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Supervisory Mechanisms and Directors Duties: Innovations in the Proposed EU Directive on Corporate Sustainability Due Diligence

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Context

There has been considerable discussion of the European Commission's proposed Corporate Sustainability Due Diligence Directive (CSDDD) since its release in February 2022. For many commentators it has been both ground-breaking in its existence, being a statement that there should be mandatory EU-wide regulation on these issues, and disappointing in its limited scope and application.

There are, though, two important, and potentially innovative, aspects of the CSDDD which have received less attention: the creation of a structure of supervisory mechanisms across the EU to monitor the CSDDD; and the introduction of some personal duties for directors of companies in this area. This paper will focus on these two areas, and offer an additional reflection on one other aspect: the inclusion of reference to climate change impacts.

Supervisory Mechanisms

Objectives

Articles 17 and 18(1) of the CSDDD proposal hold that member states should designate one or more national independent supervisory authorities of a public nature with appropriate powers and financing.[1] Here it may be relevant to emphasize that the objectives of the supervision should be clear. It should improve environmental and human rights outcomes through greater prevention of risks and remediation of actual harms and also promote the implementation of better quality due diligence processes.[2] Thus, it is important that the supervisor does not only focus on business activities to address environmental and human rights risks, but especially also on the outcomes of those activities. Otherwise, legislation and ensuing public supervision may result in administrative burdens and 'tick box' exercises without actual progress for impacted stakeholders. That said, good quality and independent data on such outcomes are scarce and such data gathering needs to be developed in order to render public supervision effective in this regard. Public supervisors need to incentivize the development of such data gathering processes. Beyond this, these stakeholder perspectives are relevant for the public supervisor in order to implement effective public supervision. The public supervisor should regularly consult stakeholders, and especially also (representatives of) affected stakeholders, on the functioning and effectiveness of its public supervision and the just mentioned perspectives are relevant in this regard.[3] Alternatively, it could rely on independently gathered data with affected stakeholder perspectives on this topic.

The CSDDD leaves it to the Member States whether they will establish one new public supervisor or embed this task with existing supervisors. Recital 53 explicitly mentions the option to embed public supervision regarding financial institutions in a separate (existing) public supervisor. However, as we have observed before, it is most logical to establish one public supervisor in connection with human rights and environmental due diligence (HREDD) or, if not feasible, a national collaborative body in which relevant public supervisors participate and which has powers granted by law to exchange information on supervised entities.[4] This facilitates (continuous) learning from different sectors, whereas public supervision divided over sectors may be unnecessarily costly and burdensome for companies if public supervisors in different sectors implement different policies and approaches with diverging requirements regarding HREDD. We feel it would be good to clarify this in the recital in case Member States choose to assign public supervision to various (existing) public supervisors.

Pursuant to Article 17(2) and (3) the competent supervisory authority is that in which the company has its registered office, branch or authorized representative in case of companies not based in the EU. However, the latter companies may file a reasoned request to change their supervisory authority pursuant to Article 17(3). This seems a rather technical point, but potentially has huge implications if the intensity or execution of public supervision varies across EU member states. Thus, entities domiciled outside the EU may chose the supervisory authority in a Member State of which they perceive public supervision as most lenient. This may jeopardise the level playing field in the EU as entities domiciled in the EU cannot choose and may be subject to much stricter supervision. This also emphasizes the need for European coordination as envisaged by Article 21.

Sanctions

Public supervisors should, pursuant to Article 18(2), be entitled to carry out investigations on their own initiative or based on complaints or substantiated concerns mentioned in Article 19. Such substantiated concerns are especially relevant as we have pointed out before.[5] Public supervisors are able to develop policies building on best practices (see below) much faster than case law also based on these substantiated concerns, and can deploy and enforce these in markets. In contrast, a decision of a court cannot be enforced against other market participants than the defendant company, although it may have implications in terms of litigation against other companies which allegedly are not complying with the rule developed in case law, though only if further litigation is commenced. Public supervisory policies are also more flexible than courts in connection with changing market conditions, such as those resulting of the Covid-19 crisis. Furthermore, these policies of public supervisors may be challenged in administrative courts, which

provides clarity regarding the conformity of this policy with the EU and Member State legislation for a whole market. There is usually legal standing for companies and NGOs to challenge such policies or they may urge public supervisors to enforce such policy against a market participant.[6] If the supervisor refuses the latter, NGOs often have recourse to administrative courts to challenge this refusal which is considered to be an administrative decision.

The public supervisor should, in our opinion, implement a risk-oriented approach, for example, by initially focusing on sectors or issues with the most severe human rights risks or where a delayed response could make them irremediable and bearing in mind companies may be unable to address all actual or potential human rights risks simultaneously. It may also require enhanced HREDD in high-risk areas as mentioned in Article 2 (1)(b). However, this is not clarified in the CSDDD or its recitals. On the contrary, Article 6 (2) seems to suggest a more limited type of HREDD in these situations, which is probably not what is intended but is still unclear.

If non-compliance with the CSDDD is found, Article 18(4) holds that a company may be granted an appropriate period of time to take remedial action, but that this does not preclude the imposition of administrative sanctions or prevents civil liability. Thus, these sanctions or civil liability may be imposed or may arise during such a period. In our opinion, this exemption should be understood in a restrictive manner. It seems logical to impose such sanctions or civil liability only if a company does not implement a (clearly evidenced) best effort approach to address, mitigate and solve the issues found, except for those cases in which it has not met the legislative requirements and damage has been suffered as a result of this. That said, in the latter situation, affected stakeholders usually have to rely on civil liability as public supervisors by and large do not have the power to impose sanctions if a company does not compensate damages in individual cases as the objective in connection with which they may use their powers is general compliance with the regulation and not to facilitate or require compensation for affected individuals. Thus, sanctions for not compensating affected individuals would be *ultra vires*. The only exception to this rule may be situations in which a company repeatedly refuses to pay damages. In other situations, public supervision may not be helpful to incentivize a company to compensate victims of corporate abuse.

If sanctions are imposed, Articles 18(5), 20(1) and recital 54 clarify that these sanctions should be dissuasive, proportionate and effective, including pecuniary sanctions and interim measures to avoid the risk of severe and irreparable harm. It is not further elaborated in recital 54 or 55 which type of sanctions are feasible, as this is apparently left to the Member States. In this regard one may wonder which type of interim measures the European Commission envisages. Do these, for example, also include the seizure of goods at the European borders or in a Member State if non-compliance with the CSDDD is suspected?[7] May this also result in a permanent sanction of forfeiture of these goods? Clarification would especially be relevant in connection with goods sold by a company which is not based in the EU, as it may be difficult to impose and enforce fines or other pecuniary sanctions on such foreign entities like, for example, Chinese companies.[8] Here European coordination may be helpful in order to prevent diverging types of sanctions across Member States and concerted action towards companies based outside the EU which provide goods to the entire EU market. Furthermore, the most helpful interim measures probably are those which have a direct impact on the human rights or environmental corporate abuses. However, these often occur outside the EU and the public supervisors do not have direct regulatory powers to monitor and enforce there as these powers will probably be implemented through national laws which do not have extraterritorial effect. Thus, if a penalty payment is imposed to mitigate or resolve such an impact, but a foreign state is hampering the implementation of such a measure or discussions arise whether this measure is actually implemented, it may be challenging to uphold this sanction in (administrative) courts in Member States without the proper power to monitor compliance or if foreign states hamper implementation. Beyond this, a public supervisor often needs to consult the affected stakeholders in order to assess whether the

envisaged interim measures enforced with a penalty payment indeed mitigate or resolve the abuse. It may be complicated, time consuming and costly to conduct such consultation in an independent, effective and culturally appropriate manner, including a gender and marginalized groups lens. Here lessons may be learnt from the Directive on Environmental Damage which also applies outside the EU.[9] Articles 5 and 6 require preventive and remedial action for environmental damage defined in article 1 and caused by activities mentioned in Annex III. It is not limited to environmental damage caused in the EU. Finally independent data gathering or observations from independent observers in states where the abuse occurs may be helpful in this respect. However, the current CSDDD does not include any guidance on this. It may be helpful if there was elaboration on this .

We feel it should be clear that sanctions imposed by public supervisors should have consequences for public procurement, access to export credit, or EU or Member State's subsidies, and may support civil enforcement if observations of the public prosecutor are made public.[10] It also may provide input in civil litigation for damages (as happens in cartel cases). In our view, it would be sensible to include in EU legislation when and how observations of public supervisors regarding HREDD should be made public and may serve as a basis in civil enforcement.[11] However, this is not yet done and seems advisable.

Article 20(2) holds that the company's efforts to comply with the remedial action required by the supervisory authority and investments made or targeted support to business relations in value chains, as well as collaboration with other entities, shall be taken into account by the public supervisor. The precise meaning of this provision is not obvious. It seems to imply that the question whether or not remedial actions as described are taken, are relevant to assess whether the remedial action required is indeed implemented. However, this raises the interesting question to what extent a public supervisor may require a company to implement measures in its supply chains, for example, by collaborating, training or incentivizing suppliers or collaborating with business peers. Obviously, it may require a best effort attempt of a company to convince a supplier or business peer to implement the required measure or to collaborate but, if these entities refuse, a result cannot be guaranteed. Especially in longer and more opaque supply chains it may be hard for the public supervisor to assess whether or not such a best effort attempt is being made. This may make supervisors reluctant to require implementation of such measures, although these may be most effective. In order to prevent 'tick the box' supervision based on paper reality, innovative ways of public supervision have to be implemented. A best practices approach, as elaborated hereinafter, may be helpful for this. This includes 'positive' supervision which does not only impose sanctions on non-compliant companies but also rewards companies which are implementing good practices.[12]

Coordination

Supervisory authorities should also cooperate and coordinate their actions according to Article 17(4), 18(3) and recital 55. To this end a European Network of Supervisory Authorities as defined in Article 21 will be set up. This seems a necessary measure to create a coherent level playing field in connection with supervision, organize concerted action of supervisors, also in connection with sanctions.[13] We have pointed out the necessity of such a coordinating body before.[14] We feel this European entity may, for example, organize meetings and capacity building events for national supervisors, establish a clearing house for exchange of monitoring or enforcement information, establish a repository of company reports on HREDD, conduct or commission research on HREDD (e.g. on methodologies) and maintain a repository of best practices or information on human rights issues in specific industries, sectors or regarding specific issues as far as relevant in connection with public supervision. However, the form of this collaboration is not elaborated in the CSDDD and recital 55 only explains it may assist national supervisors. There could be an option to grant the EU supervisory entity the power to instruct national supervisors in connection with companies which have their domicile in multiple European states or regarding a specific human rights issue of interest to the EU as a whole.[15] This seems not to be implemented

yet and it may be advisable to do so. This would even be more important as the Court of Justice of the European Union (CJEU) would have a role to decide whether public supervision in Member States is effective and meets the requirements of the EU legislation.

The CSDDD provisions on public supervision seem, as most European legislation does in connection with public supervision, to focus on sanctions. However, in our opinion, it is important also to use carrots in this field to reward companies who have implemented good quality due diligence and explain to others how they could achieve this. Therefore, the role of positive supervision is also important.[16] Positive supervision means that companies which are implementing good quality HREDD are rewarded. In this regard it is important to note that HREDD usually differs depending on the sector, state and issue at hand. It poses a challenge to develop clear, consistent and sufficiently concrete standards which apply throughout these sectors, states and issues and across Member States. This should not be solved by trying to include all these standards in EU legislation or policies of public supervisors.[17] This poses the challenge of huge legislative effort by the EU which may also result in solutions which may be hard to deploy in practice.

Best Practices

To solve this issue, implementing best practices which have been developed in industries or regarding specific challenges in a dynamic fashion and have matured in markets to a certain extent, is a way forward. This would also be a means to enable these best practices improve over time and best practices of the past are not always best practices of today.[18] This could be done by frequently adapting secondary legislation, but this creates a huge legislative effort, so implementing these best practices through public supervision may be a more feasible option as this can be more dynamic.

An additional advantage of best practices is that these are deployed in practice and companies cannot argue that the legislator has prescribed solutions which are not practical. Furthermore, best practice may apply to any of the six steps of HREDD[19] and thus enable credible implementation of all these six steps. Obviously not all best practices, not even in a specific industry or specific issue, are susceptible to be implemented by every company. For example, a small-scale solution developed by a SME, may not be feasible for larger companies. That said, this does not mean the larger company may just denounce this best practice. It is conceivable parts of the best practice can be implemented. However, the foregoing shows best practices have to be appropriate and proportionate considering the type of business activity and its context. Furthermore, these should be dependent on probability of materialization of risks, severity of actual or potential damage (more severe risks require more attention) and the ability of a company to exercise leverage on the prevention of human rights abuse or remediation of abuse. So 'comply or explain' type of approach may be indicated,[20] meaning that the larger company has to either implement the best practice or explain why it cannot implement (parts of) it and what it will do to address the issue in an alternative manner. As we have elaborated before, best practices do not necessarily need to be developed by companies but may also originate from, for example, multi-stakeholder initiatives or collaboration between companies.[21] This approach may also incentivize business support for HREDD legislation, as it is developed in consultation with markets as well as collaboration between companies and in multi-stakeholder initiatives. However, a best practice approach generally is not a solution which has to be deployed only once, it should have gained some maturity in a specific industry or regarding a specific issue. The envisaged European supervisory entity may also conduct or commission research on best practices in EU markets or could assist with training and capacity building to develop best practices.

More generally, a system incorporating best practices (through secondary legislation or public supervision) may, unlike current national public supervision, provide a 'reward' for companies or multi-stakeholder initiatives, which have developed such best practices, as these are considered to be the best achievable standard at a certain moment in time.[22] Thus, supervision build on best practices may incentivize voluntary initiatives to improve HREDD and not create a 'race to bottom' in which every company or multi-

stakeholder initiative tries to stay as close as possible to the legislative requirements. That said, it may be conceivable that public supervision still entails some minimum requirements which may be adapted over time and building on best practices which have become market standards. However, it may differ depending on market conditions how effective this supervision will be in practice. It is likely markets in which, for example, consumer or investor pressure is felt, the development of best practices is better accepted and implemented than in markets lacking such pressure. Furthermore, the European entity should also, bearing in mind article 36 Treaty on the Functioning of the EU, monitor whether best practices accepted by public supervisors of Member States do not distort the EU internal market.

A way in which these best practices may be used is that, for example, public supervisors may implement more lenient approaches towards companies which demonstrate good quality due diligence based on these best practices, either based on their internal governance or on their participation in effective multi-stakeholder initiatives. The use of benchmarks or regular visits by the public supervisor may be other ways to incentivize good quality due diligence which is aligned with these best practices.[23] This may also provide legal certainty to companies as it becomes more clear which good practices they have to live up to. Thus, public supervisors should not only impose sanctions, but also educate and advise companies how to implement these best practices. That said, in order to remain independent and credible, a clear separation has to be made between the monitoring and sanction functions and the advisory functions of the public supervisor, while also coordinating these functions and paying attention to regulatory coherence.[24] The advisory function may also be relevant to inform the monitoring and sanctioning department on current corporate (best) practice.[25] In connection with this it is important that the authority's staff has sufficient knowledge on HREDD, these best practices and related issues, in order to monitor and advise companies on these issues.[26]

Neither the provisions regarding the CSDDD or the recitals include any guidance in this regard. It would be good if this would be clarified. This is important as it is pivotal that all national public supervisors would implement this type of supervision. If not, this would create a very unlevelled, non-coherent and divergent supervisory landscape which would not be advantageous for the improvement of human rights and environmental due diligence. The European coordinating body should play an important role in developing this type of supervision, build capacity with national supervisors and see to a coherent implementation and application of it at the member state level.

Finally, public supervision also pertains to the directors' duties as elaborated hereinafter. It is not very clear how the European Commission envisages supervision in this area. It is an accepted practices in some Member States that directors may face (administrative and possibly criminal) sanctions if their company violates legislative requirements as they are considered to have steered the company in these violations. However, these sanctions are derived from non-compliance by the company and not based on self-standing violations of directors' duties as envisaged by the CSDDD. It has to be explored which type of violations of directors' duties will be sanctioned and how. For example, if the bonus of a board member is not at least partially based on sustainability parameters or on the wrong ones in the eyes of the public supervisor, may it then impose a fine on this board member or the company or even actually lower his or her remuneration? The CSDDD should, in our opinion, elaborate how this public supervision should be applied to these duties. For example, the CSDDD does not seem to lower the threshold for directors' liability, as non-compliance with those duties is not included in Article 22 on liability. Thus, it is interesting to operationalize further the type of supervision envisaged in this regard. Here some examples may be drawn from public supervision in the financial sector where public supervision includes the functioning of the board (members) and approval of director appointments after examination by the public supervisor.[27] It is unclear whether the CSDDD envisages this type of supervision.

Directors' Duties

The CSDDD sets out two provisions on directors' duties , being Articles 25 and 26. They provide

Article 25

1. *Member States shall ensure that, when fulfilling their duty to act in the best interest of the company, directors of companies referred to in Article 2(1) 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.*
2. *Member States shall ensure that their laws, regulations and administrative provisions providing for a breach of directors' duties apply also to the provisions of this Article.*

Article 26

1. *Member States shall ensure that directors of companies referred to in Article 2(1) are responsible for putting in place and overseeing the due diligence actions referred to in Article 4 and in particular the due diligence policy referred to in Article 5, with due consideration for relevant input from stakeholders and civil society organisations. The directors shall report to the board of directors in that respect.*
2. *Member States shall ensure that directors take steps to adapt the corporate strategy to take into account the actual and potential adverse impacts identified pursuant to Article 6 and any measures taken pursuant to Articles 7 to 9.*

Definitions

These provisions cover all directors of companies within the scope of the CSDDD, as set out in Article 2(1). These are companies with more than 500 employees on average and a net worldwide turnover of more than EUR 150 million, as well as companies with more than 250 employees on average and a net worldwide turnover of more than EUR 40 million in the garment, agriculture and extractive sectors. It does not extend to directors of companies which are not registered in the EU and The type of companies includes a wide range of financial institutions, which even extends to crowdfunding service providers and crypto-asset service providers (Article 3(a)).

Similarly, the definition of who is a "director" is quite wide (Article 3 (o)):

- *any member of the administrative, management or supervisory bodies of a company;*
- *where they are not members of the administrative, management or supervisory bodies of a company, the chief executive officer and, if such function exists in a company, the deputy chief executive officer;*
- *other persons who perform functions similar to those performed under point (i) or (ii).*

The board of directors means (Article 3(p)) the administrative or supervisory body responsible for supervising the executive management of the company, or the person or persons performing equivalent functions. Therefore, as the average number of directors of large companies in the EU is 8,[28] the CSDDD provisions potentially cover hundreds of thousands of directors of companies across the EU.

However, the obligations under the CSDDD for directors of companies are limited to the Member State in which the company has its registered office (Article 2(4)). Thus it is the *registered office* of a company which is crucial. This seems a step backwards from the provisions of the EU's Regulations on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters (Brussels I), which focus (in Article 4(1) on the *domicile* of a company, which can be the location of the company's central administration and its principal place of business, as well as its registered office. As registered offices can be for corporate convenience, such as for tax reasons, this restricted application reduces the powers of a Member State in relation to companies operating within its jurisdiction. In our opinion, this should be amended to be consistent with the Brussels I.

Responsibilities

Articles 25 and 26 requires directors, as part of their duties to undertake the following tasks:

- 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;
- Be responsible for putting in place and overseeing the due diligence actions required by human rights and environmental due diligence, being integration, identification, prevention, mitigation, monitoring and communicating, as well as establishing a complaints procedure;
- Have a human rights and environmental due diligence policy, updated annually, which sets out the company's approach to due diligence, has a code of conduct for their employees and subsidiaries, has a process to implement due diligence, sets out measures to verify compliance with the code of conduct and measures to extend the code of conduct to established business relationships;
- To have due consideration for relevant input from stakeholders – broadly defined in Article 3(n)) to include the company's employees, the employees of its subsidiaries, and other individuals, groups, communities or entities whose rights or interests are or could be affected by the products, services and operations of that company, its subsidiaries and its business relationships – and civil society organisations;
- Report to the board about the above policies and actions;
- To take steps to adapt the corporate strategy to take into account the actual and potential adverse impacts identified (through human rights and environmental due diligence) arising from their own operations or those of their subsidiaries and, where related to their value chains, from their established business relationships (though there may be limitations on this in regard to some sectors and for some financial institutions);
- To take steps to adapt the corporate strategy to take into account the preventative measures, mitigation actions, contractual assurances from established business relationships, support for small and medium-sized enterprises (SMEs) with which they have established business relationships, bring actual adverse impacts to an end, and have an appropriate complaints procedure in place.

In addition, Article 15 requires companies have a transition plan for climate change, which is discussed below.

Harmonisation

Including directors' duties in the CSDDD is designed to harmonise the position across all Member States as is set out in the Explanatory Memorandum to the CSDDD (p.16):

Directors' duties proposed ensure a close link with the due diligence obligations and are thus necessary for the due diligence to be effective. Directors' duties also include the clarification of how directors are expected to comply with the duty of care to act in the best interest of the company.

Legal duties on directors of companies – as duties of care and of loyalty – exist across all EU Member States, and largely operate similarly no matter the legal system. The key issue is to whom this duty is owed, which is *to the company*. Generally this means it is owed to the shareholders of the company (though it may include employees or creditors in certain circumstances). In theory, the shareholders – and usually this means the majority shareholders – can bring an action for breach of a director's duty, though there are a few alternative approaches in some Member States.[29] Such an action is very difficult to succeed as the directors usually need only show that, in their judgement, they were acting in good faith in their view of the best interests of the company.[30]

The existing position in all Member States is that set out in the EU's Non-Financial Reporting Directive (NFRD), which has been implemented in all Member States. This requires certain large public companies and financial corporations operating in the EU to report on environmental, social, human rights and anti-corruption matters, necessary for

understanding the company's development, performance, position and impact. This a part of directors' duties in each Member State. In most instances, what is required is that the directors provide a report on these issues and do not consider those issues as material to their activity, and they do not have to consult with any stakeholders, let alone civil society organisations. There are also usually no direct sanctions against the directors for failure to act on this report, though the company can be held to account in some limited instances.[31]

Indeed, the Commission was critical of the lack of ability to bring directors to account:

*Though [national] company laws in essence require corporate boards to act in the interest of the company as a whole, the company interest and directors duties are interpreted narrowly favouring maximisation of short-term financial value. Shareholder pressure also plays a role as well as directors' remuneration linked to financial performance. This market failure has been facilitated by shortcomings in corporate legislation and governance codes as they foster directors' accountability towards shareholders and do not sufficiently cover the interest of other stakeholders, including those affected by the company and the local and global environment.**[32]***

The CSDDD does not go this far, not least as the Commission was limited in its proposal by the EU's Regulatory Board.[33] This is despite some provisions in the German Supply Chain Due Diligence Act, which create explicit sustainability obligations on directors.[34]

Article 25 merely provides that the directors should '*take into account*' the consequences of their decisions on human rights, climate change and the environment, and have '*due consideration*' of stakeholder's views, in order to '*adapt the corporate strategy*'. These could be seen very weak as requirements. For example, if the board of directors receives a report on these aspects, then they can take account of them by deciding that they are not relevant and refuse to take any positive action.

However, the major differences between the CSDDD and the NFRD – other than the important express addition of climate change (discussed below) – is that there are now clear actions which the directors – as part of their duty of acting in the best interest of the company – must undertake and thus must take into account. These include putting in place appropriate policies, human rights and environmental due diligence, evaluating these matters as risks, and having monitoring systems and complaints procedures. The directors must '*take steps*', which, though a vague term, does require some action and so they cannot be passive or ignore it. This is despite the strong evidence of the risks to a company if directors ignore human rights and environmental impacts.[35]

In our opinion, changes are needed to the CSDD to turns the directors' duties to act in the best interest of the company from simple reporting with no effective consequences, into requiring them to ensure that appropriate human rights and environmental due diligence processes are in place, and that the directors provide full oversight and advice to the management of the company about them. These all contain some objective elements and are not based purely on the directors' subjective views, and so are able to be examined by the supervisory bodies to see if they have taken this action, so are not solely a subjective judgement. This could increase the accountability of both the senior management and the directors of the companies covered by the CSDDD.

Accountability

This link of accountability would be enhanced if the CSDDD was clearer in requiring directors to be responsible for the approval of the management strategies to respond to human rights, environmental and climate change matters. These would be medium-term and long-term (even inter-generational), as too few companies are concerned beyond the short-term, as seen in the responses to the Covid pandemic with the widescale actions to cut supply chains with dramatic effects on workers in the Global South. This is where the consultations with all stakeholders – which must include trade unions, women and those

with disabilities – could be important and needs to be made stronger and not optional. A requirement for there to be relevant expertise on a board would also assist this. The need for this expertise has been shown by the responses to the armed conflict in Ukraine and in many other situations worldwide, where human rights matters were not raised directly by companies.

It is at this point that new personal sanctions against directors could be effective, such as fines and banning from corporate roles. This would be even more effective if there were some remuneration consequences, as for climate change and, possibly, no insurance to cover director's liability in relation to sustainability matters.[36] These incentives will increase if each director's renumeration is linked to clear metrics which include climate change and other environmental, social and governance (ESG) matters.

Above all, the inclusion of directors' duties in the CSDDD is an acknowledgement that, for there to be effective changes in corporate practices and governance behaviour in relation to the human rights, environmental and climate change impacts of their activities, there needs to be reform of company law. While the changes shown by the CSDDD (for which some companies may lobby to reduce and other companies will be pleased about) are important, some deeper requirements in terms of corporate sustainability governance would be valuable.

Climate Change

The CSDDD also has an additional innovation, mentioned above, which is to include climate change impacts in its provisions. Article 15 provides:

1. *Member States shall ensure that companies referred to in Article 2(1), point (a), and Article 2(2), point (a), shall adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 ºC in line with the Paris Agreement. This plan shall, in particular, identify, on the basis of information reasonably available to the company, the extent to which climate change is a risk for, or an impact of, the company's operations.*
2. *Member States shall ensure that, in case climate change is or should have been identified as a principal risk for, or a principal impact of, the company's operations, the company includes emission reduction objectives in its plan.*
3. *Member States shall ensure that companies duly take into account the fulfilment of the obligations referred to in paragraphs 1 and 2 when setting variable remuneration, if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability.*

Including climate change in the CSDDD is appropriate, as its impacts are inextricably linked to environmental and human rights impacts, and there is increasing demand for more corporate action on climate change.[37]

Due Diligence

The application of due diligence to identify and address corporate climate change impacts has been widely recognised.[38] However, the CSDDD excludes climate change impacts from the due diligence provisions and – as confirmed by Article 29[39] – instead, only requires companies to put in place a climate transition plan, as set out in Article 15. In contrast to companies' due diligence policies, which need to be updated annually under the CSDDD, the CSDDD does not seem to require companies to implement or update their climate change transition plan, thus making it look like a " tick-box" exercise.

One of the core aspects of due diligence, being to establish the relationship between a company's operations and actual or potential impacts, may seem challenging to translate to climate change.[40] This is because climate change is the result of cumulative action by millions of enterprises over many years, and its impacts affect millions of people in direct and indirect ways. [41] Yet, there are a range of tools which have been specifically

developed to measure emissions, especially of greenhouse gasses (GHG) along companies' supply chains, including the Greenhouse Gas Protocol[42] and its well-established Scope 1, 2 and 3 methodology,[43] as well as CDPs' supply chain work.[44] In our opinion, there is sufficient evidence to justify including climate change as part of the due diligence requirements on companies.

It is also unclear how companies are expected to deal with climate change impacts that are linked to human rights and environmental impacts covered by the due diligence provisions in Articles 4-14 of the CSDDD. Are they within the due diligence requirements of Articles 4-14 or under the requirement to establish a climate change transition plan under Article 15? Further, as noted above, while specific civil liability provisions apply for breach of the due diligence provisions, the level of accountability of directors in regard to climate impacts seems very limited.

Transition Plan

While Article 15 requires companies to adopt a transition plan in relation to climate change risks, there is no detail as to what that plan should contain, or whether, how, and by when, the company should implement it, including emission reductions. In contrast, the due diligence provisions applying to human rights and environmental impacts include (in Article 4) an obligation of "bringing actual adverse impacts to an end and minimising their extent". It is also not clear who determines if climate change is a "principal" risk as there is no benchmarking provided, or whether it is to include Scope 1, 2 and 3 emissions.

Further, while it makes sense to expect a company to include emission reductions in its transition plan if climate change is a principal *impact* of its operations, it is puzzling to require companies to plan emission reductions if climate change is a principal *risk for* the company. The impacts of climate change are a risk for all companies, including those that are currently zero emitters. Therefore, the CSDDD should require companies to indicate emission reductions and also to indicate any measures put in place to adapt to climate change. Overall, it is not clear how this approach is meant to contribute effectively to achieving the EU's target to cut domestic net GHG emissions by at least 55% compared to 1990 levels by 2030.[45]

Alignment

The EU has been increasingly engaged in passing legislation on a range of matters related to climate change.[46] However, Article 15 is not fully aligned with provisions in other EU Directives aiming to address corporate impacts on sustainability, including climate change. For example, the proposed EU Corporate Sustainability Reporting Directive[47] addresses in much more detail corporate obligations related to a low carbon transition. In fact, the first paragraph of Article 15 of CSDDD is identical to Article 2 of the Directive on corporate sustainability reporting, but does not include the next aspect, which requires companies also to report on "any actions taken, and the result of such actions, to prevent, mitigate or remediate actual or potential adverse impacts."

This requirement for a company to go beyond reporting and to act is an important one. Reporting is not enough, nor should it become an end in itself.[48] It is essential to support it with regulation, including mandating companies to align emissions effectively with the goals of the Paris Agreement (which are not even included in the Annexes) and with the scientific evidence. In light of the gravity of the climate crisis, governments cannot rely on others, including investors, civil society, consumers, etc., to use reported information to put pressure on companies. The latest IPPC report highlights the importance of having strong climate governance in place, including laws that explicitly target mitigation.

Conclusions

We are pleased that the European Commission has included some new and important elements of business and human rights within the CSDDD, including on supervisory mechanisms, directors' duties and climate change. However, we consider that there are certain aspects of the draft which require revision in relation to these areas.

Our recommendations, based on our analysis above, are:

- Article 2(4) should be amended so that the relevant company link to a Member State is domicile and not registered office.
- Article 6 (2) should be clearer that enhanced due diligence is required in high-risk areas.
- Articles 4-14 should include on climate change as part of human rights and environmental due diligence.
- Article 15 (1) should be amended to require a transition plan in addition to including climate change in due diligence, and include an obligation to prevent, mitigate or remediate actual or potential adverse impacts, and minimising their extent as part of the transition plan, with clear targets, regular updates and annual reporting.
- Article 15(2) should replace "risk" with "impact".
- Article 17(3) should be amended so as not to allow companies which are not based in the EU to change their allocated supervisory authority.
- Articles 18(5) and 20(1) should include interim measures and also be clearer on enforcement in relation to companies domiciled outside the EU in connection with which seizure of non-compliant goods brought on the European Markets should be considered.
- Article 18 should have an additional section indicating that sanctions imposed by public supervisors should have consequences for public procurement, access to export credit, EU or Member State's subsidies, etc., and these may be included in civil enforcement if observations of the public prosecutor are made public.
- Article 18 should be amended to provide additional powers to a supervisory authority to be able to determine best practices within a sector, issue or area.
- Article 21 should be amended to allow an option to grant the EU supervisory entity the power to instruct national supervisors in connection with companies which have their domicile in multiple European states or regarding a specific human rights issue of interest to the EU as a whole.
- Article 25 should be amended to require directors to take clear steps, such as undertaking human rights and environmental due diligence, and not merely take into account the consequences of their decisions on human rights, climate change and the environment. This would also require directors to be responsible for the approval of the management strategies to respond to human rights, environmental and climate change matters.
- Article 26 (1) should be amended to make effective consultation (and not just "input") from stakeholders and civil society organisations – and expressly include trade unions – a mandatory part of directors' duties. In addition, directors should take into account relevant benchmarks and industry standards.
- Article 29(d) should be deleted.
- Recital 53 should make a clear preference to having one public supervisor in connection with human rights and environmental due diligence or, if not feasible, a national collaborative body in which relevant public supervisors participate and which has powers granted by law to exchange information on supervised entities.

[1] See recital 53 with the CSDDD. However, the Dutch Government indicates it is not clear what 'adequate resources' include. See the observations of the Dutch Government regarding the proposal, Parliamentary Documents, Second Chamber, 22 112, no. 3393, p. 9, accessible at https://www.legalintelligence.com/documents/38094198?srcfrm=comprehensive+search&alertId=157798.

[2] Shift, Enforcement of mandatory due diligence: key design considerations for administrative supervision, p. 9 and 13-15, which also mentions two other objectives, accessible at https://shiftproject.org/wp-content/uploads/2021/10/Enforcement-of-Mandatory-Due-Diligence_Shift_UN-Human-Rights_Policy-Paper-2.pdf. See also Robert McCorquodale and Martijn Scheltema, Core Elements of an EU Regulation on Mandatory

Human Rights and Environmental Due Diligence, p. 25 and 26, accessible at https://media.business-humanrights.org/media/documents/94663bf5d5e81b55fa716bc9c31bd0293513ba61.pdf.

[3] Cf. Shift, Enforcement of mandatory due diligence, p. 19.

[4] Robert McCorquodale and Martijn Scheltema, Core Elements of an EU Regulation on Mandatory Human Rights and Environmental Due Diligence, p. 25.

[5] Robert McCorquodale and Martijn Scheltema, Core Elements of an EU Regulation on Mandatory Human Rights and Environmental Due Diligence, p. 24 and 25.

[6] Cf. article 19 and recital 53.

[7] This is, for example, possible for US Customs at the US border under section 307 of the U.S. Tariff Act (19 U.S.C. §1307) in cases of suspicion of goods being produced using forced labour. See on this e.g. The Human Trafficking Legal Center, Importing Freedom, accessible at https://htlegalcenter.org/wp-content/uploads/Importing-Freedom-Using-the-U.S.-Tariff-Act-to-Combat-Forced-Labor-in-Supply-Chains_FINAL.pdf. See also the proposal by the European Commission to implement such a measure in connection with forced and child labour. See the Communication on decent work worldwide COM(2022) 66 final.

[8] Cf. the observations of the Dutch Government regarding the CSDDD, Parliamentary Documents, Second Chamber, 22 112, no. 3393, p. 5.

[9] Directive 2004/35/EU.

[10] See e.g. Cees van Dam and Martijn Scheltema, Options for enforceable IRBC instruments (report for the Dutch government), p. 101 and 102, accessible at https://media.business-humanrights.org/media/documents/Options_for_enforceable_mechanisms.pdf.

[11] Robert McCorquodale and Martijn Scheltema, Core Elements of an EU Regulation on Mandatory Human Rights and Environmental Due Diligence, p. 25.

[12] See the observations of the Dutch Government regarding the CSDDD, Parliamentary Documents, Second Chamber, 22 112, no. 3393, p. 9.

[13] Cf. the observations of the Dutch Government regarding the CSDDD, Parliamentary Documents, Second Chamber, 22 112, no. 3393, p. 8 and 9.

[14] Robert McCorquodale and Martijn Scheltema, Core Elements of an EU Regulation on Mandatory Human Rights and Environmental Due Diligence, p. 20.

[15] Robert McCorquodale and Martijn Scheltema, Core Elements of an EU Regulation on Mandatory Human Rights and Environmental Due Diligence, p. 20.

[16] Cf. Non-paper of the Dutch Government to the EU, Mandatory due diligence: Building blocks for effective and ambitious European due diligence legislation, p. 2, accessible at https://www.business-humanrights.org/en/latest-news/netherlands-government-publishes-non-paper-outlining-dutch-position-on-eu-mandatory-due-diligence/; . the observations of the Dutch Government regarding the CSDDD, Parliamentary Documents, Second Chamber, 22 112, no. 3393, p. 9; Shift, Enforcement of mandatory due diligence, p. 9 and 16-18.

[17] Robert McCorquodale and Martijn Scheltema, Core Elements of an EU Regulation on Mandatory Human Rights and Environmental Due Diligence, p. 25 and 26.

[18] See Cees van Dam and Martijn Scheltema, Options for enforceable IRBC instruments (report for the Dutch government), p. 110-118.

[19] These six steps include developing a policy and embedding it in management systems,

conducting a risk assessment in the company's operations including its value chains, preventing, ceasing and/or mitigating (potential) risks identified, tracking result, reporting about it and providing remedy when the company has caused or contributed to a human rights or environmental impact.

[20] This is for example implemented in connection with the compliance with the Dutch corporate governance code by the board of companies in Article 2:391 section 5 of the Dutch Civil Code.

[21] Robert McCorquodale and Martijn Scheltema, Core Elements of an EU Regulation on Mandatory Human Rights and Environmental Due Diligence, p. 26.

[22] Robert McCorquodale and Martijn Scheltema, Core Elements of an EU Regulation on Mandatory Human Rights and Environmental Due Diligence, p. 26 and 27.

[23] Cees van Dam and Martijn Scheltema, Options for enforceable IRBC instruments (report for the Dutch government), p. 110-118.

[24] See also Shift, Enforcement of mandatory due diligence, p. 10 and 11.

[25] Ibid, p. 11.

[26] Ibid.

[27] This approval by the Central Bank is, for example, necessary in the Netherlands. See https://www.dnb.nl/en/reliable-financial-sector/our-assessment-of-management-and-supervisory-board-members/.

[28] 191206-KF – NED report 2019 – LR SPREAD mail.pdf (kornferry.com).

[29] See, for example, the Netherlands Civil Code 1992, Articles 2:344–2:359.

[30] For a fuller discussion see Robert McCorquodale and Stuart Neely, Director's Duties and Human Rights: A Comparative Approach' (2022) *Journal of Corporate Legal Studies.*

[31] See, for example, the courts approach to company's reports in *Vedanta v Lungowe* and *Milieudefensie v Shell*.

[32] EU Initiative on Sustainable Corporate Governance, Ref. Ares(2020)4034032 – 30/07/2020 .

[33] See Explanatory Memorandum p.22. See also the negative reaction to the CSDDD by Steen Thomsen, 'Sustainable Corporate Governance and the Rod to Stagnation' (2022) OBLB.

[34] German Supply Chain Due Diligence Act 2021(*Gesetz über die unternehmerischen Sorgfaltspflichten in Lieferketten*), especially Article 25. See further, Nikolaus Manthey, Moritz Rojec and Daniel Schönfelder, 'Stakeholder Capitalism *Ante Portas*? ESG Directors' Duties & Mandatory Human Rights Due Diligence Developments in the EU and Germany' Nova Centre on Business, Human Rights and the Environment Blog, 13th May 2022.

[35] See John Morrison, Phil Bloomer and Johannes Blankenbach, 'Human Rights Due Diligence and Corporate Boards: Reflections on European Commission Proposals Relating to Director Duties and Board Oversight' (2022) Institute for Human Rights and Business.

[36] See Sanghak Choi and Hail Jung, 'Effects of the Litigation Risk Coverage on Corporate Social Responsibility'(2021) 28 Applied Economics Letters 1836, which indicates that greater liability in the absence of insurance may lead to directors taking more account of human rights and environmental impacts.

[37] There is a vast literature exploring the close links between climate change and human rights. See, for example, Alan Boyle, (2018), *Climate Change, the Paris Agreement and Human Rights*, 67 *International & Comparative Law Quarterly* 759. Our sincere thanks to Cristina Tebar Less for sharing her insights and drafts for the climate change section.

[38] See, for example Ivano Alogna and Lise Smit, 'Human Rights Due Diligence for Climate Change Impacts' (2021) BIICL, and Chiara Macchi, 'The Climate Change Dimensions of Business and Human Rights' (2021) 6 *Business and Human Rights Journal* 93.

[39] Article 29 provides for a report on the effectiveness of the Directive to be produced 7 years after its entry into force, including on whether Articles 4-14 should be extended to climate impacts.

[40] See OHCHR, Frequently Asked Questions on the UN Guiding Principles on Business and Human Rights, p. 31 and OECD Due Diligence Guidance for Responsible Business Conduct, p. 70.

[41] Cf according to the 2017 Carbon Major report by CDP, 100 companies are responsible for 71% of GHG emissions. See also the Carbon Majors Database by the Climate Accountability Institute.

[42] Greenhouse Gas Protocol | (ghgprotocol.org).

[43] Scope 1 is a company's direct emissions, Scope 2 are a company's indirect emissions, including those related to its energy use, and scope 3 are all other emissions, including those generated through its value chain.

[44] See CDP, Supply chain – CDP. There are also tools available to help companies design meaningful emission reduction targets aligned with scientific evidence, such as the Science-based Targets initiative.

[45] Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ('European Climate Law').

[46] Ibid.

[47] EUR-Lex – 52021PC0189 – EN – EUR-Lex (europa.eu)

[48] Kenneth Pucker, 'Overselling Sustainability Reporting' (2021) *Harvard Business Review*, Overselling Sustainability Reporting (hbr.org).

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