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The EU COM Proposal for a Corporate Sustainability Due Diligence Directive

Thank you for inviting me to this prestigious conference. Since I am not only holding academic positions but also serve as a company law expert to the Swedish Ministry of Justice, I must give the standard disclaimer that my remarks are my own and do not necessarily represent the views of the Ministry or its staff.

Introduction

On 23 February this year, the European Commission adopted a proposal for a Directive on Corporate Sustainability Due Diligence. The aim of this proposed Directive is, in the words of the Commission, "to foster sustainable and responsible corporate behaviour and to anchor human rights and environmental considerations in companies' operations and corporate governance." To achieve this, the Directive establishes a corporate due diligence duty. The core elements of this duty are identifying, bringing to an end, preventing, mitigating and accounting for negative human rights and environmental impacts in the company's own operations and its value chains. In addition, certain large companies need to have a plan to ensure that their business strategy is compatible with limiting global warming to 1.5 °C in line with the Paris Agreement.

The Directive also introduces duties for the directors of the EU companies covered. These duties include setting up and overseeing the implementation of the due diligence processes and integrating due diligence into the corporate strategy. In addition, when fulfilling their duty to act in the best interest of the company, directors would have to take into account the human rights, climate change and environmental consequences of their decisions.

The proposal is well embedded in European Union policies, declarations and ambitions in the field of human rights and environment. In the preamble to the Directive there are references to the Green Deal and a myriad of other EU measures as well as to UN Principles, OECD guidelines etc.

The history of the proposal is, however, anything but straightforward. Let me remind you of the, not so smooth, birth of the proposal.

Building on the EU Commission Action plan of 2018 on Financing Sustainable Growth, the Commission two years ago, in the Spring of 2020, published two studies that were to be pillars of the proposed directive. The first one was a study on Due Diligence requirements through company supply chains. The other study, entitled Directors´ Duties and Sustainable Corporate Governance, focused on "*assessing the root causes of short termism in corporate governance*".

The Commission posted the studies on its website asking for "initial feedback" and the responses did not delay. Views poured in, especially on the latter study, from industry, from investors, from academia, from NGOs as well as from Member States. Not all, but many commentators delivered, politely speaking, humiliating criticism. The bottom line was that the study on Directors´ Duties and Sustainable Corporate Governance was founded on erroneous assumptions regarding the functioning of the economy, did not meet even elementary requirements for scientific method and, in several respects, was substantially biased.

In the view of the critics the Commission should reconsider the matter. This was not, however, the conclusion of the Commission. On the contrary, the Commission moved along as though nothing much had happened and soon launched a formal "public consultation" - based on the results of the studies.

Not unexpectedly, the criticism remained and, this time around, the Commission was also criticised for having ignored the grave condemnation of the corporate governance study. Still, the Commission gave notice that a formal directive-proposal on Sustainable Corporate Governance would be presented in the Spring of 2021.

This was not the case, however. Like other proposals for directives presented by the EU Commission, this initiative was to be reviewed by the Commission's own quality control, the Regulatory Scrutiny Board. No proposed directive may be presented by the Commission without the go-ahead from the Scrutiny Board. Normally, this is a straightforward, internal process that outsiders rarely learn about. This time, however, the situation was different. At its meeting regarding the planned proposed directive in early May last year, the Scrutiny Board rendered an overall negative opinion and observed that the draft proposal and the impact assessment were associated with significant shortcomings. Hence, the draft got a red card!

As a direct consequence, the Commission amended the timetable for the proposal and set a new date for its publication: the Fall of 2021. History, however, repeated itself. When examining a revised draft, the Scrutiny Board once again raised the red card.

According to the Scrutiny Board the Commission still failed to clarify "*the need to regulate directors' duties on top of due diligence requirements*".

Now there would only be one more chance. Following a third failed attempt, the proposal would have to be withdrawn. Something radical had to be done. Hence, widening the responsibility for the directive within the Commission and taking aboard more seriously the Scrutiny Board criticism the proposal for a directive on "Sustainable Corporate Governance" was morphed into the proposal for a Directive on "Corporate Sustainability Due Diligence" that is now on the table.

The Proposal largely built on the first of the two initial expert reports – the report on due diligence requirements through company supply chains. Still, however, there were corporate governance requirements in the proposal that could easily be traced back to the second report – the corporate governance study. And, *nota bene*, of the invoked legal basis in the Treaty (Art 50 and Art 114) one (Art 50) is the very same as for the company law directives.

The proposed directive was delivered to the European Parliament and the Council, respectively, for deliberations in February this year. The Commission (as well as the then French EU Presidency) was of course eager for the Council to make quick progress. That, however, turned out not be the case. For most Member States this is quite a demanding expedition in unchartered territory where there are no obvious roads to take. Furthermore, in most Members states the issues covered by the proposed Directive involves not just one but several ministries. This, of course, many times makes it hard to quickly form the national positions.

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Turning now to the content of the Proposal, I will make some general remarks, first in relation to the sustainability due diligence parts, and then in relation to the corporate governance parts. I will refrain from digging into details. I will also leave aside today the many questions that can be raised in relation to the applicability of the Directive to non-EU companies doing business within the Union.

The sustainability due diligence parts of the proposal

Let me state from the outset that the idea of 'corporate sustainability due diligence' in my view is admirable and important. There is already heavy pressure from investors on companies taking such actions, and many, if not most, large European companies are today well aware of their responsibilities, both the legal responsibility they have if they cause direct harm, and a more discretionary moral one, when dealing with notably foreign suppliers and partners as well as of the costs of negative externalities. These responsibilities, that have developed as market practices for decades, are today also picked up by regulation and normative guidelines, including under the auspices of the OECD, as well as by individual Member States, most prominently France and Germany.

But this business practice and business compliance with existing standards also makes it worth considering whether there is at all a need to harmonise due diligence rules at Union level, or whether less intrusive instruments can be used to encourage this development. To me, it is not obvious that black letter harmonisation is the best way forward and compatible with the principles of subsidiarity and proportionality enshrined in Article 5 of the Treaty.

In the Proposal, the Commission argues that several Member States have enacted legislation on due diligence, albeit differently, while other Member States can be expected to decide not to legislate in this field, and for this reason harmonisation is necessary to secure a level playing field. This, in my view, is not a sufficient argument for harmonisation to overcome the restraints in Article 5 of the Treaty.

The premise of the principle of subsidiarity is the recognition that legislation is best dealt with at Member State level. That in turns allows each Member State to experiment on its own and, as its exercise would only affect its own subjects, there is no need for acceptance or prior approval from other Member States. Such national experimentation is crucial as a learning exercise both for the Member State enacting the legislation and for the other Member States that may observe the outcome and decide whether to follow the lead or avoid it. It should be obvious that Member States that on their own inclination have chosen to enact a certain legislation cannot use the argument of a level playing field to require that other Member States adopt something similar as a harmonisation effort on a Union level.

Furthermore, even if a directive on corporate due diligence is considered sufficiently necessary to overcome the restraints in Article 5, I question the legal basis of the Proposal. In my view the due diligence provisions mainly belong to the field of public regulation. Since the due diligence requirements put an obligation on the company and not directly concern the internal governance system of the company, Article 50 on company law can hardly be the correct basis for the directive.

Transformation of international (soft) law into national (hard) law

The Proposal foresees due diligence obligations for companies by incorporating a long list of international environmental and human rights conventions (treaties). These instruments of international law are to be used as directly binding obligations on companies covered by the Directive.

International law is, however, fundamentally different from national law. Treaties are written in a very different way from national law, which obliges individuals. Treaties are not drawn up with the granularity that must be required by legislation that seeks to place responsibilities on companies and directors. If obligations are going to be transplanted from the world of international law into the realm of national law it is crucial that these obligations are more specific and clearly defined than their soft law equivalents. This is, in my view not, by far, accomplished in the Commission Proposal.

The effects of `contractual cascading´ on SMEs

One of the main criticisms from the Regulatory Scrutiny Board on the Commission's 2020 initiative was the consequences of the proposed regulation for SMEs. In the Proposal this criticism is said to be taken into consideration, and it is stated that SMEs have been completely excluded from the scope of the Directive. That may sound good but let me point out that the so called "contractual cascading" that will be required to be used by companies directly covered by the Proposal will in fact, to a large extent, mean that SMEs that are part of value chains covered by the Directive will have to take very similar measures as the companies covered. This indirect, but very real, impact on European SMEs must be taken into account when considering the Proposal.

The full value chain focus and the incentives to exit problematic relationships

My final point on the due diligence parts of the Proposal relates to the fact that the duties stipulated regards the entire value chain of the company.

In short, companies within the scope of the directive will have an obligation to identify, prevent and bring to an end "adverse impacts", arising out of breaches of the international standards, in all firms in the full value chain and can be held liable for misconduct in all these firms. This is, to put it mildly, quite demanding.

I am in no way an expert in the field of sustainability due diligence but I believe that best practice for such efforts today is instead a risk-based approach, such as in the UN Guiding Principles, the OECD Guidelines for Multinational Enterprises and the OECD Due Diligence Guidance for Responsible Business Conduct. Such an approach allows companies to focus their efforts on the relationships and parts of their sustainability due diligence where it is most needed and valuable, which will not be possible under the Proposal.

A related issue is that, to my understanding, companies will be incentivised to exit markets where adverse environmental or human impacts might take place that the company does not believe it can fully control or oversee (thus becoming liable under the Dir). In my view it must be preferred that companies stay in these markets and do what they can to resolve issues, instead of leaving them and letting the abuse continue out of sight or be left to competitors from jurisdictions unrestrained by these considerations.

The corporate governance aspects of the Proposal

Despite the overwhelming opposition expressed in the public consultation in 2020, the Commission insisted on keeping some highly controversial corporate governance parts in the Proposal by referring to '*the political importance*' and '*the urgency of action*', arguments without any substantive underpinnings.

The inclusion of these already refuted ideas not only taints the Proposal, but also has the consequence of mixing what should be a <u>purely external</u> relationship (the legal obligations of due diligence concerning the company's conduct) with the <u>internal</u> structures for governance and the company's decision-making process.

The relevant corporate governance related provisions are Article 15 on the so-called net-zero plan, Article 25 on director's duties, and Article 26 on responsibility of the due diligence actions required.

I do not in any way dispute the Commission's right to promote any political goal as it is empowered to do according to the founding treaties, but I find it troublesome that the Commission fails to clearly signal the far-reaching intention to harmonise corporate governance, especially when that ambition has been met with considerable opposition. To ignore this opposition questions the value of public consultations and to embed such provisions in a directive on due diligence is to avoid the open discussion of the merits of any harmonisation of corporate governance, which is contrary to the principles of better regulation that the Commission is obliged to observe.

The provisions on directors' duties are unnecessary in a directive on the duty of the company to perform sustainability due diligence

The Commission argues that the provisions on directors' duties are justified because the company's compliance with due diligence necessitates a regulation of management responsibilities and duties and that the provisions harmonising corporate governance is linked to that due diligence.

I cannot see how this is correct. With regards to *Art. 15*, it requires the company's business model to strive to meet the Paris Agreement, notably the drive to a net-zero economy. There is no direct connection to due diligence and the obligation might just as well be imposed on all enterprises outside the scope of the Directive.

Considering *Art. 25*, on directors' duty of care, it imposes a general requirement that the company directors', *"when fulfilling their duty to act in the best interest of the company [...] take into account the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term.*" None of these have any obvious relevance to due diligence.

Article 26, finally, requires that the directors of companies covered by the Directive are responsible for putting in place and overseeing the stipulated due diligence obligations. This is entirely superfluous, because once such obligations have been imposed on the firm, it automatically follows from national company law that the board (and management) is equally obliged; after all, the board and the management are the embodiment of the company and bears the ultimate responsibility for all company obligations, be that in the field of environment, labour, taxes or whatever.

In summary, Articles 15, 25 and 26 are therefore completely unnecessary in relation to due diligence.

The elements of corporate governance are objectionable

Despite the fierce criticism of the Commission's original initiative on so-called 'sustainable corporate governance' by a large number of company law experts in the EU (and, incidentally, also the US) these elements were reused by the Commission in the formal Directive Proposal presented to the Council and the European Parliament.

Given this, allow me to recall that the key reason for the criticism was that the grounds for the initiative presented in the *Study on Directors' Duties and Sustainable Corporate Governance*, could not be substantiated by empirical evidence, and to those of us familiar with the research in the field, many if not all of the conclusions in the study either appeared to be very poorly substantiated or plainly wrong.

In its original initiative the Commission, at the outset, recognised that Member States' national company law requires the management of companies to show due care for the lawful and sound management of the company, including taking into account all foreseeable risks to the company, and among them the risks related to the environment and climate change. Indeed, it is impossible to dispute this fact, which can be easily ascertained by consulting national law. Quite surprisingly, however, it was contended that company directors choose to set aside these clear obligations under national law in order to accommodate the short-term desire of shareholders for maximum distributions and buy backs of shares, which depletes the companies of capital needed for the green transition. In the light of this contention, it was concluded that, in the interests of the green transition and sustainability, it is necessary to harmonise the duties of corporate governance, where it must be ensured that directors have a duty to act 'sustainably' and where shareholders must be removed as far as possible from influence over management, which must instead be monitored by a more indefinite circle called the company's 'stakeholders'.

The problem, of course, was that the second contention, that company directors choose to set aside their obligations under national law in order to accommodate the short-term desire of shareholders, was wrong. In reality shareholders and equity financing drive the green transition and demand that company boards and management consider climate risks, because the shareholders as investors are interested in companies´ long-term results, which is decisive for the present-day value of their shares and the prospective return on their investment.

A study published by the European Central Bank illustrates the point very well. The conclusion of the study is that for given levels of economic development, financial development and environmental regulation, CO^2-emissions per capita are lower in economies that rely more heavily on market based equity funding. The study identifies two main reasons for this: first, equity markets reallocate investment towards less polluting sectors more effectively than other types of financial markets; second, equity markets also push remaining carbon intensive sectors to develop and implement greener technologies. The ECB study concludes that carbon-intensive industries produce more green patents when national equity markets deepen. Broad and deep public equity markets that present investors with the ability to diversify the firm-specific risks associated with technological innovation, lower the overall societal cost of capital for research and development that result in new patents, products and processes that have a smaller carbon footprint.

In other words, the green economy transition requires the strengthening of stock markets that provide access to risk capital.

The consequence of the fact that the negative effects that the Commissioned pointed out with "shareholderism" could not be substantiated was decisive because the chain of arguments then collapsed. It was for this reason that the Regulatory Scrutiny Board did not just once but twice overrule the Commission's initiative – the Commission had failed to establish the need for EU legislation in this area. The Commission still has not succeeded doing this and it was therefore, in my view, disheartening to see that the same arguments were put forward again in the Proposal. It was as if the public consultation in 2020 never took place.

In short, the wish for harmonisation of directors' duties is a remedy for a problem that has not been proven to exist.

The negotiations

Finally some words on the ongoing discussions in the Council and the European Parliament.

In the Council Working Party (composed by civil servant representatives from the MSS) the discussions began during the French Presidency. While the Presidency, of course, started out with high ambitions, it soon became clear that to most MS lots and lots of questions would need to be answered, lots of vagueness would need to be removed and many concessions would need to be made before the Council would be ready to agree on a so called common position. Furthermore, many Member states already from the very first meeting argued for the corporate governance related provisions (Articles 15.3, 25 and 26) to be deleted.

All in all, not much progress was made during the French presidency period. Beginning in July the Czech Republic (Czechia) now holds the Presidency and is very keen on making progress. A major problem is that, still, quite a number of MS have not spoken at all on the proposal. Hence, no one knows what their positions are or will be. One thing is now clear, though: a majority of the Member states wants the corporate governance related articles to be deleted. Hence, the Presidency has presented a compromise proposal where, inter alia, articles 15.3, 25 and 26 are now deleted.

From January 1 next year Sweden will hold the Presidency and chair the continuing discussions in the Council.

In parallel to the deliberations in the Council the European Parliament is reading the Proposal. Since several Committees in the Parliament are involved the report from the Parliament will most likely be presented late Spring next year.

My guess is that the trialogues involving the Council, the Parliament and the Commission acting as broker will start maybe at the very end of the Swedish Presidency period but, more likely during the Spanish Presidency period starting in July next year! Hence, maybe, maybe by this time next year we will see the light in the end of the tunnel and a new conference can be held here in Madrid to discuss the final outcome of the Proposal for a Directive on Corporate Sustainability Due Diligence. I already look forward to participating.

Thank you for your attention.