ESG: SUSTAINABLE CORPORATE GOVERNANCE AND NEW DUE DILIGENCE DUTIES IN EUROPE

— THOUGHT LEADERSHIP
The European Union is currently consulting on sustainable corporate governance in the context of the European Green Deal. In this extract from a recent Clifford Chance webinar our experts explore the scope of the proposed legislation, including new requirements on mandatory human rights and environmental due diligence, and its impact on directors and their duty of care. We will also discuss how to influence the consultation process and how best to prepare for the next stage.

Corporate governance and the European Green Deal
As part of the European Green Deal, the European Commission has introduced a “sustainable corporate governance initiative” to ensure that “environmental and social interests are fully embedded into business strategies.” The need for corporates to focus on long-term sustainable value creation, rather than short-term financial value, is at the core of the Consultation.

The Commission’s work so far on the initiative has centred around two proposals:

• Clarify directors’ duty of care in Member State company law to reduce the short-term pressure on company directors and to promote the integration of sustainability into corporate decision-making.
• Require companies to carry out mandatory human rights and environmental due diligence (mHREDD) in respect of their own operations and their supply chains.

To shed more light on these two issues and any potential need for regulation, the Commission is currently conducting a public consultation with a deadline of February 2021. The Consultation also examines other aspects of sustainable corporate governance, including board composition, share buybacks and board remuneration.

Gail Orton, Head of EU Public Policy at Clifford Chance, who splits her time between Paris and Brussels, says the formal legislative process has not yet begun and explains: “It will only begin once the European Commission tables a formal proposal for a new piece of legislation. But that does not mean nothing is happening.” The European Parliament’s Legal Affairs Committee is working on a report that will outline the elements Parliament would like to see the Commission include in its proposal for new legislation. The Committee’s report is due to be adopted in plenary in March 2021. Orton adds: “All this work will feed into the European Commission’s formal proposal for legislation which will kick off the legislative process.”

The legislative process
After the Consultation closes, the European Commission will review the submissions it has received, as well as the report of the European Parliament, consider the various arguments and then begin drafting a proposal for legislation, or more likely tweak the draft it has already been working on. Once the proposal is finalised within the Commission, it is then passed to the co-legislators – the European Parliament and Council of the EU – for adoption.

According to the European Commission work programme, we can expect a proposal for legislation on sustainable corporate governance and an impact assessment to be published in the second quarter of 2021. This will be based on Article 50 of the Treaty on the Functioning of the EU (TFEU) (and possibly also Article 114 TFEU).

Article 50 TFEU requires that the instrument be a directive.
What should businesses do now?

The Commission’s proposal would lead to wide-ranging legal reforms placing new obligations on businesses that will have significant practical repercussions for them. The details remain uncertain and are likely to evolve as they pass through the formal legislative process, but there is broad-based support for them in principle, and there seems little doubt that new legislation is definitely on the horizon.

“A significant number of businesses have spoken out publicly in favour of the proposals in principle, but the devil is likely to be in the detail, and it is vital that business plays close attention to the possible ramifications of the new laws as they take shape,” says Rae Lindsay, London-based Co-head of Clifford Chance’s Public International Law and Business and Human Rights practices.

“Now is the time to consider what contributions can be made to try to influence the crafting of the new requirements to make them both meaningful and effective in commercially viable ways,” she says. Since the stated benefits for business include increased legal certainty, a level playing field, and harmonisation of standards for responsible and sustainable business, the details of the proposals need to be examined carefully to ensure that these objectives can be delivered.

Although the ultimate adoption of legislation may be some way off, it makes sense for business to contribute its views at the earliest possible stage, as the options to influence the legal framing of the issues will become more limited as time goes on. “As there is an open consultation, anyone interested in influencing the direction of policy in this area should seek to put in a submission. They can do this directly or by working with their trade associations, or both,” says Orton.

It is clear that the proposals have engaged the enthusiastic interest of civil society, and intense efforts are being made to lobby for very expansive requirements and for increased accountability. Indeed, the European Parliament’s proposals include the possibility of extending existing EU Member State jurisdiction for human rights and environmental harms overseas. Facilitating access to remedy for affected persons against transnational business for adverse impacts on human rights and the environment – particularly when these occur in states outside the EU – has been a core focus of these organisations for many years and supported by some policymakers.
“Businesses will want to consider whether there is a need for them to play an active role to seek to counterbalance positions that might be regarded as disproportionately burdensome, potentially ineffective and even counterproductive when viewed against the stated policy objectives of the measures,” Lindsay adds.

Even if individual businesses do not have the appetite or resources to participate in the consultation stage of the Commission’s work, it will be important to understand and monitor the likely implications of legislation as it develops, so that preparations for compliance may be made well in advance, as the necessary risk management frameworks and processes cannot be put in place overnight.

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<th>We asked our clients the following question:</th>
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<td>Will you participate in the European Commission Consultation?</td>
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<td>Yes, through a trade association</td>
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<td>Yes, in process of drafting submission</td>
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**Duty of care**

All Member States currently have legal frameworks in place which provide that a company director is required to act in the interest of the company (i.e. directors’ duty of care). The scope of this duty of care, however, is not always clearly defined. In the view of the European Commission, this lack of clarity leads to short-termism and a narrow interpretation of the duty of care as requiring a focus predominantly on shareholders’ short-term financial interests.

“To avoid this narrow focus on financial interests, the Commission specifically asks whether considerations regarding sustainability should be integrated into the company’s strategy, decisions and oversight. If this was included, the directors’ duty of care would be expanded accordingly, which could also result in an additional liability of directors,” says Düsseldorf-based Partner, Thomas Voland, who is a member of the Human Rights Risk team. In the move from short-term focus on shareholder value to long-term sustainable value creation, the Consultation attributes a key role to the interests of companies’ stakeholders who “may also contribute to the long-term success, resilience and viability of the company.”

The Commission’s objective is to clarify existing directors’ duties under Member State company law. Such duties will typically apply to companies incorporated under the relevant national law. The Commission has not indicated that it will seek to expand the application of directors’ duties to non-Member State-incorporated companies. However, it is likely that subsidiaries incorporated under the laws of a Member State of parent companies from non-EU countries would be included within the scope of any relevant measures as well. “Hence, the scope of the envisaged provisions on directors’ duties seems narrower than the mandatory due diligence requirements which will presumably also apply to non-EU companies with noteworthy business activities in the single market,” Voland adds.

**Companies’ stakeholders – who are they?**

In the Consultation document, stakeholders are understood in a very broad sense. For example, “the environment” is considered to be a stakeholder. The questions raised by the Commission suggest that the inclusion of stakeholders’ interests in the directors’ duty of care shall serve to shift the focus...
away from the pure short-term financial interests of shareholders.

To achieve this objective, directors may become obliged, in particular, to: (1) identify the company’s stakeholders and their interests; and (2) manage the risks for the company in relation to stakeholders and their interests, including in the long run. Moreover, directors may also become required to take into account the possible risks and adverse impacts on stakeholders. This would be a significant change of perspective because, then, third parties’ interests would come into focus and not only the interests of the company itself.

“This may result in binding procedural requirements to ensure that possible risks and adverse impacts on stakeholders, i.e. human rights, social, health and environmental impacts, are identified, prevented and addressed. And ultimately, directors might be held liable if they do not sufficiently implement such requirements,” says Voland.

**Is it really new?**

Generally, directors already take into account the impact of business activities on certain stakeholders, such as their employees, customers and society. However, the focus is primarily on the interests and wellbeing of the company itself. In other words, the directors would first of all ask themselves whether, for example, a negative impact of a business decision on the environment would also be negative for the company. This could be the case, for example, in relation to reputational risks. Therefore directors’ considerations would invariably have centred around the impact on the company.

“Some of the Commission’s questions suggest that this should change and that directors may become obliged to promote the integration of sustainability into corporate decision-making. This could mean that directors in the future will always have to take into account certain stakeholder interests, such as environmental issues, and that these interests may even prevail in the case of conflicts with commercial interests of the company. It needs to be seen whether stakeholders shall be entitled to challenge board decisions even if they are in the best interest of the company itself but if they do not focus sufficiently on the interests of certain stakeholders,” says Voland.

**Enforcement mechanisms**

According to the European Commission, enforcement of directors’ duty of care across the Member States currently is largely limited to possible interventions by the supervisory board (where such a separate board exists) and the general meeting of shareholders. The Consultation raises the question whether stakeholders (in particular employees, but also NGOs representing, for example, the environment and people affected by the operations of the company) should be given a role in the enforcement of directors’ duty of care.

We certainly know of situations where stakeholders who are protected by specific mandatory legislation, such as consumer protection laws, are entitled to initiate legal actions against a company. “However, the result of the Consultation and a future legislative act might go beyond such challenges in the event of a direct impact. In other words, stakeholders might become entitled to initiate legal proceedings even if they are not directly concerned in their own, individual rights and even if the company itself is not negatively affected,” explains Voland.

The introduction of such a possibility to enforce any stakeholder interests could steer – and at the same time reduce – the discretion of directors and boards to define the “best interest of the company”. Furthermore, the question arises as to whether directors will be faced with new, significant liability risks if their duty of care were to be explicitly extended to all stakeholders, namely to the impact on stakeholders independent of any direct negative effect for the company. This would be a significant change to the legal framework.
Mandatory human rights and environmental due diligence

The European Parliament’s report proposes that the mandatory due diligence requirements should apply to all businesses governed by the laws of a Member State or established within the EU and also to non-EU businesses operating in the EU market – i.e. organisations that supply goods or services into Europe. So, for example, British, American and Asian companies doing business in the EU might well be caught, at least to the extent of their European business.

“Certainly, if one objective of the new legislation is to create a level playing field for EU businesses, then it would make sense to extend the same due diligence duty to all entities, wherever incorporated, that do business in the EU single market. In terms of global trade, the proposals are also more likely to be welcomed by EU businesses if steps are taken to try to ensure that the new requirements minimise any potential competitive disadvantages that could arise vis-à-vis other international businesses, even if operating wholly outside the EU,” says Rae Lindsay. And so the Consultation asks what measures could be implemented to ensure this level playing field between EU and third-country companies.

It remains to be seen how this could be achieved. While the EU has the ability to impose requirements on business that touches the single market, there are limited options available to it regarding entirely non-EU business only conducted outside the EU – these are necessarily constrained by both international law and the practical limitations on enforcing measures against such entities. However, it certainly seems within the EU’s ambitions to spread the perceived positive benefits of these measures as widely as possible – and it is undoubtedly the case that these measures will be influential beyond the EU, regardless of the scope of the direct compliance obligations proposed.

Which businesses will it apply to?

The European Parliament’s proposal contemplates a due diligence requirement that would apply to all businesses that do business in the EU single market, regardless of size or sector. “The Commission is understood to also prefer that all sectors and sizes of organisations be covered, given the objectives of harmonisation, level playing field and certainty – as well as maximising protections for human rights and the environment,” says Lindsay. The Consultation does seek feedback on these issues; for example, should small and medium enterprises be subject to less onerous expectations to take account of their more limited resources? And one of the questions on the scope of application of the proposed duty posits the possibility that the due diligence requirement could apply only to some sectors. “Although some sectors pose higher risks of involvement in negative human rights and environmental impacts, it seems more likely to me that the Commission will ultimately prefer a generally applicable duty of due diligence with the differing risk profiles of various sectors being addressed in some other way. For example, the Consultation advances an option that the legal duty, once defined, be accompanied by sector-specific guidance,” she adds.
To what extent will these proposals affect business behaviour outside the EU?

There is no doubt that the proposed due diligence requirement will have expansive knock-on effects even beyond the territorial borders of EU Member States. For example, for those businesses required to comply, the duty is likely to affect entire groups – so that parent companies’ due diligence duties will apply in relation to their own operations and their subsidiaries, wherever they operate. And due diligence will also be required through supply chains (the definition of which we will touch on later) – but these can extend globally, offering a vast web of indirect effects as a result of EU businesses cascading expectations through their supply chains in order to meet their own due diligence duty. “In practice, this is likely to have a domino effect on practices with respect to human rights and the environment within those supply chains. In addition, many multinational businesses may opt to apply a ‘highest common denominator’ approach within their global risk management frameworks, applying due diligence consistent with the EU imposed duty even in parts of their business that are not legally subject to its compliance requirements,” explains Lindsay. This reflects the approach we have seen in other areas of responsible business conduct such as anti-bribery and corruption. There is therefore considerable potential for the new law to have extensive extraterritorial effect beyond EU borders.

Due diligence duty – human rights and the environment

Much remains uncertain about the scope and nature of the proposed duty – a variety of options is encapsulated in the consultation questionnaire and the Commission provides the opportunity for respondents to expand on these.

A working definition of the due diligence is provided, stating it to be a: “legal requirement for companies to establish and implement adequate processes with a view to prevent, mitigate and account for human rights (including labour rights and working conditions), health and environmental impacts, including relating to climate change, both in the company’s own operations and in the company’s supply chain.”

“There is quite a lot to unpack in this,” says Lindsay. “In particular – a key feature for business – what will be considered as ‘adequate processes’?” The Consultation document notes that all approaches being considered are meant to ‘rely on’ existing due diligence standards, such as the UN Guiding Principles on Business and Human Rights and the OECD Guidance on due diligence that accompanies the OECD Guidelines for Multinational Enterprises. This might provide elements of clarity on what are likely to be the features of ‘adequate processes,’ but it is important to recall that both of those sets of so-called ‘soft law’ standards impose expectations on business that go above and beyond existing legal duties. It has always been made clear that while elements of the due diligence reflected in these standards might ultimately be elevated into legal requirements by states or, in this case, the EU, they do not provide a template that can be lifted off the shelf and ‘plugged into’ law.

The phrase ‘due diligence’ in these contexts therefore requires careful transposition into legal requirements that will carry implications when they are not met – to properly reflect the ways in which it is intended by the lawmaker to meet the underlying policy objectives. There are bound to be questions about whether ‘adequacy’ will require an exact correlation with the frameworks in those standards – which not only discuss the elements of due diligence processes, but also expectations on how businesses should respond to identified risks and – in appropriate cases – provide remedy to affected persons. “An obvious question is – do those soft law instruments provide the framework for elements of the processes only, or also elements of the standards of behaviour to which businesses are to be held? How the question is answered through legal drafting has clear and potentially far-reaching ramifications for business,” Lindsay says.
What degree of flexibility do businesses have?

The definition currently offered does confirm that due diligence is inherently risk-based, proportionate and context specific, implying that there will necessarily be a considerable degree of discretion left to individual businesses and variation depending on circumstances. It may be challenging to define the duty in a way that promotes this individualised risk-based approach while creating certainty for business from day one that its approach meets the expectations of ‘adequacy.’ Consistently with the soft law standards we have mentioned, the processes are to be established and implemented with a view to prevent, account for and mitigate human rights, health and environmental impacts, including relating to climate change.

‘With a view to prevent, account for and mitigate’ implies that the processes might be capable of assessment on the basis of whether, on an objective basis, they appear reasonably capable of meeting these objectives without necessarily guaranteeing that impacts cannot, and will not, occur.

What about supply chains?

The consultation text clarifies that ‘supply chain’ is understood in the broad sense of a company’s business relationships and includes subsidiaries as well as suppliers and subcontractors. It also states that companies will be expected to make reasonable efforts to identify suppliers and subcontractors. It might be expected that supply chain is certainly not intended to be confined to first-tier suppliers and the reference to ‘business relationships’ broadly implies that it could include the entire value chain. The consultation definition indicates that the ‘extent of implementing actions’ under the due diligence duty should depend on risks of adverse impacts the company is possibly causing, contributing to or should foresee.

“It seems to me that it is in the context of supply chains in particular that careful thought will be required in the drafting of the extent of the proposed duty and, in particular, the consequences of failures to meet the duty,” says Lindsay. Some concerns have been raised that unduly onerous duties, inflexible standards with regard to implementation and potential liabilities could create perverse incentives in supply chain contexts, discouraging forms of responsible supply chain risk management that have been developing in practice.

The different approaches contemplated vary in the extent to which the EU would adopt a principles-based approach to defining the due diligence duty or would define minimum process requirements and then define the human rights and environmental matters in relation to which due diligence would be applied. All options contemplate supplementation with further rules or guidance to address sectoral differences. There is also the possibility that the EU could limit the new due diligence duty to certain sectors only, or focus only on certain thematic areas to which the due diligence duty would apply – thus not extending, for example, to all forms of human rights, but defined categories such as slavery or child labour (which to date have been the particular focus of other legislative initiatives for specific reasons of policy).

“Although the proposals for the due diligence duty tend to amalgamate human rights due diligence with environmental due diligence (including with respect to climate change), certain of the options would at least provide added clarity around what are considered to be the applicable human rights and environmental risks and standards to which due diligence might apply – thus not extending, for example, to all forms of human rights, but defined categories such as slavery or child labour (which to date have been the particular focus of other legislative initiatives for specific reasons of policy).
Directors’ remuneration

In recent years there have been many developments regarding directors’ remuneration and the current Consultation document fits into a trend. Developments such as shares as part of fixed pay, retention periods, and requirements for directors to build up a minimum shareholding, have primarily aligned directors’ interests with those of a specific group of stakeholders: the shareholders.

“However, other stakeholders’ interests have become more important,” says Amsterdam-based Floris van de Bult, Clifford Chance’s Co-head of the Global Employment practice. “For example, following the implementation of the revised Shareholder Rights Directive (SRD2), which applies to stock exchange-listed companies. Under SRD2, decisions on directors’ remuneration need to take into consideration: the interests of the wider community and society, the employees, and sustainability goals. This should not be a check-the-box exercise, but this will require a continual dialogue (and not only during the AGM itself) with the various stakeholders to find the right balance which will need to find its way into the remuneration policy.”

However, shareholders are still the only stakeholders who can formally judge whether these stakeholder interests have been duly taken on board. And they have been given stronger rights to do so.
Companies are held accountable. This means that if, during an AGM, shareholders have expressed comments and raised issues with directors’ remuneration, these need to be addressed in the subsequent AGM for the company to justify how it has dealt with these comments and issues.

The landscape is changing. For example, various corporate governance codes apply to stock exchange-listed companies and have done so for a long period of time. These codes already prescribe long-term holding periods when directors are awarded shares, to discourage short-term risk-taking and interests. Also, for many years, counteracting short-termism has been a top priority in the financial sector. Regulations such as the Capital Requirements Directive (CRD) provide a focus on long-term interests by imposing multi-year vesting periods, subsequent lock-up or retention periods, and malus and clawback mechanisms to ensure risk alignment with the company’s long-term interests. “These changes have had a massive impact on how these companies operate and we have advised many leading banks and investment firms on implementing these major changes in their approach towards remuneration,” says Van de Bult.

Short-termism in the context of remuneration can be countered by regulating the payout of bonuses: for example, the long vesting and retention periods referred to in the previous paragraph, which encourage long-term interests. But short-termism can also be addressed at an earlier stage in the remuneration process, long before the potential payout, when the targets for the bonuses are set.

SRD2, corporate governance codes and CRD have paved the way. For stock exchange-listed companies, SRD2 is already quite clear that the performance criteria should cover both financial and non-financial targets that contribute to the company’s strategy, long-term and sustainability goals. Remuneration policies will need explicitly to address these non-financial targets. Van de Bult adds: “I expect that shareholders upon request by the various stakeholders will become increasingly demanding in this respect, supported by the fact that SRD2 requires the remuneration policy to take into account the level of support in society when setting directors’ remuneration.”

The suggestions in the Consultation document – such as taking into account workforce remuneration when setting director remuneration or including non-financial objectives for variable pay—have long been part of remuneration schemes for certain companies and sectors. These are important measures in disincentivising short-term financial gain. Non-financial goals which encourage long-term focus and represent social issues will help to positively adjust the perception of directors’ remuneration in society.

SRD2 provides the obligation for stock exchange-listed companies to report in the 2021 AGM on how the company has dealt with the views and issues identified by shareholders on the implementation of the remuneration policy in 2020. He adds: “We are seeing clients preparing themselves for difficult discussions in their upcoming 2021 AGMs. Institutional investors have also been quite vocal about their expectation that the effects of the pandemic on the company and its workforce also be reflected in directors’ pay. Companies are expected to demonstrate that directors are not excluded from the ‘pain’ their companies and employees are suffering.”
Next steps
Businesses should consider the following in anticipation of the upcoming legislation:

• It is not too early to start engaging with MEPs and the Member States, given that they will ultimately decide what the new rules will require.

• With regard to governance issues, companies should check whether they are already considering all stakeholders that relate to their business. This could go hand in hand with assessing and potentially improving the procedures to determine stakeholders and their interests and to include them in the decision-making.

• It can make sense to enter early on into a discussion with the D&O insurance providers on what they would require if the new governance and due diligence requirements were implemented. As these requirements can potentially increase the liability risks for directors, the insurance coverage should be clear.

• Businesses should act now to ‘future-proof’ their internal policies, processes and risk management frameworks to be prepared for whatever legislation ultimately is passed down the line. A number of our clients are taking steps to do this now. Even if there is a grace period between the adoption of the law and its coming into effect, trying to meet the requirements from scratch only after they have been agreed would be a gargantuan task.

• Any steps taken to prepare for this European legislation would also serve organisations well in terms of anticipating additional new measures requiring proactive management of human rights and environmental risk that might be expected to develop in other parts of the world.

• Companies should review their existing performance management and remuneration schemes with the aim of amending their target setting and payout processes. In some cases, that can be a complex undertaking that would include the collaboration of works councils and/or individual employees.

We asked our clients the following question:
Do you think the proposals on directors’ remuneration to counter short-termism will be effective in terms of leading to the desired result mentioned?

Not at all
Absolutely
Perhaps
This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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