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Stakeholder capitalism ante portas? ESG directors' duties & mandatory human rights due diligence developments in the EU and Germany

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Abstract

Shareholder value theory proclaims that, when companies serve their own interest, everyone's interests are served best in a market system. Modern corporate law was built around that notion, with a focus on directors' duties to ensure corporate profitability that can be enforced by shareholders. Based on the analysis that this sets a disincentive that allows for externalization of social and environmental costs, new ESG legislation is changing that, putting stakeholder governance obligations at a central place in companies. We analyze two very relevant developments that are currently recoding the code of capital and could possibly provide important steps in the transformation to stakeholder capitalism: The German supply chain due diligence act (GSCDDA – *Gesetz über die unternehmerischen Sorgfaltspflichten in Lieferketten*) and EU Commission`s proposal for a directive on the corporate sustainability due diligence (CSDDD) have wide ranging implications for directors' duties on ESG and for directors' pay. Some companies are already using human

rights KPI when determining variable board pay. Leading examples of companies using human rights KPI in board pay already now are Unilever and Inditex. They were among 8 of 196 in the CHRB report for 2019 that scored the full 2 of 2 points on board pay, because they fulfilled CHRB`s 2019 criteria to set incentives for at least one board member related to at least one key industry risk and made this public. Only 30 out of the 196 companies reviewed achieved any points on this issue. According to their latest ESG-Conference, Mercedes-Benz-Group aims to "integrate ESG criteria in corporate governance" and board pay. From 2022, Mercedes Benz Group is linking parts of board pay to the achievement of transformation targets such as human-rights targets, CO2 emissions and ESG stakeholder engagement.

1. Status quo ante

a. Directors' duties to produce profits – incentives vs. ESG?

Before GSCDDA and CSDDD laws, corporate directors faced legal constraints when focusing on ESG. In Germany, Directors are generally obliged to produce profits for shareholders, as established by German stock corporation act (Ensuring that a company and possibly its suppliers comply with ESG aspects as diverse as paying living wages, prohibition of child labor or addressing climate change requires financial investments. Therefore, corporate directors may be forced, to defend themselves against possible shareholder claims be able to show that these investments are, under the Business Judgement Rule (BJR – Sec. 93 Subsec. 1 Sentence 2 GSCA and Sec. 43 Subsec. 1 LLCA), reasonable and might deliver future profits. If not, they might be liable for respective damages. There is no clarity on the question if and which ESG investments are profitable for companies. A compelling business case for investing in human rights is made by Blackrock`s Human Rights Strategy, possibly to shield the company`s human rights related activities against claims by investors that might argue that human rights are not material to their business. The arguments in favour of a business case for human rights seem to be strong enough to justify investments under the BJR. But legal uncertainty and thus disincentives to invest in ESG remain prior to ESG laws.

b. Board pay and ESG – Sec. 87 GSCA

Sec. 87 Subsec. 1 Sentence 2 GSCA establishes the obligation for German stock corporations (*Aktiengesellschaften*) that are listed on the stock exchange (*börsennotiert*) to structure board pay in a way that contributes to sustainability and a long-term business development. The legislator specifically clarified that this means social and ecological sustainability. However, the legislator did neither define the concept of sustainability further nor provide specific criteria that would need to be implemented, leaving this to every individual company.

The board pay system (*Vergütungssystem*) to be implemented is subject to an approval by the general meeting (*Hauptversammlung*) of the respective German stock corporation (Sec. 120a Subsec. 1 GSCA). In the event such approval is not granted, a revised board pay system has to be presented at the following ordinary general meeting at the latest (Sec. 120a Subsec. 4 GSCA).

***2. Status quo* as of 2023 – GSCDDA**

a. Directors' duties to produce profits – but legality obligations to fulfill GSCDDA and ESG factors

The GSCDDA changes the context of legal uncertainty concerning ESG investments. As, from 2023 on, certain companies will be obliged to fulfill the specific ESG obligations the GSCDDA calls for, the hurdles of argumentation to invest in ESG shrink. Boards are obliged by legality obligations to fulfill the GSCDDA. The obligation to act in the best interest of the company to provide profits for shareholders can therefore not be used anymore in possible investors` claims against boards that invest to fulfill such obligations. The GSCDDA provides a safe harbour for boards and firms to invest in the risk management systems that address the aspects covered. Uncertainty remains for other ESG aspects, such as climate or biodiversity, that are not covered by the GSCDDA. However, current climate litigation against companies (see Shell Case in NL and RWE case in Germany) might call for corresponding legality obligations for boards or, because of reputational and process risks implied, at least provide more arguments to justify climate in the BJR. Boards of companies that are not covered by the GSCDDA face more restraints when thinking about ESG investments. Nevertheless, if they are possible suppliers for companies covered by the GSCDDA or want to maintain access to financial means provided by actors that sell financial products under EU Taxonomy criteria, there are strong arguments for them to justify ESG investments under the BJR.

b. ESG board pay revised – Sec 87 GSCA in light of GSCDDA

The obligation in Sec. 87 Subsec. 2 Sentence 2 of the GSCA to link variable components of board pay to sustainability indicators has to be reread in light of the obligations the GSCDDA puts on certain companies. Prior to the GSCDDA, the legislator left it to companies to decide which sustainability criteria they referred to. This has changed. Now, Art. 2 Subsec. 2 and 3 GSCDDA`s catalogue of human rights and environmental risks shows which sustainability criteria the German legislator has deemed especially important for companies. Companies that fall both under the scope of Sec. 87 of the GSCA and the GSCDDA therefore must take into account at least the sustainability aspects covered by the GSCDDA. The legal situation gives them a certain scope of flexibility when deciding which exact criteria to use. Indicators that focus on the management of salient/prioritized risks under Sec. 5 Subsec. 2 GSCDDA and on addressing violations that occur should, because of the risk-based approach of the GSCDDA, play an important role. Setting indicators that do not take the salient risks and violations into account might be a disincentive to focus on the most urgent situations and therefore create legal and reputational risks. The current CHRB Methodology, A.2.3 Score 1 suggests linking board pay to at least one salient risk and including stakeholder views in the design of the concrete indicator used.

3. *De lege ferenda* – the CSDDD

a. ESG directors' duties in Art. 25 CSDDD

Art. 25 CSDDD establishes explicit ESG obligations for company directors, stating that "*the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences*" are to be taken into account. Formally, this is an addition to the legality obligation to ensure compliance with the CSDDD that is automatically created by the new obligations for the company. Materially, it is not clear how much further this obligation really goes. It can be presumed that, as the CSDDD and it`s Annex, Part I and II define human rights and environmental impacts, these definitions apply for the terms "human rights" and "environmental consequences". The same is implied for climate change, where Art. 15 CSDDD defines specific obligations. However, with the reference to sustainability matters in general, the scope seems to be widened further. This might imply an obligation to take into account SDGs and SDG indicators when taking decisions, as the SDGs as the global comprehensive document on sustainability are specifically mentioned in the CSDDD`s explanatory Memorandum, No. 1. Another question raised by its Art. 25 is the question of enforcement. It seems clear that Art. 25 CSDDD would, for companies covered, solve the questions of disincentive against sustainability completely, as the new director`s duties provide a complete safe harbour to pursue ESG goals.

However, Art. 25 Subsec. 2 CSDD leaves the enforcement of these new obligations to member state law. Whereas in a German limited liability company (*Gesellschaft mit beschränkter Haftung – GmbH*) the conduct of its managing directors (*Geschäftsführer*) can be directed comprehensively by respective instructions of the shareholders, the board of a German stock corporation is not subject to any instructions of the general meeting (*Hauptversammlung*), i.e. the entirety of the stockholders, or the supervisory board (*Aufsichtsrat*). Rather, according to Sec. 76 Subsec. 1 of the GSCA, the board manages the affairs of German stock corporation on its own responsibility. For the new ESG directors' duties, this means that they can be enforced in the German limited liability company by way of respective shareholders' instructions, but in the German stock corporation, on the other hand, such direct private enforcement cannot be taken into consideration. Hence, there is also no legal basis for the general meeting or the supervisory board to take legal action against the board in this respect, namely, to sue for compliance with ESG obligations. Rather, the general meeting and the supervisory board of the German stock corporation are only able to react after a breach of legally binding ESG obligations – including Art. 25 CSDD –, as such behaviour would constitute a breach of the duty of legality (*Legalitätspflicht*) pursuant to Sec. 93 Subsec. 1 Sentence 1 GSCA. In particular, a removal from office (*Abberufung*) pursuant to Sec. 84 Subsec. 4 GSCA can be taken into consideration as well as a personal liability of the board members (Sec. 93 Subsec. 1 Sentence 2 GSCA). However, a removal from office requires for a good cause (*wichtiger Grund*), which may only be assumed in the case of a material breach of ESG obligations. Moreover, a personal liability requires for a damage caused by the non-compliance with ESG obligations. However, in this respect, especially in case of material breaches of ESG obligations, it is conceivable that losses of profit could be claimed as a result of damages in corporate reputation. Therefore, in a German stock corporation the stockholders must rely on the board to comply with ESG obligations in the face of these sanctions.

b. Board pay revised 2.0. – linking board pay to climate goals (Art. 15 CSDD)

The CSDDD also addresses the question of board pay. Art. 15 calls for companies covered by the CSDDD to adopt carbon reduction plans in light with the 1,5 C goal set by the so-called Paris Agreement, including, if climate change is a "principal" "risk" or "impact" of the company, concrete reduction objectives. Art. 15 Subsec. 3 CSDD adds the obligation to take the fulfillment of this plan into account in variable board pay. This new obligation does not raise the question if existing obligations in member states law to link board pay to sustainability or human rights need to be interpreted differently, as Art. 1 Subsec. 3 CSDDD states that member states law can establish further obligations. It merely creates the obligation to take climate into account as an additional factor. The new obligation does, however, not provide guidance on when climate change should be considered as a "principal" risk. As for enforcement, Art. 17 Subsec. 1 CSDD clearly establishes the mandate and obligation for member states to enforce the climate obligations under Art. 15 Subsec. 1 and 2 CSDD, but leaves out an enforcement mandates for Art. 15 Subsec. 3 CSDD. If and how member states enforce the obligation to comply with the new rules on board pay is therefore left to them.

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