The EU's upcoming sustainable corporate governance rules: What can businesses expect?

The growing political focus on the protection of the environment, human rights and labour rights may soon translate into additional obligations on companies in order to ensure the respect of such societal values throughout their entire supply chains. The European Commission ("***Commission***") is likely to publish a legislative initiative on sustainable corporate governance,[1] which would set out rules that require companies to address adverse sustainability impacts within their operations and international value chains. The Commission is also contemplating regulating the remuneration of corporate directors and enforcing them to integrate stakeholders' interests and corporate sustainability risks into the implementation of the corporate strategy.

This client alert sets out what businesses can expect from the upcoming sustainable corporate governance initiative and its potential impacts on company operations and value chains. In section 1, we explain what the sustainable corporate governance initiative is before turning to the rules that the Commission is considering in section 2. Finally, in section 3, we briefly discuss the effects that these rules might have on businesses.

1. WHAT IS THE SUSTAINABLE CORPORATE GOVERNANCE INITIATIVE?

The sustainable corporate governance initiative forms part of the European Union ("***EU***")'s Green Deal and is a key deliverable in several of the EU's recent strategies.[2] It may require all companies operating in the EU's internal market to commit to the "do no harm" principle by setting out harmonised minimum due diligence obligations and imposing strict duties on corporate directors to integrate sustainability interests into business decisions. It is likely that such obligations and duties will not only extend to harm that may be caused in a company's own operations but also their value chains.[3] In this way, the EU intends on tackling global environmental, social and human right risks and impacts.

More specifically, the EU aims to tackle the problems associated with "short-termism", a term coined by the Commission in its inception impact assessment to describe how pressure to focus on short-term financial performance instead of long-term development and sustainability, as well as favouring the interests of shareholders over stakeholders, "reduces companies' ability to integrate sustainability considerations adequately into business strategies and decisions".[4]

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1 European Commission, Sustainable corporate governance, available here. It should be noted that while the publication of the Commission's legislative initiative is planned for the second quarter of 2021, a Commission spokesperson indicated on 21 May 2021 that it would not be published until at least the third quarter of 2021, see "Europe Inc. wins as EU delays new business rules", Politico, 21 May 2021, available here. This delay is reportedly due to the fact that the Commission's Regulatory Scrutiny Board issued a negative overall opinion on the Commission's impact assessment of the sustainable corporate governance initiative. See, "Morning Trade: Due diligence melee — EU-Angola talks — Customs union", Politico, 23 June 2021, available here.

2 European Commission, Inception Impact Assessment Sustainable Corporate Governance, available here, p. 1 ("***Inception impact Assessment***").

3 Inception Impact Assessment, p. 3.

4 Inception Impact Assessment, p. 2.

2. WHAT RULES ARE THE COMMISSION CONSIDERING?

The Commission is considering several options to meet this goal.

As a first option, the Commission is considering imposing a due diligence duty on companies operating in the EU. This duty could consist of requiring companies to "take measures to address their adverse sustainability impacts, such as climate change, environmental, human rights (including workers and child labour) harm in their own operations and in their value chain by identifying and preventing relevant risks and mitigating negative impacts".[5] The scope of what such measures would consist of is not specified by the Commission. However, the design of a due diligence duty may likely build on existing international guidelines, such as those developed by the UN[6] and the OECD[7].[8] Relevant standards could also be set in line with the goals of international conventions, such as the Paris Agreement, or the EU's human rights statutes and climate goals.[9]

The European Parliament is of the view that, in practice, due diligence should consist of "a process put in place by an undertaking in order to identify, assess, prevent, mitigate, cease, monitor, communicate, account for, address and remedy the potential and/or actual adverse impacts on human rights, including social, trade union and labour rights, on the environment, including the contribution to climate change, and on good governance, in its own operations and its business relationships in the value chain".[10] In this regard, business relationships should include all suppliers, sub-contractors and investee undertakings.[11] According to the European Parliament, companies should be required to produce a statement referring to each stage of the due diligence process and be subject to possible checks or investigations by competent authorities from EU Member States in order to ensure that they comply with such obligations.[12] The due diligence obligations would, nonetheless, need to be "proportionate and commensurate to the likelihood and severity" of a company's "potential or actual adverse impacts" depending on the size of its value chain, the sector of its activity or its resources and leverage.[13]

As a second option, which could be complementary to the due diligence duty outlined above, the Commission is contemplating imposing duty of care obligations on corporate directors.[14] Such obligations would involve defining and integrating into the corporate strategy all stakeholders' interests which are relevant for the long-term sustainability of the firm or are affected by the firm's business (i.e., employees or the environment), as well as corporate sustainability risks, impacts and opportunities.[15] These interests and risks would need to be "measurable and time-bound [and] science-based targets where relevant", according to the Commission.[16] Moreover, the implementation of the corporate strategy would need to be conducted through "proper risk management and impact mitigation procedures".[17] In addition, the Commission is

[5] Inception Impact Assessment, p. 3.
[6] See for example, the UN Guiding Principles on Business and Human Rights, available here.
[7] See the OECD Due Diligence Guidance for Responsible Business Conduct, available here.
[8] Inception Impact Assessment, p. 3.
[9] Inception Impact Assessment, p. 3.
[10] European Parliament, Report with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)), available here, p. 21 ("***European Parliament Report***").
[11] European Parliament Report, p. 21.
[12] European Parliament Report, p. 24.
[13] European Parliament Report, p. 32.
[14] Inception Impact Assessment, p. 3.
[15] Inception Impact Assessment, p. 3.
[16] Inception Impact Assessment, p. 3.
[17] Inception Impact Assessment, p. 3.

considering laying down other corporate governance arrangements, such as regulating the remuneration of corporate directors.[18]

The possibility of the Commission proposing this second option has been met with strong criticism. Denmark, Finland and Estonia reportedly sent a letter to the Commission asking it to abandon the corporate governance aspect and only tackle due diligence.[19] This view was echoed by several business organisations, who also sent a letter to the Commission urging it to consider the "two topics separately".[20]

The Commission may also establish an enforcement and implementation mechanism to accompany these two policy options, which might include the possibility for stakeholders to seek remedies for damage caused from companies failing to comply with the due diligence obligations or corporate directors failing to uphold their duties of care.[21] While the Commission has not yet decided on what such an enforcement and implementation mechanism would entail, the European Parliament envisages a comprehensive one. The European Parliament considers that a "grievance mechanism" should be established, which would allow any stakeholder to voice reasonable concerns regarding the existence of a potential or actual adverse impact on human rights, the environment or good governance.[22] In addition, the European Parliament foresees extra-judicial remedies, whereby EU Member States could ensure that when a company identifies that it has caused or contributed to, or is otherwise directly linked to, an adverse sustainability impact, it must cooperate with the remediation process.[23] The remedies could be "financial or non-financial compensation, reinstatement, public apologies, restitution, rehabilitation or a contribution to an investigation".[24] Importantly, the remediation process would be separate to civil proceedings in accordance with EU Member State's law.[25] The European Parliament also considers that EU Member States should be able to impose sanctions on companies for infringement of the rules, such as fines or exclusion from public procurement procedures, state aid or public support schemes.[26] In a letter sent to Commission officials on 22 June 2021, Members of the European Parliament stressed that establishing such a "liability regime" was one of their key demands.[27]

It is also not clear from the Commission's inception impact assessment whether all companies or only those meeting certain thresholds would be subject to the due diligence duty or the duty of care obligations. The European Parliament's position could be indicative of the final scope adopted by the Commission in this regard. In the European Parliament's view, the rules should apply to (i) large undertakings governed by the law of an EU Member State or established in the territory of the EU; (ii) all publicly listed small- and medium-sized undertakings, as well as high-risk small- and medium-sized undertakings; and (iii) all undertakings operating in "high risk sectors", which are governed by the law of a third country and are not established in the territory of the EU, when they operate in the EU's internal market by selling goods or providing services.[28] High-risk sectors should be determined by economic activity, according to the European

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18 Inception Impact Assessment, p. 4.

19 Corporate executives 'freaking out' over EU supply chain plans, *Politico*, 4 May 2021, available here.

20 Joint Letter regarding the EC initiative on Sustainable Corporate Governance – European leading associations share their views on upcoming initiatives, 3 May 2021, available here.

21 Inception Impact Assessment, p. 4.

22 European Parliament Report, p. 36.

23 European Parliament Report, pp. 36-37.

24 European Parliament Report, p. 37.

25 European Parliament Report, p. 37.

26 European Parliament Report, p. 41.

27 See, MEP Letter to Commissioners on Sustainable Corporate Governance Initiative, 22 June 2021, available here.

28 European Parliament Report, p. 30.

Parliament.[29] Importantly, the European Parliament considers its position regarding the scope of the envisaged sustainable corporate governance initiative as another one of its essential demands.[30] Adopting such an approach could thus draw a broad number of companies within the scope of the envisaged rules as it would affect not only undertakings established in the EU, but also those that are merely operating on the EU's internal market.

In contrast, if the Commission were to take inspiration from sustainable corporate governance laws adopted in certain EU Member States, the scope of the rules could be limited in a number of respects. For instance, France's law on the Duty of Vigilance of Parent Companies and on its Affiliated Entities is limited to listed stock companies headquartered in France, which employ more than 5,000 employees in France or 10,000 worldwide.[31] The Netherlands' Child Labour Due Diligence Act also only applies with respect to child labour.[32] Moreover, the recent Supply Chain Due Diligence Act adopted by the German Parliament covers the protection of basic human rights and some aspects of environmental damage, but is limited to companies with over 3,000 employees from 2023, covering approximately 700 companies, and over 1,000 employees from 2024, covering approximately 2,900 companies.[33]

It is important to note that a Commission official has hinted that there would be some specific rules for small- and medium-sized enterprises.[34] It is not yet clear, however, whether these rules would be legislative measures or merely guidance.

3. POTENTIAL IMPACTS ON BUSINESSES

Thus, in light of the potential scope of the upcoming sustainable corporate governance initiative, businesses, and particularly large companies, should anticipate changes to their internal policies in order to comply with the introduction of the due diligence and duty of care obligations and by effect, potentially also changes to their business operations and value chains.

Indeed, should the EU adopt harmonised due diligence obligations, companies would not only have to carry out a process of due diligence for their own operations and those of their direct suppliers, but also for their entire supply chains. For example, a company selling electronic goods on the EU's market could be required to ensure that the raw materials its suppliers use are not mined by using child labour or do not cause environmental harm. Furthermore, if the EU enacts a form of enforcement mechanism, outlined above, the company selling electronic goods in the EU could be held responsible for the human rights or environmental damage caused by one of its suppliers, even when that damage takes place outside of the EU.

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29 European Parliament Report, p. 21.

30 See, MEP Letter to Commissioners on Sustainable Corporate Governance Initiative, 22 June 2021, available here.

31 See, Loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre (1), available here, Article 1.

32 Wet van 24 oktober 2019 houdende de invoering van een zorgplicht ter voorkoming van de levering van goederen en diensten die met behulp van kinderarbeid tot stand zijn gekomen (Wet zorgplicht kinderarbeid), available here. See also, European Parliament Report, p. 19.

33 See, Drucksache 19/28649, Entwurf eines Gesetzes über die unternehmerischen Sorgfaltspflichten in Lieferketten, 19.04.2021, available here, as adopted on 11 June 2021 taking into account amendments of the Committee on Labour and Social Affairs, Drucksache 19/30505, Beschlussempfehlung und Bericht des Ausschusses für Arbeit und Soziales (11. Ausschuss), 09.06.2021, available here.

34 See, How Brussels wants to make your shopping woke, *Politico*, 27 April 2021, available here.

Furthermore, should the EU impose the duty of care rules on corporate directors, company boards would be required to integrate long-term sustainability objectives into their decision-making process and take into account voices of various stakeholder groups, including those that are indirectly linked to their strategic decisions. These rules would thus certainly broaden the traditional notion of a management board's role in a company and could lead to reduced dividends for shareholders. Moreover, as liability could be attached to such duty of care requirements, companies could be subject to increased risk, which might in turn threaten business opportunities and competitiveness.

In any case, even though the publication of the Commission's proposal on the sustainable corporate governance initiative is imminent, the proposal would still need to be scrutinised and agreed to by the European Parliament and the Council of the EU pursuant to the EU's ordinary legislative procedure. The envisaged sustainable corporate governance rules, outlined above, may thus not enter into force for another several years.