credit institutions.

[44] Prof. Hana Horak, PhD and Kosjenka Dumančić, univ.spec.: Neovisnost i nagrađivanje članova nadzornih odbora i neizvršnih direktora, Collection of Papers of the Faculty of Law of Split, year 48, 1/2011, p. 34

[45] Prof. Hana Horak PhD et al., p. 44

Following the latest financial crisis in 2008 and a series of recommendations, the European Commission has adopted Directive 2013/36 EU of the European Parliament and of the Council of 26 June 2013 on access to credit institutions and prudential supervision of credit institutions and investment firms[46], which lays down the obligation for companies to adopt the remuneration policy. In this connection, the European Banking Authority as the supervisory authority issued guidelines on the content of the remuneration policy. The Directive has been implemented in the Law on Credit Institutions (NN 15/18) in Articles 37 and 100, and the Decision of the Croatian National Bank on Employee Remuneration, 2017 (hereinafter referred to as the Decision) detailed all the prescribed guidelines and prescribed a large part of the requirements arising from Directive 2017/828.

The decision prescribes the obligation of credit institutions relating to the establishment and implementation of a remuneration policy, introduces the principle of proportionality for companies to meet their obligations in a way and to the extent that is appropriate to their size, internal organization and the nature, scale and complexity of their activities. It prescribes that remuneration policies must exercise adequate and effective risk management and should not encourage the takeover of risks that exceed the level of credit risk acceptable to the credit institution. The remuneration policy must be consistent with the long-term interests of the credit institution and include measures to prevent conflicts of interest. The decision also forbids any circumvention of the provision on remuneration by providing directors with hidden variable remuneration via a controlled undertaking or contrary to the objective and purpose of the Decision.

This is identical to the requirements laid down in Directive 2017/828. The Decision prescribes additional requirements for credit institutions. The additional requirements imposed by the Decision are the limitation of the amount and deferral of the variable remuneration, and the application of the "*malus*" or clawback clause. Namely, the Decision prescribes that the relationship between the variable and the fixed portion of the total remuneration of a particular worker is to be determined in the maximum amount of the variable remuneration which does not exceed the fixed portion on an annual basis. Only exceptionally, credit institution may determine the amount of the variable portion of the remuneration up to double the amount of the fixed portion of individual worker's remuneration, provided the adoption of such a decision by the general meeting of the company.

[46] https://eur-lex.europa.eu/legal-content/HR/TXT/?uri=CELEX%3A32013L0036 (24.09.2018)

Credit institutions are obliged to defer at least 40% of the variable portion of the remuneration, or exceptionally 60% where high amount is involved, for a maximum of 3 years, in order to evaluate the business risk undertaken by every worker in the performance of jobs. Where it is established that the risk undertaken by a worker has caused damage or has not achieved the expected profit, the credit institution may apply the *malus* (clawback) clause and withhold the payment of the deferred portion of variable remuneration up to 100% if the envisaged performance criteria have not been met.

Credit institutions are prescribed mandatory establishment of a board within the supervisory board to review the remuneration policy and propose decisions to the supervisory board. The remuneration committee may consist of members of the supervisory board and also of external independent experts and such a practice would be effective in other undertakings as well.

A part of the requirements of Directive 2017/828 has not been included in the Decision and will pose challenges for companies as well as for credit institutions. So far, Croatian legislation has not prescribed the obligation to adopt the remuneration policy by the general meeting or to make it publicly available. It is not known yet whether the Croatian legislator will decide to prescribe the recommendation for the remuneration policy to determine the extent of directors' remuneration and thereby the basis for variable remuneration as well.

5. CONCLUSION

With regard to the pronounced need for an "actively engaged shareholder" being encouraged to take on social responsibility through the long-term viability of the company, one of the key issues is raised - whether a Croatian legislator will take a cogent or dispositive approach to incorporating the provisions of Directive 2017/828 in relation to the mandatory or advisory nature of the shareholders' vote on the remuneration policy at the general meeting of the company.

If the latter solution is adopted, it will be interesting to see the behavior of the companies because of the fact that companies, also in the case of the dispositive approach taken by the Croatian legislator, do not have any obstacles to prescribe independently by their internal acts the binding nature of the shareholder vote.

The above said refers primarily to the members of the managing and supervisory bodies of the company, to their possible readiness to change the ratio of strengths when deciding on remuneration in favor of the shareholders of the company, on the one hand; and subordinately to the openness and transparency towards (potential) investors in the company.

In both cases, the incorporation of the provisions of Article 9a of Directive 2017/828 will require more active engagement of the shareholders themselves.

The Croatian legislator may opt for an alternative approach (either-or). In that case, the question remains open as to whether and to what extent the market is to be valued by those undertakings that appreciate and encourage active participation of shareholders in adopting the remuneration policy, as opposed to those who assume a more passive attitude.

Pursuant to Directive 2017/828, remuneration policy should contribute to the business strategy, long-term interests and sustainability of the company. Although the public disclosure of variable remuneration awarded to directors contributes to the transparency toward investors, the public disclosure of reward amounts as well as the public disclosure of the remuneration policy will be the biggest challenge for companies to be faced with. How far in detail the companies will go in prescribing the criteria, conditions and ways of measuring success and in discussing all that at the general meeting, and in making them publicly known thereafter, will be a specific test of the transparency of companies towards investors.

In addition, among the challenges that companies will encounter in practical implementation is the issue of how the performance of a director should be determined and measured, while maintaining the balance between frequently opposed long-term interests of shareholders and short-term objectives of the directors. In what way the remuneration policy will prescribe the measuring of the appetite for undertaking the risk of a director in business decision-making and what the acceptable business risk will be for the company in relation to long-term objectives will be left upon the shareholders to decide. Differing attitudes toward business ethics and moral standards are just as hard to observe, but undeniably play a role in the CEO's propensity to manage risk[47]. Where applicable to a company, determining the results of directors' performance on the basis of non-financial criteria will include environmental, social and governance factors that will require listing in the remuneration policy.

This will require an even greater expertise and involvement of shareholders in the operation of the company during the debate and voting on the remuneration policy, which can consequently be reflected in the increasing demand for professional services (lawyers, brokers, financial experts, etc.).

Everything mentioned above applies in the same way to the attitude the Croatian legislator will take in prescribing the possibility of temporary derogation

[47] Luc Thevenoz, Rashid Bahar, Conflict of interest – Corporate Governance & Financial Markets; Kluwer Law international 2007; p 157

from the adopted remuneration policy. Whether a temporary derogation will be allowed and to what extent it will be regulated by law and to what extent it would be left to arbitrary decision on the companies themselves –remains one of the challenges at this moment. However, it is certain that, from the remuneration policy, it will be possible to see the basic strategic guidelines for the development of the company, because by defining long-term interests and non-financial criteria, shareholders will express their clear views on where and how they see the future of the company.

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