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JUDICIAL FEDERALISM IN THE ECJ'S  
BERLUSCONI CASE: TOWARDS MORE  
CREDIBLE CORPORATE GOVERNANCE  
AND FINANCIAL REPORTING?

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JUDICIAL FEDERALISM IN THE ECJ'S BERLUSCONI CASE: TOWARDS MORE  
CREDIBLE CORPORATE GOVERNANCE AND FINANCIAL REPORTING?

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ABSTRACT:

The objective of this note is to analyze the importance of three joint cases - one of them against the Italian Prime Minister Silvio Berlusconi - where the amendment of Italian financial reporting law is at issue, and to situate them within the bigger picture of the current state of corporate governance and financial reporting. Part I explains the legal context of these cases and outlines the opinion submitted by the Advocate General Juliane Kokott. Part II analyzes the three most important parts of the Advocate General's opinion in detail: the application of EU law on the nondisclosure of accounts to the publication of false accounts, the need for effective enforcement, and the effect of the principle *nulla poena sine lege* - that there must be neither crime nor punishment without law. The Advocate General recommends that Italy's judges should ignore the new Italian law, which takes a lax view of accounting fraud. On the one hand, this is surprising, as EU directives on corporate law and accounting do not address the issue at all. On the other hand, this strict approach to financial reporting is in line with increasing efforts toward stronger involvement of the EU federal level in corporate governance in general, in consideration of recent US corporate governance developments as well as the economic underpinnings of accurate accounting. Part III then addresses the issue of how the Berlusconi case may contribute to an increased effectiveness of EU efforts to strengthen and harmonize corporate law.

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## Recent Developments

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### JUDICIAL FEDERALISM IN THE ECJ'S *BERLUSCONI* CASE: TOWARD MORE CREDIBLE CORPORATE GOVERNANCE AND FINANCIAL REPORTING?

#### INTRODUCTION: CURRENT TRENDS IN CORPORATE GOVERNANCE AND FINANCIAL REPORTING IN THE UNITED STATES AND THE EUROPEAN UNION

In recent years, the general public in many countries has become increasingly aware of issues concerning business accounting and financial reporting. Americans hardly need to be reminded of the Enron debacle, where members of the company's senior management engaged in fraudulent off-balance sheet transactions to disguise the true state of the company's financial condition, a scheme that auditors failed to uncover until the company's implosion.<sup>1</sup> This and other major corporate governance cases involving questionable or fraudulent accounting practices led to the Sarbanes-Oxley Act of 2002.<sup>2</sup> This law was an unprecedented Congressional intervention into corporate governance, an arena that had previously been left largely to Securities and Exchange Commission ("SEC") rules and professional self-regulation (e.g., auditor independence requirements),<sup>3</sup> or to state corporate law (e.g., requirements for board committees and their composition).<sup>4</sup>

Accounting scandals are not, however, a phenomenon limited to the United States. As a result of similar events in some European states, accounting reform has recently appeared on their policy agendas as well.<sup>5</sup> Italy is notable in this regard, due in large part to its home-grown Parmalat scandal—until now

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1. For more on the Enron case see, e.g., John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002); Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125 (2003); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002); Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, J. ECON. PERSP., Spring 2003, at 3; Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics, and Enron*, 8 STAN. J. L. BUS. & FIN. 9 (2002).

2. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.).

3. Cf. William R. McLucas & Paul R. Eckert, *The Securities and Exchange Commission's Revised Auditor Independence Rules*, 56 BUS. LAW. 877, 884 (2001) (noting a departure from the private standard-setting model with respect to auditor independence).

4. Audit committees are not an issue of Delaware corporate law, but special committees approving interested-party transactions are. See, e.g., *Kahn v. Lynch Communication Sys., Inc.*, 669 A.2d 79 (Del. 1995); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

5. For an overview, see Luca Enriques, *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, 38 WAKE FOREST L. REV. 911 (2003).

Europe's most expensive financial scandal. At the end of 2003, a 14.8 billion gap that had been disguised by the establishment of an offshore subsidiary was discovered in the firm's accounts.<sup>6</sup> Surprisingly—at least at first glance—at a time when other countries were strengthening their stance toward accounting fraud, Italy eased the grip of its criminal law on accounting fraud in a 2002 legislative decree amending the Italian Civil Code.<sup>7</sup> The Italian courts have submitted this amendment to the scrutiny of the European Court of Justice (“ECJ”) for a preliminary ruling.

The objective of this note is to analyze the importance of three joint cases<sup>8</sup>—one of them against the Italian Prime Minister Silvio Berlusconi—where the amendment of Italian law is now at issue, and to situate them within the bigger picture of the current state of corporate governance and financial reporting. Part I explains the legal context of these cases and outlines the opinion submitted by the Advocate General Juliane Kokott.<sup>9</sup> Part II analyzes the three most important parts of the Advocate General's opinion in detail: the application of E.U. law on the nondisclosure of accounts to the publication of false accounts, the need for effective enforcement, and the effect of the principle *nulla poena sine lege*—that there must be neither crime nor punishment without law. The Advocate General recommends that Italy's judges should ignore the new Italian law, which takes a lax view of accounting fraud. On the one hand, this is surprising, as E.U. directives on corporate law and accounting do not address the issue at all. On the other hand, this strict approach to financial reporting is in line with increasing efforts toward stronger involvement of the E.U. “federal” level in corporate governance in general, in consideration of recent U.S. corporate governance developments as well as the economic underpinnings of accurate accounting. Part III then addresses the issue of how the *Berlusconi* case may contribute to an increased effectiveness of E.U. efforts to strengthen and harmonize corporate law.

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6. For the most recent developments, see Parmalat Press Releases, at <http://www.parmalat.com/en/fset.html?sez=eg> (last visited Apr. 20, 2005).

7. See *infra* Part I.A.

8. See Opinion of Advocate General Kokott, Joined Cases C-387/02, C-391/02, & C-403/02, Berlusconi (Oct. 14, 2004), at <http://curia.eu.int/jurisp/cgi-bin/form.pl?lang=en> (not yet translated into English) (last visited Apr. 20, 2005) [hereinafter Opinion Advocate General].

9. According to the CONSOLIDATED VERSION OF THE TREATY ESTABLISHING THE EUROPEAN COMMUNITY, art. 222(2), Dec. 24, 2002, 2002 O.J. (C 325) 33, 123 [hereinafter EC TREATY], it is “the duty of the Advocate General, acting with complete impartiality and independence, to make, in open court, reasoned submissions on cases which, in accordance with the Statute of the Court of Justice, require his involvement.” In about eighty percent of all cases, the ECJ follows the Advocate General's opinion. See, e.g., Paul Meller, *Monti Hits Snag in Merger Spat. Attempt Fails to Alter Tetra-Side1 Ruling*, INT'L. HERALD TRIB., May 26, 2004, at Finance 2, 2004 WLNR 5205532.

## I. THE ADVOCATE GENERAL'S OPINION

## A. Legal Context

According to prior Italian law, any person who committed accounting fraud was to be imprisoned for one to five years, and was to be fined two to twenty million lire.<sup>10</sup> This provision was amended in 2002 by a legislative decree.<sup>11</sup> First, the penalty for cases in which no potential harm to shareholders or creditors is shown was reduced to imprisonment for not more than one year and six months.<sup>12</sup> If the fraud was capable of causing harm to the company's shareholders or creditors, the perpetrator is to be imprisoned for six months to three years for non-listed companies, and one to four years for listed companies.<sup>13</sup> Second, shareholders or creditors of non-listed companies who wish for infractions to be tried under these stricter provisions must lodge a criminal complaint.<sup>14</sup> Third, because of the reduced penalty, the criminal provision where no potential harm to shareholders or creditors is shown is now a misdemeanor (*contravvenzione*) rather than a felony (*delitto*).<sup>15</sup> This has various consequences, such as reducing the statute of limitations from ten to three years. Finally, margins of tolerance have been introduced.<sup>16</sup> If a violation involves incorrect estimates below certain thresholds, criminal prosecution is not available.

These changes toward a more lenient criminal law for accounting fraud were based on the assertion that financial standards had been too onerous for non-listed companies. Instead of a "one-size-fits-all provision," a multi-tiered approach was claimed to be more appropriate. Yet the description of the new law would be incomplete if the personal background of the Italian Prime Minister Silvio Berlusconi were not taken into account. When Berlusconi was elected in 2001, a criminal trial was pending at the *Tribunale di Milano*, where he was personally charged with false accounting for his non-listed holding company Fininvest. Since the new rules are supposed to apply retroactively, the consequence of the 2002 amendment would be dismissal of the charges against Berlusconi. With respect to the *Berlusconi* case as well as two other cases, Italian courts have asked the ECJ to decide whether Italy's mitigation of accounting law is compatible with E.U. law.

The European law on this issue is based on the First, Fourth, and Seventh Corporate Law Directives. According to the First Directive, "Member States

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10. CODICE CIVILE [C.C.] art. 2621 (2000) (Italy) (repealed 2002). Two to twenty million lire is equivalent to 1,033 to 10,329.

11. Decreto Legislativo No. 61, Apr. 11, 2002, Gazz. Uff. No. 88, Apr. 15, 2002, at <http://gazzette.comune.jesi.an.it/2002/88/1.htm> (last visited Apr. 20, 2005), amending art. 11 of Law No. 366, Oct. 3, 2001, Gazz. Uff. No. 234, Oct. 8, 2001, at <http://gazzette.comune.jesi.an.it/2001/234/1.htm> (last visited Apr. 20, 2005).

12. C.C. art. 2621 (2002) (Italy).

13. *Id.* art. 2622.

14. *Id.*

15. *Id.* art. 2621.

16. *Id.* arts. 2621, 2622.

shall provide for appropriate penalties in case of . . . failure to disclose the balance sheet and profit and loss account.”<sup>17</sup> The Fourth Directive requires that “annual accounts shall give a true and fair view of the company’s assets, liabilities, financial position and profit or loss,” and that the “annual accounts . . . shall be published as laid down by the laws of each Member State in accordance with Article 3 of” the First Directive.<sup>18</sup> In contrast to U.S. law, all companies must therefore disclose their accounts, regardless of whether they are listed or not.<sup>19</sup> Finally, the Seventh Directive on consolidated accounts mirrors the provisions regarding the “true and fair view” requirement and appropriate sanctions of the First and Fourth Directives.<sup>20</sup>

### B. Overview of the Advocate General’s Opinion

The Advocate General Kokott opines that the amendment of Italian law is incompatible with the aforementioned European Corporate Law Directives.<sup>21</sup> She argues that publication of false accounts ought to be treated under E.U. law as a failure to publish accounts at all. Thus, according to the Advocate General, Member States must provide appropriate sanctions for the publication of false accounts. Although states have some discretion, penalties must be effective, proportionate, and dissuasive. This is not the case with respect to the more lenient new Italian law. Neither the margins of tolerance, nor the limitation rules, nor the condition that shareholders or creditors lodge a criminal complaint satisfy the requirements of E.U. law. Hence, the prior Italian law is still applicable. The principle that penalties must be lawful (*nulla poena sine lege*) does not exclude this result, because at the time of their conduct the defendants could not have had any expectation that their acts were not punishable.

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17. First Council Directive 68/151/EEC of 9 March 1968 on Coordination of Safeguards, art. 6, 1968 O.J. SPEC. ED. 41.

18. Fourth Council Directive 78/660/EEC of 25 July 1978 Based on Article 54(3)(g) of the Treaty on the Annual Accounts of Certain Types of Companies, arts. 2(3), 47(1), 1978 O.J. (L 222) 11.

19. For a comparative overview, see Gerard Hertig & Hideki Kanda, *Creditor Protection*, in *THE ANATOMY OF CORPORATE LAW* 71, 79–83 (Reinier Kraakman et al. eds., 2004). It should be noted that there are a number of exceptions for small- and medium-sized companies in the E.U. Directives, which considerably reduce the extent of disclosures they need to make. Most strikingly, Member States may waive the duty to have an audit conducted and to disclose a profit and loss account for the smallest companies. However, an abridged balance sheet must always be disclosed under the Fourth Council Directive, *supra* note 18, arts. 11, 12, 27, 44, 45(2), 47(2), 47(3), 51(2), and the Seventh Council Directive 83/349/EEC, art. 6, 1983 O.J. (L 193) 1.

20. Seventh Council Directive 83/349/EEC of 13 June 1983 Based on the Article 54(3)(g) of the Treaty on Consolidated Accounts, arts. 16(3), 38(6), 1983 O.J. (L 193) 1.

21. See Opinion Advocate General, *supra* note 8.

## II. ANALYSIS OF THE ADVOCATE GENERAL'S OPINION

### A. *Does False Accounting Equal Nondisclosure of Accounts?*

In the United States, the criminal provisions of securities law cover persons who do not make required disclosures or who make false or misleading statements.<sup>22</sup> In contrast, the First and Seventh European Directives only state that in cases of "failure to disclose," appropriate penalties or sanctions must be provided. As the charges against Berlusconi et al. concerned false accounting, it is therefore doubtful whether European law is relevant to these Italian cases.

Furthermore, the Italian government, in defending the Italian law, argued that false accounting was less harmful than nondisclosure of accounts, because in the former case everybody could scrutinize the existing (but false) accounts, whereas in the latter case there would be no information at all.<sup>23</sup> This line of argument is, however, rather specious. It disregards the fact that in the case of deliberate false accounting there is an element of fraud, and therefore, for instance, investors and creditors may see no reason to question the correctness of the accounts. Nondisclosure could even be seen as less harmful, because the market can theoretically identify and discount this lack of disclosure.<sup>24</sup> Parties dealing with the company or purchasing shares will know that no credible accounts have been publicized, which is why they are likely to request them directly from the company or demand a risk premium. In contrast, fraudulently distorted financial statements may create the impression of providing reliable and truthful information and will thus induce third parties to deal with the company or buy the issuer's shares. The argument made by defendants that users of financial statements could reexamine the company's accounts is unlikely to work in practice. Even if they had access to adequate information for doing so, they should not be required to reexamine financial information for mandatory accounting (and auditing) to have any benefit.

The Advocate General Kokott suggests that, according to the E.U. Directives, the publication of false accounts is equivalent to a failure to publish accounts at all.<sup>25</sup> According to her opinion, the wording does not exclude this interpretation, because "failure to disclose" could also be understood as failure to disclose the truth; the First, Fourth, and Seventh Directives have to be seen as a whole. The cross-references in these Directives make it clear that Member States are expected not only to ensure that accounts are pub-

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22. Securities Act of 1933 § 24, (codified as amended at 15 U.S.C. 77x (2000)); Securities Exchange Act of 1934 § 32, (codified as amended at 15 U.S.C.A. 78ff(a) (West Supp. 2004)); Sarbanes-Oxley Act of 2002 § 807(a), Pub. L. No. 107-204, 18 U.S.C.A. 1348 (West Supp. 2004).

23. Cf. Opinion Advocate General, *supra* note 8, ¶ 75.

24. This relates to the discussion of whether mandatory disclosure is necessary at all. For a concise overview, see, e.g., Gerard Hertig et al., *Issues and Investor Protection*, in *THE ANATOMY OF CORPORATE LAW*, *supra* note 19, at 193, 204-07.

25. Opinion Advocate General, *supra* note 8, ¶¶ 67-81.

lished, but also to provide a complete system of sanctions to ensure the publication of accurate accounts. This is also supported by the purpose of the Directives, because investors and creditors are not adequately protected if they cannot rely on the correctness of published accounts.<sup>26</sup>

However, the Advocate General's expansive interpretation of the Directives is not entirely convincing. The language and development of the Directives suggest that European law only requires sanctions for nondisclosure. As the First Directive was not designed to harmonize substantive accounting law, the wording of Article 6 ("failure to disclose") must be taken seriously. It cannot be read as "failure to disclose the truth" because the correctness of accounts cannot be ascertained without looking at national law. The Fourth and Seventh Directives on substantive accounting issues do not fill this gap either, because they leave many options for the Member States. It is therefore not possible, solely under European law, to determine whether false accounting has taken place. Finally, the Advocate General's attempt to equate the publication of false accounts with the failure to publish accounts at all by reference to the purpose of accounting is not compelling. Different sanctions for each situation may be reasonable. False disclosure is not the same as nondisclosure, because (1) the former concerns an act while the latter concerns an omission, (2) margins of tolerance are conceivable in the former case while in the latter case violations are easier to ascertain, and therefore (3) public registers will usually be sufficiently equipped to sanction violations in the latter case, while, with respect to substantive misstatements, private institutions, such as auditors and independent directors, will be necessary for enforcement.

Nonetheless, we agree with the outcome reached by the Advocate General, but argue that it should be based on the principle of effective remedies (*effet utile*) rather than an analogy of nondisclosure to false accounting.<sup>27</sup> The Advocate General has correctly put forward the additional argument that even if a provision of E.U. law does not provide a specific sanction, the Member States must ensure that violations are penalized under conditions that make the penalty effective, proportionate, and dissuasive.<sup>28</sup> This also applies to false accounting. Although a comprehensive substantive harmonization has not yet been achieved by the European Directives,<sup>29</sup> the substantive rules of the Fourth Directive must be supplemented by appropriate sanctions.

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26. From an economic perspective, it must be noted that misstatements in financial statements may seriously affect stock prices. See, e.g., Mason Gerety & Kenneth Lehn, *The Causes and Consequences of Accounting Fraud*, 18 *MANAGERIAL & DECISION ECON.* 587 (1997) (finding significant abnormal negative returns when the SEC announces charges for accounting fraud).

27. This principle is based on EC TREATY, *supra* note 9, art. 10 ("Member States shall take all appropriate measures, whether general or particular, to ensure fulfillment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community's tasks.").

28. Opinion Advocate General, *supra* note 8, ¶ 80. See also Case C-68/88, *Commission v. Hellenic Republic*, 1989 E.C.R. 2965, 2984-85; Case C-341/94, *Allain*, 1996 E.C.R. I-4631, 4657; Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd.* 2003 E.C.R. I-10155, ¶ 62.

29. However, beginning in 2005, all listed companies are required to apply International Financial



B. *Enforcement: Effective, Proportionate, and Dissuasive Penalties*

1. *Requirement of Dissuasive Penalties and the Deterrence Calculus*

The E.U. law requirement of “appropriate penalties” in cases of account misstatements raises the question of what such penalties should look like. In line with previous ECJ case law,<sup>30</sup> the Advocate General states that penalties must be “effective, proportionate, and dissuasive.”<sup>31</sup> The Advocate General considers a sanction to be effective where implementation of the sanction is neither practically impossible nor unduly hampered. This requirement is derived from the principle of *effet utile*.<sup>32</sup> A sanction is considered proportionate where it is (1) tailored to achieve its legitimate aims (by virtue of being effective and dissuasive) and (2) the least burdensome possible sanction that fulfils the criterion. Furthermore, the sanction must be in proportion to the goal pursued.<sup>33</sup>

The most complex of the three criteria is the requirement for the sanction to be dissuasive. The Advocate General explains that dissuasive penalties must have a deterrent effect against violations of the aims and rules of Community law; dissuasiveness is a function of the amount of the sanction and the probability of its enforcement.<sup>34</sup> Even though the Advocate General does not elaborate on the interplay of a sanction’s severity and enforcement probability, the opinion, by virtue of this argument, seems to point to the canonical law and economics calculus on deterrence through legal sanctions. In its most simplified version, this calculus posits that the expected cost of conviction should be set equal to the social cost of the offense, where expected costs to the perpetrator are the costs of the sanction multiplied by the probability of detection (and prosecution) of the crime. In such a case, an offender will only violate the law where his expected benefits exceed his expected costs, meaning that individual rational behavior will result in maximal social welfare.<sup>35</sup>

Let us briefly consider how such an analysis would come to bear on the issue of accounting fraud. Conceivably, this calculus could result in different results for failure to disclose accounts and fraudulent misstatements. The

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Reporting Standards (formerly known as International Accounting Standards) in their consolidated financial statements. See Council Regulation 1606/2002 of July 19, 2002, on the Application of International Accounting Standards, art. 4, 2002 O.J. (L 243) 1.

30. See *supra* note 28.

31. Opinion Advocate General, *supra* note 8, ¶¶ 86–92.

32. *Id.* ¶ 88.

33. *Id.* ¶ 90.

34. *Id.* ¶ 89.

35. The theory ultimately goes back to Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968). See also Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1233–34 (1985); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 242–50 (5th ed. 1998); A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 79–90 (3d ed. 2003). Expressed formally, a fine or penalty should be set so that  $C = p \cdot F$ , where  $C$  is the social cost resulting from the offense,  $p$  is the probability of detection of the perpetrator, and  $F$  is the fine or the monetary equivalent of a nonmonetary sanction such as jail time. The simple analysis here assumes risk neutrality. *Id.* at 79–83.

probability variable will likely approach one hundred percent in cases of failure to disclose. Reporting requirements for public companies aside, under the scheme of the E.U. Directives, financial statements must always be submitted to a public register, which is usually required to take action if disclosure duties are not observed.<sup>36</sup> By contrast, accounting fraud is often implemented with enough sophistication that it will frequently pass unnoticed, at least in the short run, especially when management succeeds in deceiving the auditor.

Furthermore, the benefits from nondisclosure will usually be relatively low.<sup>37</sup> Short-term benefits to directors from misstatements—who might see their position challenged by shareholders if the company's actual performance came to light, or who fear reputational losses resulting from impending bankruptcy—will usually be higher. But crucially for the deterrence calculus, social harm is likely to be significantly greater in cases of false disclosure than in cases of nondisclosure. Normally, potential users of financial benefits are not likely to draw any positive conclusions about the financial situation of the company from a failure to disclose, while in the case of fraudulent misstatements, the outward appearance of a healthy state of affairs creates the potential for widespread deception and relatively significant social harm.

Thus, the requirement for dissuasive penalties must mean something different for accounting fraud than for failure to disclose financial accounts. If

36. For example, in the United Kingdom, financial statements for private companies must be submitted to the Companies House headed by the registrar of companies within ten months after the balance sheet date. Companies Act, 1985, c. 6, § 244(1)(a) (U.K.). Failure to disclose may result in the imposition of penalties on the company ranging from £100 to £1,000, depending on the length of the delay. *Id.* § 242A. In addition, directors may be criminally liable. *Id.* § 242(2). In Austria, disclosure to the court in charge of the register must usually be made within nine months. § 277(1) HANDELSGESETZBUCH (2005) (Aus.). The court can impose penalties of up to 3,600, which however, can be done repeatedly until disclosure has been effected. § 283 HANDELSGESETZBUCH (2005) (Aus.). Similarly, in Germany, financial statements must be submitted to a court within twelve months. § 325(1) HANDELSGESETZBUCH [HGB] (2003) (F.R.G.). Failure to do so may result in penalties on directors between 2,500 and 25,000. *Id.* § 335a. German courts may only impose such penalties upon request (by any party). *Id.* § 335. Thus, it is still doubtful whether Germany conforms to E.U. law here. In Italy, failure to submit financial statements may result in penalties ranging from 206 to 2,065. C.C. art. 2630 (2002) (Italy).

37. To be sure, such benefits appear to exist. For example, in *Lutz GmbH*, Austrian companies that had failed to disclose their accounts argued that disclosure would allow competitors or others to make estimates about trade secrets from the accounting data. Case C-182/00, 2002 E.C.R. I-547. Trading partners might conceivably estimate profit margins, which would put the disclosing company at a disadvantage in price negotiations. Parties sought to obtain a preliminary ruling from the ECJ to declare that disclosure requirements imposed on small- and medium-sized companies contravened basic rights. The case was dismissed by the ECJ on procedural grounds. If there were no such benefits to at least some (closely held) companies, they would not have taken such pains to avoid disclosure by seeking a ruling from the ECJ and the Austrian Constitutional Court. In a recent joint case decided on Sept. 23, 2004, the ECJ ruled against a similar complaint on the merits. Joined Cases C-435/02 & C-103/03, *Axel Springer AG v. Zeitungsverlag Niederrhein GmbH*, at <http://curia.eu.int/jurisp/cgi-bin/form.pl?lang=en> (not yet available in English) (last visited Apr. 20, 2005). Springer, a large German media conglomerate, had asked a court to impose penalties on a small publisher and a radio station (and their managers) in order to induce them to disclose their financial statements. The defendants argued that duties to disclose accounts under E.U. law violated freedom of occupation, freedom of the press, and the equal treatment clause. The ECJ rejected those arguments.

the ECJ follows the Advocate General's opinion, E.U. law will therefore have to require Member States to provide for penalties that are sufficiently severe to deter accounting fraud in light of differences in detection probabilities and social harm. Even at present, these factors can help explain why E.U. Member States usually impose only modest fines for nondisclosure<sup>38</sup> but severe criminal penalties, including prison sentences, for accounting fraud.<sup>39</sup>

## 2. Enforcement Ex Officio

The ECJ has already addressed the issue of penalties for failure to disclose accounting documents in two related cases concerning implementation of the European Corporate Law Directives in the Federal Republic of Germany. In *Verband deutscher Daibatsu-Händler eV v. Daibatsu Deutschland GmbH*<sup>40</sup> and *Commission v. Germany*,<sup>41</sup> the issue was Germany's insufficient enforcement system. The E.U. law requiring disclosure of financial statements from publicly traded firms as well as from all business associations with limited liability<sup>42</sup> exceeded the previous requirements in many Member States. Thus it is not surprising that, in some Member States (such as Germany), mandated disclosure for small- and medium-sized companies has met with considerable resistance.<sup>43</sup> Germany, moreover, failed to implement an E.U. directive<sup>44</sup> extending accounting obligations to partnerships whose general partners were exclusively limited-liability business associations.<sup>45</sup>

The objective of the European Accounting Directives, generally, is "the protection of members [i.e., shareholders] and third parties."<sup>46</sup> Already in the two cases discussed above, the ECJ has taken this objective seriously when dealing with a provision of German law under which courts could only impose penalties on companies failing to disclose their accounts *upon request* of a member of the company, a creditor, or the works council (a representative body of employees).<sup>47</sup>

With respect to privately held companies, it is likely that no such party will choose to strain its relationship with the perpetrator company by asking a court to impose penalties on the firm. Moreover, no party may consider doing so to be worth the effort, because they may be granted access to financial

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38. For examples, see *supra* note 36.

39. For example, the penalties under the new Italian law are significantly stricter than penalties for failure to disclose even after the reform. See *supra* Part I.A; *supra* note 36.

40. Case C-97/96, 1997 E.C.R. I-6843.

41. Case C-191/95, 1998 E.C.R. I-5449. This case adds little to *Daibatsu*, but it is concerned with the Commission's ongoing attempts to induce the German government to comply with E.U. law.

42. *Supra* Part I.A.

43. See *Lutz GmbH* and the joint *Springer* case, *supra* note 37 (resulting from the struggle against disclosure requirements).

44. Council Directive 90/605/EEC of Nov. 8, 1990, 1990 O.J. (L 317) 60.

45. Case C-272/97, *Commission v. Germany*, 1999 E.C.R. I-2175 (Germany found in violation of Community law for not transposing Council Directive 90/605/EEC).

46. See Fourth Council Directive, *supra* note 18, Preamble.

47. See cases cited *supra* notes 40–41. § 335 HGB (2003) (F.R.G.).

data directly. However, in *Daibatsu*, where the German subsidiary of a Japanese carmaker had failed to disclose, the association of German car dealers trading in that brand was not able to induce the company, on which the members of the association were obviously strongly dependent, to disclose its financial statements to them.<sup>48</sup> The fact that the association had to ask courts to intervene bolsters both the theory that companies are likely to underproduce information and the case for mandatory disclosure.<sup>49</sup> In the preliminary ruling in the *Daibatsu* case, the ECJ pointed to the language in the preamble to the First Directive and concluded that “disclosure of annual accounts is primarily designed to provide information for third parties who do not know or cannot obtain sufficient knowledge of the company’s accounting and financial situation,” enabling *all interested parties* to inform themselves on these matters.<sup>50</sup> Thus, Member States may not restrict the imposition of such penalties to cases involving a request by parties such as creditors or members of the company concerned, as Germany had done in its previous legislation on penalties for failure to disclose.<sup>51</sup>

The new Italian provision on fraudulent accounting is ambiguous with respect to this aspect of the enforcement mechanism. The provision imposing stricter penalties where perpetrators intended to deceive shareholders or creditors in order to enrich themselves requires a request by a harmed shareholder or creditor for criminal prosecution.<sup>52</sup> While the ECJ’s language in *Daibatsu* was relatively cautious, referring only to the particular enforcement system (for failure to disclose) in place in Germany at that time, the Advocate General in *Berlusconi* sweepingly concludes that penalties requiring a request from a third party do not provide for adequate enforcement *per se*, as disclosure requirements are designed to protect *all* third parties.<sup>53</sup> Given that the list of parties entitled to make such a request is even more restrictive than it was in the German statute underlying the *Daibatsu* case, application of the previous ECJ case law to the Italian provision is elementary once the conclusion that E.U. law requires adequate penalties for accounting fraud has been drawn. According to the Advocate General, it follows that, should the Italian courts conclude that the general provision imposing weaker penalties<sup>54</sup> did not create sufficient deterrence, the provision imposing stronger penal-

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48. In *Springer*, *supra* note 37, it was apparently a competitor who requested access to financial statements that had not been disclosed, in violation of the German law as amended after *Daibatsu*.

49. See, e.g., Hertig et al., *supra* note 24, at 204–07 (summarizing the reasons for mandatory disclosure for public companies); *contra* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 286–314 (1991). The issue of mandatory disclosure for privately held companies (as required by E.U. directives) appears not yet to have drawn much attention in law and economics.

50. Case C-97/96, *Daibatsu*, 1997 E.C.R. at 6865.

51. *Id.*

52. C.C. art. 2622 (2002) (Italy).

53. Opinion Advocate General, *supra* note 8, ¶ 115.

54. C.C. art. 2621 (2002) (Italy).

ties but requiring a criminal complaint by a harmed party<sup>55</sup> cannot make up for this deficiency under E.U. law.<sup>56</sup>

The dangers of releasing false information to the public lie not only in individual harm, but also in a loss of confidence in financial reporting, which could result in increased caution by all potential investors, creditors, or trading partners relying on the financial statements of a company. While discouraging investment may be the consequence in public corporations, users of financial statements may refrain more generally from dealing with or demand higher risk premiums from those firms that cannot credibly ascertain that their own balance sheets are accurate. Enhanced accuracy of financial information is therefore likely to benefit markets on the whole, including providers of financial statements. Thus, the Advocate General's view that making criminal prosecution dependent on requests from individually harmed persons cannot create sufficient deterrence to maintain the benefits of financial disclosure is highly persuasive.

### 3. Zero Tolerance Policy in Accounting?

The amendment to Italian law introduced margins of tolerance under which false accounting statements could not result in criminal penalties where inaccuracies or omissions do not materially alter the representation of the economic and financial situation of the company.<sup>57</sup> The new law assumes that this is *never* the case when profits before taxes are not affected by more than five percent or net assets are not affected by more than one percent. Furthermore, criminal penalties are precluded where false statements or omissions are the consequence of estimates that, when viewed individually, do not deviate by more than ten percent from the correct valuation.<sup>58</sup>

The Advocate General takes a critical view of these provisions. Starting from the requirement of the Fourth Directive under which financial statements should show "a true and fair view of the company's assets, liabilities, financial position and profit or loss,"<sup>59</sup> the opinion concludes that sanctions are necessary where misstatements will potentially betray the reader's belief in the accuracy of the accounts, but not necessarily where they will not. Thus, a limitation of criminal penalties to cases where misstatements are material is not precluded *per se*. However, a misstatement of five percent may mean something different in each particular company, which is why the law needs to allow assessments depending on the circumstances of the particular case. Furthermore, specific margins of error such as the ones set out in the Italian statutes may foster the habit of misstatements just below the permissible threshold, which could undermine the reliability of financial statements in

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55. *Id.* art. 2622.

56. Opinion Advocate General, *supra* note 8, ¶ 117.

57. C.C. arts. 2621, 2622 (2002) (Italy). The margins of tolerance are identical in both articles.

58. *Id.*

59. Fourth Council Directive, *supra* note 18, art. 2(3).

general. Deliberate misstatements with the intention to deceive or to enrich oneself are particularly problematic for maintaining confidence in public markets, which suggests that there should be *no* tolerance thresholds for such misstatements.<sup>60</sup>

In practice, certain margins of tolerance are inherent to the process of accounting. Even where accounting standards mandate specific treatment of a business transaction, the necessity of estimates brings a degree of subjectivity into financial statements. Directors are naturally biased in their judgment, which is why they are more likely to use their discretion to shed a favorable light on the financial situation.<sup>61</sup> Even though discretion cannot be unlimited, the line between justifiable (even if not entirely accurate) accounting treatments and bold misstatements is not always clear. The degree of certainty achieved by an audit will, for example, be affected by the size of samples taken by the auditor. Furthermore, even auditors are not expected to induce firms to make financial statements perfectly accurate, but only to ensure that no “material” misstatements remain. Information is commonly considered material when it would have an impact on a decision by a user of financial statements.<sup>62</sup> The actual thresholds of tolerance are not always clear, and may vary across countries and client types.<sup>63</sup> Materiality is frequently measured in terms of the percentage effects on net income, total revenues, and total assets, where an effect of below five percent is usually considered immaterial and an effect of more than ten percent material, with a grey zone in between.<sup>64</sup>

Materiality concerns also affect the assessment of accounting judgments made by corporate directors and officers during the process of drawing up financial statements. As stated above, the Advocate General argues that national legislation that does not implement penalties where the effects of misstatements are immaterial is not inherently problematic. However, bright-line rules that do not allow the courts to consider the circumstances of the

60. Opinion Advocate General, *supra* note 8, ¶¶ 96–100.

61. Cf. Mahzarin R. Banaji et al., *How (Un)ethical Are You?* HARV. BUS. REV., Dec. 2003, at 56 (describing how business executives underestimate their own biases); Max H. Bazerman et al., *The Impossibility of Auditor Independence*, SLOAN MGMT. REV., Summer 1997, at 89 (describing how self-serving bias enters accounting judgment); Paul E. Fischer & Robert E. Verrecchia, *Reporting Bias*, 75 ACCT. REV. 229 (2000) (modeling the consequences of biased accounting judgments on managers' wealth).

62. This approach is taken, for example, by the U.S. Financial Accounting Standards Board in its Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* 7 (May 1980), at <http://www.fasb.org/pdf/con2.pdf> (last visited Apr. 20, 2005). See, e.g., Donald F. Arnold, Sr., et al., *The Association Between European Materiality Estimates and Client Integrity, National Culture, and Litigation*, 36 INT'L. J. ACCT. 459, 466–67 (2001); Eugene G. Chewning, Jr., & Julia L. Higgs, *What Does “Materiality” Really Mean?*, J. CORP. ACCT. & FIN., May/June 2002, at 61, 63 (both referring to professional pronouncements discussing materiality). *But cf.* SEC Regulation S-X, 17 C.F.R. § 210.1-02(o) (2004) (defining “material” as limiting “the information required to those matters about which an average prudent investor ought reasonably to be informed”).

63. Arnold, Sr., et al., *supra* note 62, at 467–72 (estimating materiality in various countries by empirical study).

64. See, e.g., Seong-Yeon Cho et al., *Measuring Stockholder Materiality*, 17 ACCT. HORIZONS, 63, 64 (Supp. 2003).

particular case violate Community law.<sup>65</sup> On this measure, the outcome is in line with the requirements of accounting practice. However, a zero tolerance policy is required when a misstatement is the result of an intention to deceive users of accounting documents or to enrich oneself. A similar policy toward materiality is taken in the United States. As the Advocate General herself points out,<sup>66</sup> the SEC is very skeptical about quantitative rules of thumb such as these, as it lists a number of qualitative circumstances under which even a quantitatively small effect can be material. For example, significant effects may result from misstatements covering up a change in earning trends or affecting a firm's compliance with regulatory requirements.<sup>67</sup>

### C. Nulla Poena Sine Lege for Berlusconi?

The principles of *nullum crimen sine lege* and *nulla poena sine lege* mean that there must be neither crime nor punishment without law. They follow directly from the rule of law principle,<sup>68</sup> and are part of most national legal systems,<sup>69</sup> as well as of E.U. law<sup>70</sup> and international treaties.<sup>71</sup> Additionally, according to some laws, if prior to a final judgment there is a change in the relevant law that is more favorable to the accused, this more recent and more lenient law must be applied. This exceptional retroactivity of criminal law is part of Italian law and the Rome Statute of the International Criminal Court ("Rome Statute"), among many others.<sup>72</sup>

With respect to the *Berlusconi* case, the Advocate General Kokott contends that neither of these principles was infringed. The acts alleged against the defendants were criminal offenses under national law at the time they were committed. At that time, the defendants could not have had any expectation that their conduct would later become unpunishable. The principle of the retroactive application of a more lenient law did not change this outcome either, because it would only have been justified if this law had been compatible with E.U. law.<sup>73</sup>

65. Opinion Advocate General, *supra* note 8, ¶ 105.

66. *Id.* ¶ 101.

67. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999) (codified at 17 C.F.R. pt. 211), available at <http://www.sec.gov/interp/account/sab99.htm> (last visited Apr. 20, 2005).

68. See JOSEPH RAZ, *THE AUTHORITY OF LAW* 213–14 (1979).

69. In the United States this principle can only indirectly be inferred from U.S. CONST. art. I, § 9. See also STANISLAW POMORSKI, *AMERICAN COMMON LAW AND THE PRINCIPLE NULLUM CRIMEN SINE LEGE* 25 (Elżbieta Chodakowska trans., 2d. ed. 1975); Heyward D. Armstrong, Comment, *Rogers v. Tennessee: An Assault on Legality and Due Process*, 81 N.C. L. REV. 317, 321–25 (2002).

70. See Opinion Advocate General, *supra* note 8, ¶ 141. See also TREATY ESTABLISHING A CONSTITUTION FOR EUROPE art. II-109(1), Dec. 16, 2004, 2004 O.J. (C 310) 1, 52 [hereinafter EUROPEAN CONSTITUTION].

71. See, e.g., Council of Europe, EUROPEAN CONVENTION FOR THE PROTECTION OF HUMAN RIGHTS AND FUNDAMENTAL FREEDOMS art. 7, Nov. 4, 1950, 213 U.N.T.S. 221; ROME STATUTE OF THE INTERNATIONAL CRIMINAL COURT arts. 22, 23, July 17, 1998, U.N. Doc. A/CONF.183/9, 37 I.L.M. 999 (1998) [hereinafter ROME STATUTE].

72. See CODICE PENALE art. 2(3) (2002) (Italy); ROME STATUTE art. 24(2).

73. Opinion Advocate General, *supra* note 8, ¶¶ 139–168.

In order to understand the Advocate General's reasoning, we must decide whether the amended Italian law or the former Italian law is applicable. First, application of the amended Italian law could be based on a *European* principle of retroactive application of the more lenient law. It is, however, not yet clear whether this principle is part of E.U. law.<sup>74</sup> Furthermore, the rationale for such a European principle would only be that the same rules required by European law for future crimes should also apply for crimes committed in the past. Hence, this rationale cannot be brought forward in the *Berlusconi* case, because Italy is required to restrengthen its criminal law on accounting fraud to respond to future crimes. The second problem is that, according to *Italian* law, the new law should also apply to old cases. This follows directly from the new Italian law, but could perhaps also be based on the Italian principle of the retroactive application of a more lenient law.<sup>75</sup> It is therefore decisive whether the principle *nulla poena sine lege* requires the European Union to accept this rule of Italian law. This could be the case, because, in general, European citizens can rely on their national laws and need not worry whether such law is a proper implementation of a European directive. However, in the present situation, defendants present no reliance interest worth protecting. As the alleged crimes were committed before the amendment of the Italian law, there is no reason for European law to be put aside. Consequently, the older and stricter Italian law should apply.

### III. IMPLICATIONS: TOWARD A STRONGER EUROPEAN INFLUENCE ON THE DEVELOPMENT OF CORPORATE LAW

#### A. "Weak" Supranational European Corporate Law?

Beyond the individual policies and interpretations at stake, the *Berlusconi* case can be seen as a remarkable move in the ongoing development of European corporate law, particularly in view of recent ECJ case law on the subject. The most important recent shift has come from a series of cases that have started to define Europe as a diversified market for corporate law, akin to the multitude of laws and standards in the United States.<sup>76</sup> In the future,

74. See *id.* ¶¶ 154–168. This principle is stated explicitly in the EUROPEAN CONSTITUTION art. II-109(1).

75. In contrast, the Opinion Advocate General discusses the Italian law as an alternative to a European rule on this issue. Opinion Advocate General, *supra* note 8 ¶¶ 166–167.

76. See Case C-212/97, *Centros Ltd. v. Erhvervs- og Selskabsstyrelsen*, 1999 E.C.R. I-1459 (holding that Danish authorities may not deny the registration of a branch office of a British Private Limited Company that had obviously been set up to do business in Denmark only); Case C-208/00, *Überseering BV v. Nordic Construction Company Baumanagement* (Nov. 5, 2002), at <http://curia.eu.int/jurisp/cgi-bin/form.pl?lang=en> (holding that German courts may not deny the legal personhood of a Dutch company that had set up its main office in Germany) (last visited Apr. 20, 2005); Case C-167/01, *Inspire Art*, 2003 E.C.R. I-10155 (finding that a Dutch law subjecting formally foreign companies to additional capital requirements was contradictory to E.U. law); Case C-9/02, *de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie* (Mar. 11, 2004), at <http://curia.eu.int/jurisp/cgi-bin/form.pl?lang=en> (finding taxation on unrealized gains of a natural person moving from France to Belgium in violation of E.U. law, which is expected to apply also to companies moving from one state to another).



actors on the corporate law stage will likely be able to choose their preferred national corporate law, irrespective of where the corporation is headquartered or does most of its business, whereas it will become harder for Member States to pursue their particular policies in view of regulatory competition.<sup>77</sup>

For the future development of European corporate law, the influence of the European “federal” level may be crucial. In some ways, the European Union can be compared to U.S. federal authorities as an actor in corporate governance issues. In a recent article, Professor Mark Roe persuasively argues that in the United States, Congress, the federal courts, and the SEC have a powerful influence on the development of state corporate law. This influence precludes actors in individual states, including Delaware (the state where most public companies are incorporated), from pursuing their own policies without inhibition, for federal control may be exercised by means of actual legislation or other direct intervention, as well as by the mere threat of federalization.<sup>78</sup> In view of the recent ECJ case law, Professor Roe points out that the development of European corporate law on the national level will thus depend on whether and in what direction the E.U. “federal” level pulls national laws.<sup>79</sup>

As to the present situation, it is safe to say that the influence of European institutions on corporate governance is weak compared to those in the U.S. context. ECJ cases on European corporate law have remained relatively rare, and the European Union still lacks a transnational capital markets enforcement authority such as the SEC, let alone a transnational stock exchange comparable to the New York Stock Exchange (“NYSE”), which can influence corporate governance in listed companies.<sup>80</sup> There is a considerable amount of “derived” E.U. corporate law in the form of directives, but these are often seen as ineffectual.<sup>81</sup> Some commentators have argued that European directives have avoided dealing with issues that are really important for corporate governance, such as the structure of corporate decisionmaking bodies<sup>82</sup> or

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(last visited Apr. 20, 2005). Furthermore, regulatory competition will be fostered by the forthcoming cross-border mergers Council Directive. See Mathias M. Siems, *The European Directive on Cross-Border Mergers: An International Model?*, 11 COLUM. J. EUR. L. (forthcoming 2005).

77. For more on the impact of these cases, see Mathias Siems, *Convergence, Competition, Centros and Conflicts of Law: European Company Law in the 21st Century*, 27 EUR. L. REV. 47 (2002); Jens C. Dammann, *Freedom of Choice in European Corporate Law*, 29 YALE J. INT'L. L. 477 (2004); Tobias H. Troeger, *Choice of Jurisdiction in European Corporate Law: Perspectives of European Corporate Governance*, at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=568782](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=568782) (last visited Apr. 20, 2005).

78. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

79. *Id.* at 643–44.

80. However, a wave of mergers among European stock exchanges has occurred during the past few years. Euronext was created in 2000 when the Paris, Brussels, and Amsterdam Exchanges merged. See <http://www.euronext.com>. Both Euronext and the Deutsche Börse, which runs the Frankfurt Stock Exchange, are attempting to take over the London Stock Exchange. Silvia Ascarelli, *Euronext Makes LSE Pitch*, WALL ST. J., Feb. 10, 2005, at C18.

81. See, e.g., Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 454 (2001) (“[E]fforts at harmonization have generally borne little fruit.”).

82. A directive was planned but never implemented because of disagreement between different Member States. See Amended Proposal for a Fifth Directive Founded on Article 54 (3)(g) of the EEC Treaty

fiduciary duties.<sup>83</sup> Where the directives have dealt with vital issues, some Member States have been able to circumvent them by applying narrow constructions that have never been challenged before the ECJ, such as in the cases of the directives on mergers and spin-offs,<sup>84</sup> or the Second Directive's requirements for raising and maintaining capital.<sup>85</sup> The accounting requirements of the Fourth and Seventh Directives include an exceedingly large number of elective provisions that allow Member States either to decide the issue on the basis of their own judgment or to pass the question on to individual companies.<sup>86</sup>

*B. Judicial Activism and Future Legislation:  
The Path Toward Increased Supranational Influence?*

The Advocate General's opinion discussed in this note might be seen as one step—complementary to the ECJ's opening up of E.U. corporate law for regulatory competition—in tightening the boundaries set by E.U. law within which national actors may operate.

However, it is unclear whether the specific regulatory path proposed by the Advocate General would prove optimal. The doctrinal argument for the newly created duty of Member States to deter accounting fraud adequately should preferably not rest on an analogy to the duty to deter nondisclosure of financial statements, but on the principle of *effet utile* alone.<sup>87</sup> This principle could also enhance the effectiveness of the European Corporate Law Directives in general. Whereas the ECJ has not often had the opportunity to restrict Member States' scope of discretion in the interpretation of Community corporate law by extensively interpreting directives or restraining even the most blatant circumventions, *effet utile* could be taken as a basis to ensure that the policies embodied in the Corporate Law Directives are taken seriously by Member States' legislators and courts. Conceivably, such an approach could result in a strengthening of Community-derived corporate law in the long run. The general principle of *effet utile* has great potential, as Member

Concerning the Structure of Public Limited Companies and the Powers and Obligations of their Organs, 1983 O.J. (C 240) 2.

83. E.g., Harald Halbhuber, *National Doctrinal Structures and European Company Law*, 38 COMMON MKT. L. REV. 1385, 1406 (2001).

84. Third Council Directive 78/855/EEC of 9 October 1978, 1978 O.J. (L 295) 36; Sixth Council Directive 82/891/EEC of 17 December 1982, 1982 O.J. (L 378) 47. See Halbhuber, *supra* note 83, at 1407 n.111 (explaining that equivalent transactions are effected through different means in the United Kingdom, where the provisions of the directives are not taken to apply).

85. Second Council Directive 77/91/EEC of 13 December 1976 on Coordination of Safeguards, 1977 O.J. (L 26) 1. See Halbhuber, *supra* note 83, at 1406 n.109 (noting that, whereas German case law has developed draconian sanctions for circumvention of the rules for contributions in kind, no such sanctions exist in the United Kingdom, France, or Belgium).

86. The Fourth Directive, for example, includes more than 40 elective provisions left open to the Member States and 35 options left to individual companies. RICHARD M. BUXBAUM & KLAUS J. HOPT, *LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE*, 4 INTEGRATION THROUGH LAW 235 (Mauro Cappelletti et al. eds., 1988).

87. *Supra* Part II.B.

States are required to follow ECJ opinions, and, over time, the requirements of E.U. law will be specified in more detail by the court in future cases.

One example where the effectiveness of European harmonization is somewhat in doubt is insider trading. Although a directive requiring Member States to prohibit insider trading was issued in 1989,<sup>88</sup> there has been comparatively little success in enforcement.<sup>89</sup> However, current E.U. insider trading law requires sanctions imposed by Member States to be “effective, proportionate, and dissuasive.”<sup>90</sup> A strong stance by the ECJ on the effectiveness of sanctions might, in the years to come, imply that Member States will be required to strengthen their enforcement systems or even impose more severe penalties.

Such an activist judicial approach is not without problems, as it may generate further issues that courts will be called upon to resolve. The *Berlusconi* case’s examination of the meaning of “dissuasive penalties” is illustrative. As discussed above,<sup>91</sup> it is likely that this term will mean something different—i.e., greater penalties—in cases of accounting fraud than in cases of mere failure to disclose.

In any case, the strong stance taken by the Advocate General is in line with the policy pursued by the E.U. Commission to promote more Community involvement by means of legislation in both corporate governance and financial reporting. With respect to accounting requirements, the strengthening of the European level of regulation seems to be coming, in part, from legislation. Perhaps most importantly, an E.U. regulation adopted in 2002 requires public companies to use International Financial Reporting Standards (“IFRS”) (formerly known as International Accounting Standards (“IAS”)) for their consolidated statements beginning in 2005.<sup>92</sup> The large number of elective provisions in the Accounting Directives (most of which are related to substantive issues of accounting) effectively allowed Member States to maintain their accounting traditions, and failed to provide uniform, comparable financial statements.<sup>93</sup> Pressure from capital markets to introduce a

88. Council Directive 89/592/EEC of 13 November 1989 Coordinating Regulations on Insider Dealing, 1998 O.J. (L 334) 30. According to Article 14, this directive had to be implemented by June 1, 1992. It has now been repealed by Council Directive 2003/6/EC of 28 January 2003 on Insider Dealing and Market Manipulation, 2003 O.J. (L 96) 16.

89. See, e.g., EILÍS FERRAN, BUILDING AN EU SECURITIES MARKET 33 (2004) (reporting “only nineteen convictions for insider dealing were achieved in Britain, Germany, France, Switzerland and Italy in the five years before 2002, contrasting sharply with the forty-six successful prosecutions achieved in the same period by a single district court in Manhattan.”); Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 80–81 (2002) (reporting the total absence of any cases of enforcement in three E.U. Member States).

90. Council Directive 2003/6/EC, *supra* note 88, art. 14(1).

91. *Supra* Part II.B.1.

92. Council Regulation 1606/2002, *supra* note 29.

93. E.g., Werner F. Ebke, *Accounting, Auditing and Global Capital Markets*, in CORPORATIONS, CAPITAL MARKETS AND THE BUSINESS IN THE LAW: LIBER AMICORUM RICHARD M. BUXBAUM 113, 119 (Theodor Baums et al. eds., 2000). See also Axel Haller, *International Accounting Harmonization. American Hegemony or Mutual Recognition with Benchmarks? Comments and Additional Notes from a German Perspective*, 4 EUR. ACCT. REV. 235, 237 (1995) (“The new accounting rules were interpreted in the light of the existing

uniform set of accounting standards prompted the Commission to support the efforts of the International Accounting Standards Committee and then to implement IAS for the consolidated accounts of European publicly traded firms.<sup>94</sup> Furthermore, the Commission has recently proposed a new auditor directive that is to include specific provisions on auditor independence, requirements for audit committees, and rules for the auditor appointment and dismissal processes.<sup>95</sup> Following a report on corporate governance by the High Level Group of Company Law Experts,<sup>96</sup> it also issued an action plan that, among other things, aims at strengthening shareholder rights and improving board composition, foremost with respect to independent directors and audit committees.<sup>97</sup> However, with respect to accounting enforcement and especially account fraud, the increased credibility may be enhanced by judicial activity. The opinion discussed in this Note and the ECJ ruling that is expected to follow may become important steps along the way.

This growth of E.U. accounting and corporate law can be seen as a reaction to developments in U.S. law. With the U.S. Congress “federalizing” issues of corporate governance through the Sarbanes-Oxley Act of 2002 and generally trying to strengthen the financial reporting environment, for example by extending auditor independence requirements,<sup>98</sup> it has become a priority for the Commission and European policymakers to follow suit. For example, there has been a clear influence of U.S. law on the Commission’s recommendation on auditor independence<sup>99</sup> and on a recent German act implementing, among other things, amendments to auditor independence requirements.<sup>100</sup> This is due in part to the many important European companies that are cross-listed on the NYSE.

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German accounting model . . .”); Sabine D. Selbach, *The Harmonization of Corporate Taxation & Accounting Standards in the European Community and their Interrelationship*, 18 CONN. J. INT’L L. 523, 550 (2003) (“These options reflect the different attitudes towards accounting and financial reporting in the Member States.”); Hilda Theunisse, *Financial Reporting in EC Countries. Theoretical Versus Practical Harmonization: Two Case Studies*, 3 EUR. ACCT. REV. 143 (1994) (finding significant differences between accounting in Belgium, France and Germany).

94. Cf. Council Regulation 1606/2002, *supra* note 29, Preamble, ¶¶ 4–18.

95. *Commission Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC*, COM(2004)177 final (Mar. 16, 2004).

96. Jaap Winter et al., Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Nov. 4, 2002, at [http://europa.eu.int/comm/internal\\_market/en/company/company/modern/consult/report\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf) (last visited Apr. 20, 2005).

97. *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*, at 13, 15, COM(2003)284 final (May 21, 2003).

98. Sarbanes-Oxley Act of 2002, tit. II, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. 78a).

99. Commission Recommendation of 16 May 2002, Statutory Auditors’ Independence in the EU: A Set of Fundamental Principles, COM(2002)1873, 2002 O.J. (L 191) 22; see also *Commission Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC*, COM(2004)177 final (Mar. 16, 2004).

100. Gesetz zur Einführung internationaler Rechnungslegungsstandards und zur Sicherung der Qualität der Abschlussprüfung (Bilanzrechtsreformgesetz), v. 9.12.2004 (BGBl I S.3166).

In the United States, regulating the accounting practices of publicly traded firms has long been a prerogative of institutions at the federal level, most of all the SEC, which sets forth requirements for annual financial disclosure in Regulation S-X.<sup>101</sup> Enforcement of financial accounting standards and prevention of fraud is thus also an issue of SEC activity. With Sarbanes-Oxley, the U.S. Congress tried to deter fraud by implementing harsher penalties.<sup>102</sup>

In contrast, in spite of E.U. directives on accounting, so far accounting fraud in Europe has been left completely to the national legislatures and enforcement bodies. The Advocate General's opinion and the ECJ's expected ruling represent initial moves toward a federal regime more like the one in the United States. If the ECJ is serious about the "dissuasive penalties" requirement, at least some aspects of enforcement must be taken out of the hands of national actors. If more serious penalties result in increased deterrence of accounting fraud, this shift is likely to be beneficial.

The highly politicized *Berlusconi* case shows how national actors can be subject to conflicts of interest resulting from peculiar political circumstances. On a more general level, national legislators may sometimes be targets for local pressure groups in corporate law.<sup>103</sup> Even though the European supranational level is probably an equally good breeding ground for lobbyists, the ECJ's independent position appears to provide an effective balancing force at least when lobbyists prevail upon the national level, as in this case. We therefore agree with the strong policy statement implied in the Advocate General's opinion. In conjunction with the introduction of International Financial Reporting Standards for consolidated accounts of listed companies beginning in 2005, Europe seems to be on the right track toward a financial accounting system that will be taken seriously by investors across national borders.

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Mathias M. Siems\*\*

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101. 17 C.F.R. §§ 210, 211 (2004).

102. Sarbanes-Oxley Act of 2002, tits. VIII, IX, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in 18 U.S.C. §§ 1341, 1343, 1348–1350).

103. Local pressure might explain German resistance to disclosure requirements for small companies, as evidenced by Case C-97/96, *Daibatsu*, 1997 E.C.R. I-6843, by Case C-191/95, *Commission v. Germany*, 1998 E.C.R. I-5449, and by Case C-272/97, *Commission v. Germany*, 1999 E.C.R. I-2175.

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