The EU's Corporate Sustainability Due Diligence Directive: An Excessively Diligent Proposal

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The recently-proposed Corporate Sustainability Due Diligence Directive (the 'Proposal') introduces environmental and human rights due diligence duties applicable to companies and their directors along the entire value chain. We argue that the Proposal is not well-calibrated in its content and effects and that the European Parliament and the Council should postpone the introduction of its many provisions on supervision, sanctions, enforcement, and liability.

The Proposal is the most prominent outcome of the debate on stakeholderism in the EU, and follows the publication in July 2020 of the Ernst & Young Study, which was subject to harsh critiques, including those of the European Company Law Experts Group and of some Harvard Professors, and the March 2021 resolution of the European Parliament, calling for the introduction of a corporate due diligence obligation.

In essence, the Proposal requires Member States to ensure that companies (i) integrate human rights and environmental due diligence into their policies, (ii) identify actual and potential adverse human rights and environmental impacts arising from their own operations, (iii) prevent and mitigate potential adverse impacts, and (iv) cease actual adverse impacts (Articles 5, 6, 7, 8). It also introduces an updated version of directors' duty of care, along the lines of Section 172(1) of the UK Companies Act 2006. In discharging their mandate to act in the best interest of the company, directors would now have to take into account the human rights, climate change, and environmental consequences of their decisions in the short, medium, and long term (Article 25).

The Proposal's critical points

While pushing towards more sustainable business models may seem a desirable policy objective, almost all the most salient aspects of the Proposal raise significant concerns.

First, the scope of application ends up being excessively broad. The Proposal applies directly only to larger companies. They are, however, entrusted with a demanding control over their value chain to ensure that their business partners (including SMEs) do not commit violations of the company's code of conduct. This inevitably makes compliance with the new obligations complex for the large companies (potentially, even non-European ones), while imposing indirectly significant burdens and costs on SMEs.

Second, the mechanism—the reference to the many international conventions listed in an annex to the Proposal—deployed to identify the negative impacts that the due diligence duties of companies and directors should deal with does not provide sufficient legal certainty. These conventions become thereby directly applicable to companies, and this inevitably makes the exact borders of the newly-conceived corporate due diligence fluid and uncertain (the climate change requirements of Article 15 provide a notable example of this hurdle).

Third, the amended duty of care imposed on directors is both ineffective and dangerous. Directors should 'take into account' the consequences of their decisions on a wide range of interests, but their underlying incentives (eg election and remuneration) remain fundamentally unchanged. It is hard to fathom why directors would care about the impact of their decisions on non-financial issues beyond what they may already be doing today: actually, evidence from the United States indicates that without incentives directors are unlikely to use their enhanced discretion to advance stakeholders' interests. Meanwhile, this duty of care would increase directors' insulation in a market where monitoring by non-controlling shareholders remains relatively difficult, despite regulatory efforts (such as those brought by the Shareholder Rights Directive II) to promote it and signals indicating at least some increase in the intensity of shareholder activism in Europe.

Equally troubling—and this brings us to our fourth concern—are the enforcement mechanisms. Member States shall:

- designate a supervisory authority (Article 17) with significant powers (Article 18);
- provide the (many) stakeholders in Article 9(2) with the right to submit complaints to the companies regarding adverse human rights and environmental impacts produced by the companies' own operations, those of their subsidiaries and of their value chain (Article 9); and
- ensure that any natural or legal person is entitled to submit substantiated concerns to supervisory authorities if a company fails to comply with the national provisions adopted pursuant to the Proposal (Article 19).

Some stakeholders (in the complaints procedure) or even all natural and legal persons (in the substantiated concerns) would then be able to hold directors accountable for violations of the provisions adopted pursuant to the Proposal, including the rather vague due diligence and duty of care imposed on companies and directors respectively. To complicate things even more, a breach of the former would make companies liable for damages (Article 22), while a violation of the latter would trigger the national laws' sanctions for the breach of directors' duties (Article 25 (2)). The resulting framework would inevitably create an environment in which at least some degree of companies' and directors' 'hyper-liability' is constantly in sight, which might ultimately produce a chilling effect even on that degree of risk-taking that might, from time to time, be economically desirable.

Looking Ahead

In sum, our feeling is that the Commission's desire to intervene immediately on issues (rightly) perceived as salient translated in an excessively ambitious proposal, not well-calibrated in its content and potential effects.

It is essential that the European co-legislators do not underestimate the excesses and consequences of the Proposal and rethink many of its provisions. For instance, it would at least be advisable to directly identify the negative impacts that generate sustainability obligations, to avoid that companies become prisoners of the complications and uncertainties of international conventions. Equally desirable would be to clarify the scope of the provisions on the value chain, to reduce burdens and liabilities for the companies (especially SMEs) involved.

Still, a mere fine-tuning of the text, however important, is insufficient. Rather than strengthening the Proposal as advocated by others, we believe that the European Parliament and the Council should adopt a proportionate approach and repeal, at least for now, the provisions of the Proposal on supervision (Articles 17, 18, and 21), sanctions (Article 20), enforcement (Articles 9 and 19), and liability (Articles 22 and 25(2)). Even without these provisions, the Proposal would be a significant step in establishing and regulating sustainability due diligence beyond what some corporate governance codes already do. The introduction of these provisions could then be suspended: after a first period of application of the Directive, which would also give companies and directors time to adapt to the new framework, the Commission could then assess whether these provisions (notably, those on enforcement) are truly indispensable. The report that evaluates the effectiveness of the Directive in reaching its objectives and that the Commission shall submit under Article 29 to the co-legislators no later than 7 years after the entry into force of the Directive would be a valuable opportunity to conduct this assessment.

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