BUSINESS, HUMAN RIGHTS AND THE ENVIRONMENT

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Linking Board Pay to Human Rights – New Developments from Germany

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Companies in Germany and possibly soon all of the EU will be legally obliged to implement human rights and environmental due diligence to manage and reduce corresponding risks. To secure buy in on this process from top management, linking board pay to human rights indicators might be a useful and – at least in the context of German Company Law – even an obligatory measure.

Do such incentives work? The short answer is yes, most likely they do. A German study found that compensation incentives can boost a company's performance on ESG KPIs, some of which were human rights related. More recent data from the World Benchmarking Alliance supports this finding: companies that linked board remuneration to relevant human rights indicators, such as promoting gender equality or ensuring the health of local communities, scored significantly higher overall on the "Corporate Human Rights Benchmark" (CHRB) than those that did not. Compensation schemes were measured, if they addressed at least one key industry risk for the company and along its supply chain (indicator A.2.3, see p. 21 of the CHRB methodology).

This finding leads to the follow-up question of whether companies are legally obliged to use renumeration incentives as a tool to improve their human rights practices. Sec. 87 Subsec. 2 Sentence 2 of the German Stock Corporation Act (GStCoA) requires listed companies to orient their board remuneration structure towards the promotion of a sustainable development of the company – "sustainable" meaning ecological and socially responsible business practices. Arguably, this could mean that human rights related KPIs are mandatory for remuneration schemes, because they promote socially responsible business practices and therefore sustainable development of the company. Nevertheless, the wording of the law remains too broad and general to conclude that specifically human rights KPIs need to be implemented.

However, the new German Supply Chain Due Diligence Act (GSCDDA) could now bring clarity and guide the interpretation of the word "sustainable". This new act does not specifically oblige companies to link board pay to human rights KPIs, but obliges companies to implement due diligence processes and risk management measures, which address a number of specific risks to human rights and the environment. The legal definitions of these risks (Sec. 2 GSCDDA) could help to outline the term "sustainable" of Sec. 87 GStCoA, as they define clearly what the German legislator understands to be the most relevant risks to sustainability in a business context. As a focus on other indicators might even divert board attention away from the concrete human rights obligations of Sec. 2 GSCDDA, Sec. 87 GStCoA should be read in light of them. Therefore, we see a strong argument that Sec. 87 GStCoA requires companies to at least include indicators related to identifying and mitigating the risks which are delineated by the GSCDDA.

Nevertheless, companies might decide to link board pay to the performance on these indicators regardless of any legal obligation to do so. Since Sec. 10 Subsec. 2 No. 3 GSCDDA requires companies to evaluate their due diligence measures on a regular basis and to report on this evaluation, companies will already be measuring human rights KPIs that might also be used for determining board pay. Moreover, Sec. 4 Subsec. 2 GSCDDA obliges companies to implement effective measures for HRDD (Human Rights Due Diligence), and this will require buy in from the highest level of the company. Linking board pay at least to the human rights performance (Sec. 2 GSCDDA) would increase the strategic attention that boards need in order to commit to the issue and therefore could in itself be a measure to ensure the effective implementation of HRDD. The 2019 CHRB results support this view: 88 % of companies who scored 0.5 or more on indicator A.2.3 also scored points on the HRDD indicators (B.2), while only 45% of companies who did not score on A.2.3 managed to score points on HRDD. Specifically, companies could decide to link board pay to indicators related to "salient" risks which are listed in Sec. 5 GSCDDA.

To design KPIs, which can be derived from the GSCDDA, companies can draw upon tools from NGOs, which help to develop targets and KPIs for human rights performance (e. g. the Indicator Design Tool by Shift or a compilation of quantitative

human rights indicators indicators by ecosense). Companies that are included in benchmarks like the CHRB could also link pay to their company´s performance as measured there – an approach taken by Total in 2020, which took into consideration the CHRB score when deciding about the CSR linked part of 2019`s board pay (see Total`s report, p. 178). Consequently, efforts to introduce remuneration incentives do not have to start from scratch, but can build upon solid resources, which make the process simple and cost-effective.

The following points may serve as key take-aways:

– There is robust evidence, that linking board compensation to ESG and human rights related KPIs leads to better and more transparent management of those issues.

– Moreover, there is a strong case that German corporate law now requires that board compensation must be tied to human rights related KPIs, which are derived from the new GSCDDA.

– Even if no such legal obligation exists, the changes which the GSCDDA brings, will make it easier and worthwhile to implement compensation incentives anyway.

– Looking forward, new recommendations by the European Commission's advisory group "Platform on Sustainable Finance" point to upcoming EU-wide requirements to link board compensation and ESG-KPIs. Thus, companies which act now, may gain a competitive edge by being well prepared for future regulation.

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