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Company law and corporate governance after Brexit: from short-term disruption to long-term sustainability?

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Policy implications and recommendations

Brexit has a number of implications for companies operating in the UK as well as for company law and corporate governance in both that country and the EU. Firstly, at the end of the transition period (currently 31 December 2020), the EU's freedom of establishment will end in the UK, potentially 'trapping' foreign businesses that incorporated in the UK. Individual Member States should provide for temporary recognition of these companies until they can 'return'. Secondly, the UK might – depending on its obligations under any agreement on the future relationship to align with the EU – water down or remove worker involvement rights in the EU *acquis*. Trade unions in the UK should continue to defend these worker involvement rights, as well as continue to resist further drift in the direction of shareholder primacy corporate governance. Thirdly, the EU now has an important opportunity to move towards a corporate governance system that takes account of different stakeholder interests and steers companies towards greater sustainability. Trade unions should push for and support this transition. However, this will not be easy because the UK was not the only obstacle to moving EU policy in this direction.

Introduction

Following the election of a majority Conservative government on 12 December 2019, the UK finally left the European Union on 31 January 2020, with a transition period running to the end of 2020. Regarding the future trade relationship between the UK and the EU from 2021, the UK government has publicly committed not to extend the transition period, leaving a very tight timetable to reach an agreement on the future trading relationship between the UK and the EU.

Much has been said about the UK's departure from the EU ('Brexit'), but considerably less about its implications for company law and corporate governance in the UK and the EU. This briefing note sets out to correct that. The first section examines the specific issue of corporate mobility and the end of freedom of establishment. The second section looks at the implications for company law and corporate governance in the UK after Brexit. The final section highlights the opportunity after Brexit for the EU to put in place a regulatory framework across the Union which aims to steer companies towards a more inclusive and sustainable approach.

Corporate mobility and the end of freedom of establishment

The various EU instruments that implement freedom of establishment by permitting and regulating cross-border mergers, allowing the creation of European Companies (SEs) and European Economic Interest Groupings (EEIGs) and regulating the disclosures made by branches of companies, will be repealed in the UK.

It is clear that companies have, for some time, been leaving the UK in preparation for Brexit. Important ongoing research by Biermeyer and Meyer (2019) confirms that there has been a massive increase in UK companies moving across borders, primarily using the cross-border merger mechanism to head to Germany and the Netherlands.

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One key question concerns the thousands of small businesses from Germany and other Northern European Member States that took advantage of the Court of Justice of the European Union (CJEU) decision in *Centros*. The court ruled in that case that freedom of establishment gives businesses the right to incorporate in the Member State whose rules 'seem… the least restrictive' and then carry on business through branches in other Member States, effectively bypassing much of the mandatory regulation in their 'home' Member State. They chose the UK's 'flexible' system of company law but are now in an unenviable position. Once the UK's transition period ends and freedom of establishment is no longer guaranteed by the Treaty on the Functioning of the European Union, those pseudo-foreign companies may no longer be recognised in their 'home' jurisdiction, potentially losing limited liability or becoming subject to other rules to bring them in line with domestic law on matters such as minimum share capital (Lehmann and Zetzsche 2016). These companies will need to change their applicable law, something which is rather difficult as UK law does not allow UK incorporated companies to change their jurisdiction of incorporation and governing law without dissolution, which is likely to trigger tax liabilities. These companies will be allowed to use the complicated and expensive cross-border merger route until the end of the transition period.[1] Employees of smaller companies will face considerable uncertainty about the identity – and perhaps even continued existence – of their employer, especially as most of these companies will be below the threshold of 50 employees that triggers the 2002 Directive on Employee Information and Consultation.

As Biermeyer and Meyer show, larger companies are also relocating in order to guarantee access to the single market: large companies in the financial services, information and communication, wholesale and retail trade sectors are using the cross-border merger mechanism to move out of the UK and into the Netherlands and Germany. These employees may also face uncertainty about the future of their company. However, it is possible that employees of these companies will see their rights enhanced if their employers become subject to a legal regime which is more protective of employee rights.

Similarly, SEs and EEIGs will no longer enjoy freedom of establishment. SEs that have not moved their registered office out of the UK before the end of the transition period will be converted into a 'UK Societas' form by operation of law. Their governing rules (including on employee involvement) will remain the same but there will be no new creation (there are only around 25 UK SEs and most have no employees, being holding companies in the insurance sector) and transfer of the registered office out of the UK will no longer be permitted. The UK Societas is intended only as a 'temporary stage for entities rather than a long-term corporate choice'.[2] Likewise, any remaining EEIGs will convert into UK Economic Interest Groupings, with the same rules applying.[3]

1 See The Companies, Limited Liability Partnerships and Partnerships (Amendment etc.) (EU Exit) Regulations 2019 (SI 2019/348), Reg 5.

2 Explanatory Memorandum to the European Public Limited-Liability Company (Amendment Etc.) (EU Exit) Regulations 2018, para 7.6.

3 European Economic Interest Grouping (Amendment) (EU Exit) Regulations 2018 (2018/1299).

There appears to have been no discussion to date between the EU and the UK about mutual recognition of companies. The UK is likely to fall back on its pre-existing (and fairly liberal) common law rules for the recognition of overseas companies, whilst EU Member States will no longer be obliged by EU law to recognise companies incorporated under UK law. Hence, individual Member States will be free to determine their own approach to the recognition of UK companies, potentially paving the way for a strict application of the 'real seat' rule in some cases (with the effect of denying recognition to companies incorporated in the UK but having their management and control centre in that Member State). Individual Member States should consider introducing 'grandfathered' (time-limited) rules providing for recognition of pseudo-foreign companies until they can 'return'.

Implications of Brexit for company law and corporate governance in the UK

Although immediate changes to UK company law and corporate governance are highly unlikely, in the medium to long run, acquired workers' rights may be under threat. Under the European Union (Withdrawal) Act 2018, the EU *acquis* will be translated into domestic law. At the end of the transition period, which is currently scheduled for 31 December 2020, national legislation implementing EU directives will remain in force, whilst directly effective EU law will 'form part of domestic law'.[4] It appears that both primary legislation which originally implemented EU law and that which transplanted directly effective law will be amendable by regulations (that is, secondary legislation, largely bypassing parliament).[5] The ease of amendment of these rules has caused controversy, but amending the rules relating to company law and corporate governance is unlikely to be a top priority in the near future, given that the government will be preoccupied with trade negotiations for some time. In addition, the question of whether the UK will maintain regulatory alignment with the EU in order to continue market access under any future trade deal remains unresolved.

In light of these considerations, it would not be surprising if the Conservative government proposed substantial changes in the medium term, given that the Conservative Party has traditionally been hostile to workers' rights (although the new government has promised to protect and enhance workers' rights through domestic law). It is certainly conceivable that the rules implementing the European Works Council and Employee Information and Consultation Directives could, in the not-too-distant future, be removed from domestic law by secondary legislation. Similarly, we might expect the rules which cap bankers' bonuses – which a previous Conservative government challenged before the CJEU until an adverse Advocate-General opinion was delivered in 2014 – to be removed from domestic law.

Other areas of company law will almost certainly be a medium-term target for reform. In particular, minimum capital requirements and rules on financial assistance for public companies are not viewed

4 ss2 and 3 of European Union (Withdrawal) Act 2018.

5 ss7 to 9 of European Union (Withdrawal) Act 2018.

favourably and are likely to be amended the next time company law is reconsidered (the last company law review took place between 1998 and 2002, i.e. quite a while ago).

On broader questions of corporate governance, far-reaching changes are possible, although it would be surprising if the Conservative government moved in a progressive direction. UK parliament reports on *Corporate Governance* (2017) and *Carillion* (2018) recognise that the UK's corporate governance system is deeply flawed, with the failure of companies such as BHS highlighting the short-termist, asset-stripping culture, whilst Carillion and Interserve surely call into question the wisdom of outsourcing whole swathes of public services to highly leveraged private sector 'partners'. It is true that since the 2016 referendum, there have been limited moves in a more stakeholder-focused direction. For example, the 2018 UK Corporate Governance Code requires companies to adopt one of three employee voice mechanisms (employee board-level representative, designated non-executive director, or a formal workforce advisory panel) or to disclose their alternative arrangements and explain how they are effective at ensuring workforce engagement. This is regrettably weak and a far cry from Theresa May's 2016 promise to mandate employee board-level representation. At the same time, the future of the Financial Reporting Council (FRC), which administers the UK Code, is uncertain, with the 2018 Kingman Review concluding that the FRC is 'built on weak foundations' and should be replaced with an 'Audit, Reporting and Governance Authority'. The UK government announced in March 2019 that a new statutory authority would 'have strategic direction and duties to protect the interests of customers and the public by setting high standards of statutory audit, corporate reporting and corporate governance'.[6] A 2019 consultation on the functions of the new authority refers only to setting and applying high standards of corporate governance. Whilst there is a recognition that the Stewardship Code 'must be demonstrably improved',[7] wholesale changes to a corporate governance model that relies on shareholder activism appear unlikely, especially with the FRC having carried out an extensive consultation and issued a revised Stewardship Code in 2020. This Conservative government is therefore very unlikely to make any fundamental change to the shareholder primacy trajectory of UK corporate governance.

We might, in the medium term, expect the UK to repeal the laws implementing the revised Shareholder Rights Directive. That Directive was only implemented because of the UK's repeated failure to leave before the 10 June 2019 deadline for transposition. The Directive forced the Financial Conduct Authority and Department of Work and Pensions to take a more regulatory approach to relevant institutional investors and asset managers, something which runs contrary to the UK's preference for dealing with matters of corporate governance through soft law. However, with the just-published Stewardship Code 2020 aiming to disseminate best practice beyond the regulatory requirements imposed by the Directive (which in turn were largely modelled on the UK's earlier Stewardship Code), wholesale change does not appear imminent. Much will presumably depend on the response of pension funds, insurance companies and asset managers to the new regulatory obligations. If they tell the government that they find them little more than burdensome 'red tape' then changes will presumably be forthcoming.

Finally, far-reaching changes to takeover regulation are unlikely, given that the Takeover Directive largely reflected (albeit with some optionality) the UK's existing approach. Employees are particularly vulnerable under the UK's system of takeover regulation: whilst bidders must declare their intentions in relation to the target's employees, this requirement normally produces little concrete information. It was strengthened to a limited extent following the controversial takeover of Cadbury by Kraft, in which Kraft reneged on undertakings given, but UK trade unions should continue to demand more far-reaching changes to takeover regulation.

The TUC insists that any Brexit deal should 'maintain workers' existing rights and establish a level playing field so that British workers' rights do not fall behind those of other European workers'.[8] This is likely to set up a major clash with the government, which is committed to a comprehensive free trade agreement, supplemented by specific agreements in relation to a number of other areas, and is unwilling to commit to a regulatory level playing field. Trade unions in the UK have long resisted, and no doubt will continue to resist, attempts by the UK government to reduce employee involvement rights from current levels or increase shareholder primacy,[9] both of which look likely.

Implications of Brexit for the EU's approach to company law and corporate governance

The UK's approach to company law and corporate governance profoundly influenced the approach taken by the EU to these matters, from opposition to the Fifth Company Law Directive and employee board-level participation, through the blueprint for a Takeover Directive aimed at creating a market for corporate control, to a post-financial crisis emphasis on enhancing shareholder rights which was supposed to correct the tendency towards short-termism. Now that the UK will no longer be part of the process, the EU has the opportunity to strike out in a radically different direction, with corporate governance focusing on balancing the welfare of all stakeholders and ensuring that companies play their part in the essential transition to economic, environmental and social sustainability.

6 https://www.gov.uk/government/news/audit-regime-in-the-uk-to-be-transformed-with-new-regulator
7 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/784988/independent-review-financial-reporting-council-initial-consultation-recommendations.pdf

8 TUC, 'TUC General Council statement on Brexit: No to no deal, for a future fit for working people', 7th September 2019. https://www.tuc.org.uk/news/tuc-general-council-statement-brexit-no-no-deal-future-fit-working-people
9 TUC, 'ALL ABOARD – Making worker representation on company boards a reality', 2nd October 2016. https://www.tuc.org.uk/research-analysis/reports/all-aboard-making-worker-representation-company-boards-reality

With the European Green Deal, there are signs that the European Commission (European Commission 2019) is preparing for the EU to become a global leader in the transition to climate neutrality. This growth strategy commits to 'transform the EU into a fair and prosperous society, with a modern, resource-efficient and competitive economy where there are no net emissions of greenhouse gases in 2050 and where economic growth is decoupled from resource use'. This will entail job-creating investments in innovation and the introduction of legal obligations requiring all sectors of the economy to contribute to the transition. Sustainability will be mainstreamed in all EU policies, implying changes to company law and corporate governance. In particular, a renewed sustainable finance strategy will be presented in 2020, and '[s]ustainability should be further embedded into the corporate governance framework, as many companies still focus too much on short-term financial performance compared to their long-term development and sustainability aspects'. Among other things, this will entail providing better information to investors; the Non-Financial Reporting Directive will thus be reviewed and there will be support for changes to natural capital accounting practices. There will also be efforts to introduce standardisation to make it easier for investors to identify sustainable investments, whilst climate and environmental risks will be managed and integrated into the financial system.

Beyond this, the Commission has already committed, in its Sustainable Finance Action Plan of 2018 (European Commission 2018), to explore 'the possible need to require corporate boards to develop and disclose a sustainability strategy, including appropriate due diligence throughout the supply chain, and measurable sustainability targets', as well as to consider clarifications to directors' duties to act in the company's long-term interest. A coalition of academics have suggested one way in which such a strategy could be embedded within mainstream company law mechanisms (Johnston *et al.* 2020), whilst the SMART project at the University of Oslo has advanced another set of innovative proposals (Sjåfjell *et al.* 2020). Looking at global supply chains, the ETUC has called for a directive on mandatory human rights, due diligence and responsible business conduct (ETUC 2020). It is clear that the European Commission is losing patience with relying on voluntary measures in this area and is considering a mandatory due diligence standard which would level the playing field between companies that do and do not take seriously their environmental and human rights responsibilities. This course of action is broadly supported by a detailed study undertaken on the Commission's behalf (European Commission 2020).

Other, complementary reforms to company law and corporate governance are also possible and desirable to reinforce this long-term focus. These could include: reforms of the Takeover Directive; enhanced guidance on executive remuneration to encourage board committees to link pay to environmental, social and governance (ESG) criteria and to achieve the targets set out in the sustainability strategy; and a framework directive providing for ambitious minimum standards of board-level employee representation and high levels of employee information and consultation as proposed by the ETUC (ETUC 2014, 2016). Many of these proposals are already well developed as part of the progressive agenda to reorient companies towards greater sustainability.

Without the UK there will be more scope to move in the direction of establishing a world-leading stakeholder system of corporate governance aimed at supporting the transition to long-term sustainability across the whole EU. There will be less opportunity for regulatory arbitrage, and hence less downwards pressure on regulatory standards within the remaining Member States. Ireland might provide an alternative for companies seeking to escape onerous capital requirements, but businesses are likely to be more wary, given the inconvenience suffered by companies that have been incorporated in the UK. Moreover, there will no longer be a large Member State strongly insisting on shareholder primacy and constantly opposing the integration of any other policy goals in company law and corporate governance. Last but not least, it appears that the academic tide is turning, with those of us who have long argued for stakeholder-centric corporate governance with a long-term perspective now joined by some of those who used to strongly advocate shareholder primacy (such as Winter 2020).

However, the importance of the UK's departure and these other developments should not be overstated. There remain a number of other obstacles to moving EU policy in the direction of more sustainable companies with greater employee participation. Powerful institutional investors will continue to demand shareholder-friendly norms, and much of the shareholder-value thinking in the last two decades has come from the Commission, inspired by law and economic thinking that originated primarily in the US, rather than being influenced by UK practice. In addition, not all Member States are supportive of the European Green Deal, mandatory rules on due diligence, and the expansion of workers' rights, but the UK's departure is likely to make it harder for them to hide their opposition.

Conclusion

Brexit marks the end of the UK's exceptionalism, and developments since 2016 have also shown that the Member States are willing to unite behind the European Commission when there is a threat to the EU. The UK's attempts to divide the Member States failed.

At the same time, Brexit should not only be seen as a reflection of the peculiar cultural identity of the British, but also as a cautionary tale against too much neoliberalism, and in particular against allowing the gap between the rich and poor to widen too far. There is no room for complacency in the EU, where the dislocations created by the financial crisis have been patched up but not resolved, and existing massive inequality both within and between Member States will be exacerbated by the pandemic. Support for the EU may be at an all-time high, but there are also growing numbers of EU citizens who are undecided about the merits of remaining in the EU. Therefore, much still needs to be done, including the introduction of fiscal transfer mechanisms within the eurozone. Company law and corporate governance could play their part: a return to the agenda of making companies more accountable to their employees and to the workers in their supply chains could be supported on the basis that it will narrow the divide between rich and poor within and between the Member States.

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