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Due diligence and sustainable governance

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Introduction

European companies are facing serious challenges as a result of the pandemic and are unable absorb further burdens. However, even in the present situation where companies should be given breathing space, there are new legal obligations continually emerging that imply more costs for companies.

The ideas currently under discussion regarding due diligence and sustainable governance, on which the European Commission is expected to present legislative proposals in the autumn, are an alarming example.

These proposals, which were initially expected for June 2021, were postponed as a result of the intervention of the Regulatory Scrutiny Board, an advisory body of the European Commission, which considered several of the proposals to be problematic. Following this assessment, the Commission is reviewing its project.

CIP, together with its European counterparts within BusinessEurope, has been debating these issues, and alerting to serious concerns regarding the disproportionate impacts that some of the measures now under discussion will have on the operation of companies, should they go forward.

Among the main concerns, is the possibility of companies being held responsible for the entire value chain where they operate, as well as the emergence of abusive interference in corporate governance.

The proposals presented by the European Commission must be proportionate, adequate to the reality of companies, in particular SMEs, and compatible with the principle of entrepreneurial freedom. Otherwise, future legislation on these important issues, instead of achieving the goals, will only manage to have a profound impact on European companies, destroying entrepreneurship, and substantially reducing foreign investment in the EU.

1. Due diligence

The European Commission's ideas, which were expected in June, aimed at introducing the duty of companies to identify, prevent, and mitigate adverse impacts on human rights, health, social and environmental aspects, in all sectors and covering their whole supply chains. The scope of the proposal should cover companies of all sizes. The new framework should also combine elements of transparency (information requirements), enforcement (supervision of administrative authorities) and accountability measures (civil and potentially criminal, fines, prohibition of public contracts or obtaining European funds, etc).

Naturally, companies are aware of the need to prevent and mitigate risks in their value chains. Indeed, European companies operate within an existing framework that addresses adverse impacts on human rights and environmental issues. There are frameworks at the UN and OECD level, which provide ample scope for action for companies and reinforce the public-private effort. Due diligence initiatives (both at sectoral and individual level) have been increasingly adopted by companies, with good results, and the integration of these considerations into business strategies is gradually becoming the norm.

But it will not be possible to hold companies responsible for actions that are beyond their control, and whose responsibility belongs to other entities in third countries. It is practically impossible for companies to be held responsible for everything that goes on upstream in the value chains where they are integrated. Moreover, the State cannot transfer its responsibilities to companies. If it is not well conceived, this European initiative will go against the objective it wants to achieve, which is to improve the situation in the supply chains.

Recommendations:

- ✓ The legislative proposal should focus on the area of direct impact, that is, companies' own operations, and tier 1 suppliers in the supply chain, according to the severity of the risk, as mentioned in the OECD guidelines.

- ✓ The level of detail required should be proportionate to provide clarity for business and legal certainty. Regulatory requirements must be sufficiently clear so that companies can implement them with confidence of compliance. Key terms must be clearly defined, and definitions must be established with reference to internationally recognized standards such as the Universal Declaration of Human Rights, OECD guidelines and ILO core Conventions. It must also be ensured that there are no additional burdens arising from national legislative initiatives, which are potentially incompatible or lead to a duplication of burdens.

- ✓ The reality of SMEs must be taken into account. Exemptions and lighter requirements should be considered. It will be necessary to support SMEs, irrespective of whether they are covered by the proposal: by participating in value chains, SMEs could end up being affected by the implementation of the legislation.

- ✓ It is necessary to ensure a level playing field: one of the benefits of European action is to ensure that the same rules apply in all Member States. This must be ensured when transposing the rules into national law, paying special attention to this process in order to avoid "gold-plating". In addition, private or public companies from third countries operating in the internal market must also be covered by the future EU framework. This framework should also take into account the impact on the competitiveness of EU companies vis-à-vis companies from other parts of the world.

- ✓ As regards accountability, it would be inappropriate to hold only European companies responsible for damages, when it is impossible to control all components of the value chain and the various actors involved.
    - Civil liability should only apply if (i) due diligence has not been carried out and (ii) the usual civil liability rules are satisfied (damages have occurred and a causal link between the two has been established). There should be no vicarious liability whereby companies become responsible for actions of autonomous entities.
    - Rules on the burden of proof must be proportionate, and there must be no reversal of the burden of proof.

- ✓ The EU and Member States must take responsibility and share the burden of due diligence, creating an enabling environment for companies to carry out their duties in an effective, viable and legally secure way. The task of gathering information on the global human rights situation should not be left to business alone. As a complementary measure to future proposals, the EU should consider the idea of developing a "European contact point / observatory" where European companies can obtain reliable information on regional human rights situations that would allow them to make / justify decisions in relation to their value chains, get guidance and support. The European External Action Service and European Commission Delegations in third countries could be used to collect and transmit this information to the contact point. This could then, based on the information received, comprehensibly categorize the risk of violations in order to provide companies with the information they need to fulfill their due diligence obligations.

2. Corporate governance

Sustainability is unavoidable and companies are committed to integrating sustainability concerns at the heart of their strategies and business models, favouring actions to boost investment in sustainable activities. The development of appropriate, proportionate and viable tools, taking into account the needs of the real economy, can facilitate this transition.

The EU corporate governance framework has proven, over the last two decades, that it is able to adapt to new challenges, thanks to a framework of well-balanced, targeted rules (some very recent, such as the Shareholder Rights Directive II and Non-Financial Reporting Directive), complemented by corporate governance codes (frequently updated) and company practices.

There are major concerns with the European Commission roadmap on these issues, which point to a radical rather than an evolutionary approach. This is based on a widely criticized study prepared by E&Y, anchored in false assumptions and a dubious methodology, which leads to a

misleading image of European companies. Not only do companies agree with the need to take into account the interests of different stakeholders, as they have no alternative given the direct impact it has on their performance. The idea that companies only follow the immediate financial interests of their shareholders is equally outdated. Moreover, there are also legal frameworks to ensure these behaviours such as the directors' duties, corporate governance codes, and market practices, which exist in all Member States.

Clearly, it will not be possible to follow the objectives of the Commission, which intends to change the market economy model and the entire legal system, so that stakeholders (shareholders with at least 1%, unions, NGOs) start having legal rights in relation with the management of companies, as well as enforcement powers that would give them legitimacy to enforce new obligations.

These radical changes would negatively affect the very foundations of the operation of companies (anchored in the European model of market economy), would be conducive to deadlocks in decision-making and would promote endless litigation. It would naturally lead to companies becoming more risk-averse and less entrepreneurial and, ultimately, less attractive to capital.

Recommendations:

- ✓ Sustainable governance and due diligence should be distinguished in the initiatives that are to be taken. Although these areas are interrelated to some extent, it is not appropriate to treat them equally, which can lead to inappropriate solutions.

- ✓ A possible new framework should ensure that companies preserve their flexibility to balance the different interests of stakeholders, as well as their compatibility with the company's interests in the short, medium and long term. We stress that it is not possible to identify stakeholders' ex-ante and consider them as a single category, given the different and potentially contradictory interests they represent. This also makes the task of defining and assessing the different interests/needs of interested parties a cumbersome process for companies.

- ✓ Stakeholders cannot, as such, be given the right to challenge the decisions of the company's governing bodies because they do not have the legitimacy or representation to do so.

- ✓ Directors should only have fiduciary duties to the company itself and not to third parties. Directors need the flexibility to identify which stakeholder interests should be considered, taking into account the activity, structure, nature and size of the company.

- ✓ An unbalanced legislative intervention would be disproportionate and counterproductive, with negative impacts on several fundamental principles, such as freedom of enterprise and property (ownership) rights, leading to impasses in the decision-making processes of companies and reducing risk-taking and entrepreneurial initiatives.

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