Good Intention, but a Bad Approach

February 16, 2023

The Proposal to Reform Directors' Duties under Article 25 of the Corporate Sustainability Due Diligence Directive

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The European Commission's (EC) Sustainable Corporate Governance Initiative aims at '*fostering more sustainable corporate governance and contributing to more accountability for companies' sustainable value creation*'. The EC commissioned the auditing firm Ernst & Young (EY) to conduct a study outlining options for a possible future EU-wide action in the area of corporate law and governance, which resulted in a report in July 2020 (EY Report). Drawing upon the report, the EC has introduced new corporate governance requirements in the Proposal for a Directive on Corporate Sustainability Due Diligence (CSDDD or Commission Proposal) published in February 2022. Article 25 of the draft clarifies that directors, under their duty of care, must account for sustainability matters when pursuing the best interests of the company. Article25 reads as follows:

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.*

This proposition has been met with huge criticism. While the EC proposed to reform the scope of directors' duties, the Council of the European Union, in its General Approach to the CSDDD, recommends the deletion of Article 25.

This blog post discusses (1) the role and importance of directors' duties as a tool to harness sustainable corporate governance; (2) the drawbacks of the current formulation of Article 25 in the Commission Proposal; and (3) the issues that may arise when enforcing Article 25 within the EU. I argue that a future CSDDD should include a provision detailing directors' duties to consider stakeholders' interests, with modifications to Article 25 as it stands. Furthermore, the final CSDDD should provide for effective enforcement of a revised Article 25, if the EU desires that corporations meaningfully engage with non-shareholder constituencies such as creditors, employees, the environment, and the community at large (stakeholders) in corporate decision-making.

Role and Importance of Directors' Duties

Under corporate law, directors owe a fiduciary duty to promote the interests of the company. Directors' duties have been an integral part of global corporate governance frameworks. I advance a couple of arguments on why directors' duties considering stakeholders' interests are an appropriate tool to make corporations more 'sustainable'. First, from an agency-problem perspective, directors' duties have been used as a tool to contain externalities against stakeholders. In the *ex-ante* sense, they refrain directors from acting opportunistically and penalise directors *ex-post* for breaches.

Second, most litigations against corporations, for instance regarding climate change, have had to take the route of tort law to pin responsibility on directors – a process that is arduous and less effective. Various legal scholars and academics, under the aegis of the Commonwealth Climate and Law Initiative, have issued legal opinions stating that climate change-related risks may enhance directors' liability in major jurisdictions. They envisage that it is only about time that directors' duties consider stakeholders' interests as we will see more litigation by pro-stakeholder shareholders (see, for instance, the recent litigation initiated by ClientEarth against Shell). Having a clear codification of directors' duties to consider stakeholders' interests would provide pro-stakeholder shareholders a less restrictive option to hold companies accountable. Third, effective enforcement of directors' duties would provide better linkages to other sustainability-enhancing mechanisms such as ESG, human rights and environmental due diligence (HREDD), and sustainability reporting (SR), among others. Violations of these mechanisms may provide a ground to argue a breach of directors' duties. Such a situation would make directors more vigilant. Fourth, enforcing directors' duties would also make directors more accountable and limit greenwashing. Furthermore, an enforcement mechanism would put in place certain procedural safeguards such that stakeholders do not misuse the enforcement procedures.

Fifth, external regulation that aims to protect the interests of stakeholders, such as consumer protection law, insolvency law, labour law, environmental law, and financial regulation among others, will not be effective until corporate law (internal regulation) integrates stakeholders' interests in corporate decision-making. Directors' duties aim to provide for this synergy between internal and external regulation. Sixth, the magnitude of corporate fraud in the EU requires that directors take full responsibility. The Dieselgate scam and the Wirecard fraud clearly outline the need to provide for the enforcement of directors' duties. Armour, a leading corporate law scholar, had suggested public enforcement of directors' duties in the case of the Dieselgate fraud where Volkswagen systematically exploited external regulation.

Lastly, disclosures and reporting requirements have mostly been reduced to a 'tick-box' exercise and the monetary penalties have been absorbed as *'costs of business'*. Monetary sanctions have not been able to deter corporate managers from committing serious violations harming stakeholders. Thus, I argue that it would be naïve to discredit the role and importance of directors' duties in contemporary times.

The Drawbacks of Article 25: Proposals for Reform

The EY Report noted that while all jurisdictions have defined the core duties of the board of directors, there is ambiguity surrounding the term 'interests of the company'. It is often interpreted as being in the interests of shareholders. The Commission Proposal aims to clarify this position. Furthermore, it seeks to harmonise this interpretation across Member States such that companies do not resort to 'forum shopping' and thereby disturb the internal EU market. This goal, by itself, is crucial for creating a more stakeholder-oriented legal framework among the EU Member States. It needs to be borne in mind that the Member States cannot claim to be effectively protecting stakeholders' interests unless their company laws remain shareholder centric. Such dichotomy of allegedly robust external regulation with shareholder-centric company law and enforcement produces undesired results, which are not in the interests of stakeholders.

There is an overwhelming majority of academic and policy scholarship claiming that Article25 will do no good (see, OBLB Series on the EY Report and the CSDDD). The Council of the European Union in its General Approach to the CSDDD deleted Article 25 citing ' *strong concerns expressed by Member States*' as it will be an ' *inappropriate interference with national provisions'* which may be '*potentially undermining directors'* duty to act in the best interests of the company' (para. 31). This is not a well-substantiated criticism in any sense (see also, Bonheur Minzoto, for more details). However, for reasons argued above, it is worth examining whether the Article 25, as proposed by the Commission, has scope for improvement.

The current formulation of Article 25 has four controversial limbs – first, the term 'take into account' is not strong enough such that a breach can be enforced. The rapporteur of the European Parliament on the legislative procedure concerning a CSDDD, Lara Wolters, hence recommends in her report to amend Article 25 – suggesting to use *'evaluate and address'* instead of 'take into account'. While the proposed wording is stronger than the current formulation of Article 25, a joint reading of the proposed formulation in her report neither inspires confidence. The proposed term does not have any legislative or jurisprudential history either.

Second, Article 25 does not adopt an approach of mentioning stakeholders, collectively or in terms of individual categorisation and with or without hierarchy. Instead, it delineates a very general classification – 'sustainability matters' for the consideration of the directors of the company. Furthermore, the language in Article 25 makes this vague classification of sustainability matters non-exhaustive by stating that such matters include 'human rights, climate change, and environmental consequences'. This is problematic as the contours of 'sustainability matters' are neither defined nor explored in the context of legal and jurisprudential traditions of EU Member States. The term 'human rights' has also different connotations as individual countries both within and outside the EU attach different meanings to it. Lara Wolters, in her report, proposes to insert the term 'good governance' in the list of matters with an undefined scope in Article 25 of the CSDDD. This may increase the remit of Article 25, but at the grave cost of clarity.

Third, the language of Article 25 is not clear enough to signify a choice of model concerning stakeholder governance – an enlightened shareholder value (ESV) model (where shareholder interests have more prominence in comparison to interests of other stakeholders (as in the UK)) or the pluralist model (which has no hierarchy within stakeholder constituencies (as in India)). The high-level option (as formulated on page 51 of the EY Report) provides an alternative formulation – that when acting in the interests of the company, 'directors should properly balance the following interests, alongside the interest of shareholders: long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large'. Article 25 does not mention any stakeholder constituencies but instead relies on broad concepts. Such confusion of language and approach could serve as potential roadblocks to effective enforcement. Fourth, it is assumed that consideration of the long-term interests of the company leads to consideration of stakeholders' interests as a whole. Article 25 of the Commission Proposal, in a last bid to clarify this position, has entangled itself in the debate of short-termism v. long-termism, which may be unwarranted as directors' duties to consider stakeholders' interests must be adhered to, irrespective of the time horizon.

Lastly, the applicability of Article 25 is contingent on the personal scope of a future CSDDD (see Article 2 of the Commission Proposal for details on which companies are covered). Distinguishing between corporations that are or are *not* covered by the directive will not create a level-playing field for all companies, insofar as the directors' duties to consider stakeholders' interests and their enforcement are concerned. There is no doubt that Article 25 needs major amendments, but deletion of Article 25 from the final version of the CSDDD will be a huge setback for all stakeholders.

Enforcement of Directors' Duties to Consider Stakeholders' Interests: The Challenges

To give more teeth to the proposal on directors' duties, the EY Report suggests that stakeholders (excluding shareholders) must be empowered to bring lawsuits against directors for alleged violations of the duty of care and loyalty. However, the Commission Proposal does not directly allude to this recommendation. It does not seem to provide any private enforcement options exercised by either shareholders or stakeholders. Furthermore, shareholders may be able to enforce directors' duties to an extent but the UK ESV model under Section 172, Companies Act, 2006 has also seen limited success. Article25(2) defers it to the best judgement of the EU Member States to 'ensure that their laws, regulations and administrative provisions providing for a breach of directors' duties apply also to the provisions of this Article'.

This choice of the Commission raises several issues. First, there is no discussion regarding procedural safeguards (which exist in the case of shareholder litigation) to avoid frivolous and vexatious litigation. Absent safeguards, litigation could lead to increased uncertainty for businesses. Second, stakeholders may not have enough information (particularly in the case of global conglomerates) to bring effective action against directors. This problem may amplify in case of human rights abuses by companies (Injustice Incorporated, 2018). Third, they may lack adequate incentives, face resource constraints, or suffer from collective action problems. Fourth, judges may not have adequate information or expertise to entertain such cases and may suffer from hindsight bias. A judicial evaluation will become more complex when businesses resort to 'innovative' or 'non-standardised' decisions (Spamann, 2016), as is likely to be the case in balancing stakeholders' interests. Fifth, over-aggressive enforcement of the duty of care could also stifle risk-taking (Blair and Stout, 2003).

The EY Report also proposes the establishment of a new regulator or strengthening the existing regulatory apparatus to bring proceedings against executive directors of companies that have caused serious harm to third parties or the environment. However, Article 25 of the draft CSDDD does not clearly mention that a public enforcement mechanism would be available for providing a remedy in case of a breach. Recital 53 of the proposal suggests that EU Member States may designate national authorities for enforcing the directive. However, given that it is not an operational part, and no specific mention to enforce Article 25 is provided, EU Member States may not be keen to amend their domestic legislation to this effect.

The EY Report and the CSDDD, to an extent, downplay the costs involved in setting up a new regulator or empowering an existing regulator to enforce directors' duties. This proposal is inspired by the Australian model, which provides for the public enforcement of directors' duties. However, the Commission Proposal does not discuss whether criminal and civil penalties for violations of directors' duties (as it is the case in Australia) will be provided. Most likely, this aspect may be left to national law. While the Australian model has been hailed for its effective enforcement (Jones and Welsh, 2012), the Australian securities regulator has been accused of negotiating outcomes (Hayne Royal Commission Final Report, 2019). Furthermore, Australian courts have applied criminal safeguards to the determination of civil penalties thereby leading to unsuccessful outcomes (Comino, 2014). An empirical study has also revealed that much lower penalties (as compared to the statutory maximum) have been imposed (Hedges, Bird, Gilligan, Godwin & Ramsay, 2016) against defendants for breach of directors' duties. The draft CSDDD also fails to recognise that institutional factors, such as the politics-business nexus, interference in the functioning of regulators, regulatory architecture, and corporate ownership structures among others, will play a crucial role in ensuring successful public enforcement of directors' duties. In addition, failure to lay down key contours of the enforcement of Article 25 at the EU level will do no good towards its goal to harmonise directors' duties across EU Member States. Companies will continue to resort to forum shopping.

Thomas A Edison had remarked, '*good intention, with a bad approach, often leads to a poor result*'. The proposed CSDDD depicts a noble conception of evolving ' *sustainable'* corporate governance practices, which is a welcome move. Article 25 yet needs to be re-formulated such that it adheres to either the ESV model or the pluralist model. A revised version of the CSDDD must also detail the modes of public and private enforcement and iron out substantial details, such as legal standing or the types of remedies (criminal and civil) for breach of directors' duties to consider stakeholders' interests. Most importantly, a revised Article 25 should apply to all companies, irrespective of their size and business sector. The current formulation of Article 25 in the Commission Proposal is marred by multiple shortcomings, which may lead to a 'poor result'.

Suggested citation: P. Pandya, 'Good Intention, but a Bad Approach: The Proposal to Reform Directors' Duties under Article 25 of the Corporate Sustainability Due Diligence Directive', Nova Centre on Business, Human Rights and the Environment Blog, 15th February 2023.