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EUROPEAN COMMISSION INITIATIVE ON MANDATORY HUMAN RIGHTS DUE DILIGENCE AND DIRECTORS' DUTIES

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The European Green Deal sets out that "sustainability should be further embedded into the corporate framework, as many companies still focus too much on short-term financial performance compared to their long-term development and sustainability aspects." As part of the Green Deal initiative, the European Commission (EC) is considering adopting mandatory human rights and environmental due diligence requirements for certain companies, determined mainly by their size. The Commission is also exploring amending company directors' duties with the aim of lengthening the time horizon of corporate decision-making, and to ensure that it adequately addresses negative human rights and environmental risks posed by a company's own operations as well as well as well as throughout its supply chains.

I am on record in support of a mandatory due diligence requirement based on the UN Guiding Principles on Business and Human Rights (UNGPs), which the EC references as a model. However, I have three reservations about combining this with additional directors' duties in the same instrument: (1) directors are not the main driver of short-termism; (2) opposition to addressing directors' duties is substantial and may jeopardize the entire initiative; and (3) doing so may be largely unnecessary, because a properly constructed mandatory due diligence requirement itself will significantly change directors' duties in the desired direction. I elaborate these points below.

I. DIRECTORS' DUTIES

According to Guiding Principle 3, "States should enforce laws that are aimed at, or have the effect of, requiring business enterprises to respect human rights, and periodically to update the adequacy of such laws to address any gaps." It adds that States also should "ensure that other laws and policies governing the creation and ongoing operation of business enterprises, such as corporate law, do not constrain but enable business respect for human rights." This is what the EC is attempting to achieve by seeking to embed sustainability into the corporate governance framework while reducing short-termism in corporate policies and practices.

Thus, the UNGPs themselves provide good reasons periodically to reexamine corporate law in general and directors' duties specifically. However, directors' duties are not the root cause of short-termism.

Short-termism

If one imagines a causal chain that ends with corporate short-termism, the first link would not be directors. It is true that recent years have seen declines in business investment as well as increased shareholder payouts and executive as well as directors' compensation (coupled with wage stagnation). But directors are as much intermediaries in these trends as they are direct causes. Directors themselves are responding to investor pressure, especially from hedge funds, other so-called activist investors and private equity firms, whose primary interest is in obtaining short-term returns and then moving on. Investors elect directors. Only investors can bring derivative suits against the company and its directors for not acting in what they consider to be the best interest of the company. In the U.S., investors have consistently opposed so-called constituency statutes (also known as stakeholder statutes) and have worked to undermine them. Today, on average, the big indexers combined own more than a majority of the voting power of major public companies. The turn-over rate in portfolios held by asset managers has been getting shorter. Even union pension funds, university endowments and sovereign wealth funds have sought higher returns in riskier and shorter-term investments in order to meet their commitments to current and soon-to-be beneficiaries. There are numerous ways to penalize investor short-termism and encourage longer-term investments, including robust forms of variable taxation, unrelated to directors' duties. But, in the language of social science, directors are intervening variables in short-termism, not independent factors.

Permissibility

Furthermore, corporate law even now generally does not prevent directors from supporting making investments and developing policies for the longer term. Even under Delaware law, perhaps the jurisdiction more business friendly than most others (which is why more than half of major U.S. corporations are registered there), directors are largely protected by the so-called business judgment rule, whereby courts typically defer to the judgment of corporate executives acting provided that they are exercising their duty of care. The main contrary case (*Revlon v. MacAndrews,* 1986) ruled that once a firm is already on the auction block are directors required to adhere strictly to maximizing shareholder value. Moreover, explicitly adding words to corporate law to the effect that directors may take stakeholder concerns into account in the best long-term interest of the firm, such as exists in UK company law, has made little if any difference in practice. The same is true of the much-heralded 2008 *BCE vs. Debentureholders* ruling by the Supreme Court of Canada.

To underscore the point, when Paul Polman became CEO of Unilever, one of the world's largest consumer products company, he openly rejected what he called "the quarterly rat race," for which he blamed investors, not his board. Indeed, he urged shareholders to put their money somewhere else if they don't "buy into this [meaning his] long-term value-creation model, which is equitable, which is shared, which is sustainable."[1]

[1] Quoted in Andy Boynton, "Unilever's Paul Polman: CEOs Can't Be 'Slaves' To Shareholders," https://www.forbes.com/sites/andyboynton/2015/07/20/unilevers-paul-polman-ceos-cant-be-slaves-to-shareholders/?sh=2e649447561e.

II. RISKING OVEERREACH

The idea of mDD is not as controversial as it once might have been. One reason is that leading companies have had nearly a decade of exposure of working with the human rights due diligence provisions of the UNGPs, and many have appointed chief sustainability officers. Thus, when the EC indicated that it would issue an obligatory Directive on human rights and environmental due diligence it was welcomed by numerous companies and business associations as a way of bringing laggards along. The same is not true for amending directors' duties in any significant manner.

There are many reasons for this resistance. One is the fact just described—the belief (and fact) that directors' duties are not the root cause of the short-termism problem. Another may be self-interest; boards do very well financially under the current system. Some also argue that short-termism imposes a discipline on boards that would otherwise be lacking, that boards as well as management would become insulated from market pressures and would be free to follow their own whims without it.

But perhaps the most compelling reason has to do with the role and culture of corporate counsel, both in-house and external. Waitzer and Sarro have expressed this well: "This reflects the dual expectations placed on general counsel as managers of their internal legal departments and external counsel—that they will support business objectives identified *within* the company while helping to minimize legal risk."[2] As the law currently stands, the greatest litigation risk for breaches of fiduciary duties comes from shareholders and from securities laws that remain closely aligned with shareholder primacy. And the law in question has little to do with directors' duties.

Thus, opening up directors' duties is unlikely to be well received by the community of corporate counsel, which at the end of the day exercises considerably more power with companies and over securities law than chief sustainability officers, and when challenged frontally might well turn against the entire EC initiative.

III. MANDATORY DUE DILIGENCE & DIRECTORS' DUTIES

The construct of human rights due diligence (HRDD) in the UN Guiding Principles was deliberately adapted from other due diligence processes (legal, financial, technical) that are familiar to business – but with critical distinctions. One is that HRDD is not a transactional process, as for a new acquisition, partnership or investment, but an ongoing process. It must reflect the fact that human rights risks connected to a company's operations and value chain are themselves constantly changing, whether due to internal factors such as a new product development or evolving workforce composition, or due to external factors such as regulatory changes, moves into new markets, or unexpected occurrences in its operating environment. This both broadens and lengthens the horizon of company decision making.

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[2] Edward J. Waitzer & Douglas Sarro, "In Search of Things Past and Future: Judicial Activism and Corporate Purpose," *Osgoode Hall Law Journal*, 55 (Summer 2018), p. 804, italics added.

A second critical distinction lies in engagement with stakeholders. HRDD reflects the general categories – employees, suppliers, customers and communities – that are typically cited in reference to stakeholders other than shareholders. Yet it avoids the common critique that these categories are too expansive and the interests of their members too varied for executives to make sense of them in their deliberations. It is a distinct feature of HRDD that it does *not* attempt to identify general classes of stakeholders ex ante. Instead, it places the focus on and requires engagement specifically with those people (or their legitimate representatives) whose basic dignity and equality are at risk of harm from the ways in which a company does business. In other words, the relevant stakeholders are identified situationally, not in ex ante categorical terms. While HRDD can be included within broader enterprise risk management systems, it must go beyond simply identifying and managing material risks to the company itself, to include risks it poses to these affected stakeholders. This requires companies to internalize more of the costs of doing business that they previously imposed on stakeholders.

By making HRDD mandatory, with penalties for non-compliance as the EC intends, it becomes a legal responsibility not only for management but also for board oversight. In response to mandatory HRDD boards may need to add members with relevant subject matter expertise and/or appoint a cross-sectional advisory body. Neither is a hardship or without precedent. And neither poses the obstacles of unnecessarily addressing directors' duties head-on.

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