Corporate Sustainability Due Diligence and the New Boundaries of the Firms in the European Union

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Abstract

To support the policies provided by the Action Plan on Financing Sustainable Growth and the European Green Deal, an intense activity of revising and updating European rules applicable to the business sector has been undertaken. EU Institutions tried to achieve the shift toward an inclusive and sustainable economy mainly indirectly, through soft law or reporting requirements and regulation of financial markets. In 2020 the Commission launched complementary initiatives in the field of company law to tackle the problem from an *ex-ante* perspective and in February 2022, a proposal for a directive on Corporate Sustainability Due Diligence has been published. The core of the proposal is to foster sustainable and responsible corporate behavior throughout global value chain by providing a general due diligence duty for companies and directors, but it also includes other provisions linked to a broader sustainable corporate governance project. It provides obligations related to climate change targets and tries to harmonise some aspects of directors' fiduciary duties in European companies. After an analysis of the content of the proposal, this study stresses the emergence of a policy shift from self-regulation to statutes in the field of private procurement and the impact of sustainability on the boundaries of the firm.

Keywords

Value chain, corporate due diligence, sustainable corporate governance, climate change, director's duties, firm's boundaries, corporate civil liability, corporate sustainability reporting, sustainable growth, European company law

1. Introduction

Sustainable development has long been at the heart of the European project[1] and the call to drive the economy towards a more sustainable, inclusive and resilient model

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[1] The issue of sustainable development was included in the Maastricht Treaty of 7 February 1992 (see Article B), and in the Amsterdam Treaty of 2 October 1997 (see *e.g.*, amendment of Article B

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has been recently reiterated in *Next Generation Europe*, the recovery plan elaborated to tackle the crises generated by the SARS-CoV-2 pandemic.[2]

Even before 2015,[3] but even more so after, with the adoption of the UN 2030 Agenda for Sustainable Development (the '2030 Agenda') and its SDGs,[4] and the Paris Agreement on climate change,[5] the EU has been working extensively on strategies aimed at achieving their goals and targets.

Companies, as private sector actors, are recognised as an essential part of this path toward inclusive and sustainable economic growth but the achievement of those commitments requires changes to how companies produce and procure on one side, as well as changes able to unlock the power of private capital, channelling investments to support the transition to a sustainable economy.

To foster such transition, a clear European strategy and an effective legal framework ensuring a level playing field were necessary. Accordingly, among others,[6] the

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and Article 2, as well as the 'principle of integration' of environmental policies into all other Union policies of Article 6). Nowadays, the consolidated version of the Treaty on European Union (TEU), art. 3, paragraph 3, refers to a balanced and sustainable development of economic activities, while Article 11 of the consolidated version of the Treaty on the Functioning of the European Union (TFEU), recall the protection of the environment and the promotion of sustainable development. With regards to the business sector, from the early 2000s onwards, the EU recognised the UN Guiding Principles for Business and Human Rights and developed its Strategy on Corporate Social Responsibility (through, e.g., the Green Paper *Promoting A European Framework for Corporate Social Responsibility*, 18.7.2001, COM(2001) 366; the Commission Communication of 15 May 2001: *A Sustainable Europe for a Better World: A European Union Strategy for Sustainable Development*, COM(2001) 264; the Commission Communication of 13 December 2005 *On The Review of the Sustainable Development Strategy – A Platform for Action*, COM(2005) 658; the Commission Communication of 25 October 2011 on *A Renewed EU Strategy 2011-14 for Corporate Social Responsibility*, COM(2011) 681)).

[2] Commission Communication of 27 May 2020 *Europe's Moment: Repair and Prepare for the Next Generation*, COM(2020) 456.

[3] See e.g., *Europe 2020. A Strategy for Smart, Sustainable and Inclusive Growth,* Communication from the Commission, COM (2010) 2020, 3 March 2010.

[4] See A/RES/70/1, Transforming our world: the 2030 Agenda for Sustainable Development, launched by a UN Summit in New York on 25-27 September 2015. The affirmation of the commitments to the SDGs is expressed in the EU Commisson Communication of 22 November 2016, *Next Steps for a Sustainable European Future. European Action for Sustainability* (COM(2016) 739), which linked these goals to the Union policy framework to ensure that all Union actions and policy initiatives, both in and beyond the Union, take those goals on board at the outset. See also Council conclusions on *A Sustainable European Future: The EU Response to the 2030 Agenda for Sustainable Developmen*t, adopted by the Council at its 3552nd meeting held on 20 June 2017, according to which the Council confirmed the commitment of the Union and its Member States to the implementation of the 2030 Agenda in a full, coherent, comprehensive, integrated and effective manner, in close cooperation with partners and other stakeholders.

[5] Paris Agreement to the United Nations Framework Convention on Climate Change, Dec. 12, 2015, T.I.A.S. No. 16-1104. The agreement has been adopted by the European Union through Council Decision (EU) 2016/1841 of 5 October 2016 on the conclusion, on behalf of the European Union, of the Paris Agreement adopted under the United Nations Framework Convention on Climate Change (OJ L 282, 19.10.2016, p. 1)

[6] See e.g., the Communication on *Closing the Loop. An EU Action Plan for the Circular Economy*, of 2 December 2015, COM/2015/0614, then renewed with the Communication from the Commission

EU Commission published in 2018 the Action Plan on Financing Sustainable Growth,[7] launching an ambitious and comprehensive strategy on sustainable finance, and in 2019 The European Green Deal[8] to make all sectors of the EU's economy fit to meet climate targets, such as the reduction of emissions by at least 55% compared to 1990 levels by 2030, and climate neutrality by 2050.

Moreover, as for the social dimension, with its communication on *A Strong Social Europe for Just Transitions,*[9] the Commission try to tackle the challenges related to the achievement of a climate-neutral and environmentally sustainable economy, setting out the road towards a just and fair transition that leaves nobody behind, in line with the European Pillar of Social Rights.

2. EU Disclosure Initiatives

To match these innovative policies an intense activity of revising and updating the European rules applicable to the business sector was likewise indispensable. As for the legislative tools used by the European Institutions to drive sustainability into the business sector, it is worth noting that from an initial promotion of voluntary instruments through soft law, as in the case of corporate social responsibility (CSR) programs[10] or good governance standards for directors' remuneration,[11] the focus has shifted towards the production of hard law, revising or introducing specific rules to encourage or require the adoption of more sustainable business practices. Examples are the Directive on Non-Financial reporting of 2014,[12] imposing to certain large public-interest companies[13] reporting requirements on sustainability-related matters on a 'comply or explain' basis, and the Shareholder Rights Directive

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on *A New Circular Economy Action Plan. For a Cleaner and More Competitive Europ*e, of 11 March 2020, COM/2020/98.

[7] Communication on *Action Plan: Financing Sustainable Growth* of 8 March 2018, COM/2018/097.

[8] Communication on *The European Green Deal*, of 11 December 2019, COM/2019/640.

[9] Communication on *A Strong Social Europe for Just Transitions*, of 14 January 2020, COM(2020) 14.

[10] See, e.g., the Green Paper *Promoting A European Framework for Corporate Social Responsibility* 18.7.2001, COM(2001) 366.

[11] See Commission Recommendations 2004/913/EC, 2005/162/EC and 2009/385/EC. The Recommendations promoted the inclusion of good governance standards regarding directors' remuneration in corporate governance codes, voluntary "comply or explain" instruments existing across all Member States and adopted by business associations or stock exchanges. The ineffectiveness of this approach was showed by the Report on the application of the Commission Recommendation on directors' remuneration (SEC 2007, 1022), and Report on the application of the Commission 2009/385/EC Recommendation (SEC(2010)285).

[12] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups ('the Non-Financial Reporting Directive').

[13] Directive 2014/95/EU is applicable to large EU 'public interest' entities and to 'public interest' entities which are parent companies of a large group that have more than 500 employees and, alternatively, a total balance sheet exceeding EUR 20 million or a net turnover exceeding EUR 40 million.

II of 2017,[14] promoting more long-termism in share ownership and shareholder engagement.[15]

A closer look at the most recent EU legislative policies reveals how, so far, EU Institutions tried to achieve the shift toward a sustainable economy mainly indirectly,[16] *i.e.*, through reporting requirements and the regulation of financial markets. In particular, the Sustainable Finance package, an ambitious and comprehensive strategy to help investors to re-orient their investment towards sustainable activities across the European Union was launched to reach climate neutrality target by 2050. The package comprises the Regulation on Sustainability-related disclosure in the financial services sector of 2019 (SFDR), which provides the disclosure of sustainability information by certain financial market participants,[17] and the Taxonomy Regulation on the establishment of a framework to facilitate sustainable investment decisions and tackle greenwashing.[18]

To support the required disclosure of sustainability-related information, a revision of the existing Non-Financial Reporting Directive was also necessary. Thus, in April 2021 the European Commission published a proposal for a Corporate Sustainability

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[14] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, complemented by the Commission Implementing Regulation (EU) 2018/1212.

[15] According to Directive (EU) 2017/828, the remuneration policy should contribute to the business strategy, long-term interests and sustainability of the company and should not be linked entirely or mainly to short-term objectives. Moreover, the Directive and the Regulation (EU) 2018/1212, improved transparency of institutional investors and asset managers regarding how they engage with the companies they invest in, and how they consider and monitor the long-term and non-financial performance of these companies and their environmental and social impact, requiring investors to disclose their engagement policy and their strategy. However, these governance rules strengthened shareholder rights and directors' accountability towards shareholders, but do not cover directly the interests of other stakeholders and the environment.

[16] With some partial exceptions of directives that have affected the organization and management of companies, such as the above-mentioned Shareholder Rights Directive II (Directive (EU) 2017/828), and the Directive (EU) 2019/2121 of the European Parliament and of the Council of 27 November 2019 amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions, according to which the rights of companies to convert, merge and divide across borders should be properly balanced with the protection of employees, creditors and members.

[17] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

[18] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (the 'EU Taxonomy Regulation'). See also Commission Communication of 21 April 2021 on *EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing Finance towards the European Green Deal*, COM(2021) 188. The classification of environmentally sustainable economic activities will be based on technical screening criteria for each environmental objective (1. climate change mitigation, 2. climate change adaptation, 3. sustainable use and protection of water and marine resources, 4. transition to a circular economy, 5. Pollution prevention and control, 6. protection and restoration of biodiversity and ecosystems). The first delegated act on sustainable activities for climate change adaptation and mitigation objectives has been adopted in December 2021 (Commission Delegated Regulation (EU) 2021/2139, of 4 June 2021), and a second delegated act was planned for 2022.

Reporting Directive[19] (CSRD) to revise and strengthen rules previously introduced and to ensure that companies report reliable and comparable sustainability information to investors and other stakeholders. The directive has been approved on November, 2022 by the European Parliament and the Council.[20]

The main objective of the directive is to extend the scope of the reporting requirements of non-financial information (*i.e.*, information related to environmental matters, social matters, treatment of employees, respect for human rights, anti-corruption and bribery, diversity on company boards) to all large undertakings, whether listed or not, meeting at least two out of the three following criteria: *i)* a net turnover of more than EUR 40 million; *ii)* balance sheet assets greater than EUR 20 million; *iii)* more than 250 employees.[21] Sustainability reporting requirements would also be applicable to all undertakings with securities listed on EU regulated markets (except listed micro-enterprises),[22] while insurance undertakings and credit institutions will be required to comply regardless of their legal form, provided they meet the relevant size criteria. Nonetheless, listed micro companies and non-listed small-medium enterprises (SMEs) can apply the provisions on a voluntary basis. Non-European companies with substantial activity in the EU (i.e., a net turnover over EUR 150 million euro in the EU) will also have to report according to the directive.

The directive requires an assurance of the sustainability information reported through a limited audit (related to the compliance with the Directive requirements and the applicable reporting standards) carried out by statutory auditors or audit firm, or by Member States authorised independent assurance services providers.

Finally, the new rules will end flexibility[23] in reporting methods, introducing more detailed and standardised reporting requirements. Sustainability information indeed,

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[19] Proposal for a Directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, of 21 April 2021, COM(2021) 189, 2021/0104 (COD). After the provisional political agreement between the European Parliament and the Council of the European Union reached in June 2022, the Corporate Sustainability Reporting Directive has been approved at the end of 2022.

[20] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

[21] Non-Financial Reporting Directive is applicable to large public-interest companies with more than 500 employees and a balance sheet of more than EUR 20 million, or a net turnover of more than EUR 40 million.

[22] Micro-enterprises are defined by art. 3 of the Accounting Directive (2013/34/EU) as undertakings that do not exceed the limits of at least two of the three following criteria: (a) balance sheet total: EUR 350 000; (b) net turnover: EUR 700 000; (c) average number of employees during the financial year: 10. It is worth noting that for small and medium-sized listed undertakings the requirements will begin to apply three years after the Directive's entry into force to lighten the compliance burden.

[23] Non-Financial Reporting Directive allows significant flexibility with respect to the reporting method to be used. Undertakings may rely on international, European, or national frameworks to produce their non-financial statements. The Directive Recital 9 refers, *e.g.*, to national frameworks, Union-based frameworks such as the Eco-Management and Audit Scheme (EMAS), or international frameworks such as the United Nations (UN) Global Compact, the Guiding Principles on Business and Human Rights implementing the UN 'Protect, Respect and Remedy' Framework, the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, the

should be included in companies' management report and disclosed in a digital, machine-readable format.[24] Moreover, companies must report according to mandatory EU Sustainability Reporting Standards, the drafting of which has been assigned to the European Financial Reporting Advisory Group (EFRAG). The standards, based on the 'double materiality' principle (covering both, the outside-in and the inside-out perspectives, *i.e.*, the impacts of external factors on a company and the impacts of a company on society and the environment), need to be consistent with the European Green Deal as well as with the existing legal framework (*i.e.*, Sustainable Finance Disclosure Regulation and Taxonomy Regulation). EFRAG approved the first set of standards on November 16, 2022, while the publication of a second set of standards (specifying complementary sustainability information, including sector-specific considerations) is expected for October 2023. The standards will be reviewed regularly.

The comparability of non-financial information is central, and it was one of the main principles informing the Non-Financial Reporting Directive. However, the impact of the 2014 directive was limited by the diverse range of options available for reporting. This flexibility undermined the comparability of disclosed nonfinancial information, and without consistency and comparability the information's relevance is substantially low. The Corporate Sustainability Reporting Directive try to overcome this problem introducing common rules on sustainability reporting and its assurance to create a level playing field for companies established in the different Member States.

The existence of European standards is undoubtedly essential to ensure the comparability and relevance of reported information, and to facilitate the assurance and enforcement of sustainability reporting. At the same time, it is worth noting that differences can still exist between sustainability reporting due to the different attitudes of those preparing the documents[25] and diverse materiality analysis, especially if indicators are too general and vague that can be adapted or modified according to the needs of companies. Moreover, considering that economy is global, global recognized standards are needed. For this reason, the EFRAG Sustainability Reporting Standards

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International Organisation for Standardisation's ISO 26000, the International Labour Organisation's Tripartite Declaration of principles concerning multinational enterprises and social policy, the Global Reporting Initiative. Trying to minimise flexibility the European Commission published voluntarily Guidelines to help companies disclose environmental and social information in 2017 and Guidelines on reporting climate-related information in 2019.

[24] This requirement is linked to the European Commission proposal for a Regulation establishing a European single access point providing centralised access to publicly available information of relevance to financial services, capital markets and sustainability of 25 November 2021(COM(2021) 723; 2021/0378 (COD)), which is part of the EU Capital Markets Union action plan provided for in Communication from the Commission on *A Capital Markets Union for People and Businesses-New Action Plan*, of 24 September 2020, COM/2020/590.

[25] See Andrea Venturelli, Simone Pizzi, Fabio Caputo, Salvatore Principale, *The Revision of Nonfinancial Reporting Directive: A Critical Lens on the Comparability Principle* 29 Business Strategy and the Environment 3586 (2020). On the issue Dominique Diouf, Olivier Boiral, *The Quality of Sustainability Reports and Impression Management: A Stakeholder Perspective* 30 Accounting, Auditing and Accountability Journal 643 (2017).

need to be aligned with accepted standards currently being developed at the international level.[26]

The new European rules are expected to enter into force for reporting year 2024, with first submissions due in 2025 for large public-interest companies already subject to the non-financial reporting directive, in 2026 for large companies not covered by the non-financial reporting directive, and in 2027 for listed SMEs (with the possibility to opt out during the transitional period, until 2028).

3. EU Initiatives on Company Law

The Corporate Sustainability Reporting Directive, together with the Sustainable Finance Disclosure Regulation and Taxonomy Regulation, are central in the European sustainable finance strategy giving that they allow a consistent and coherent flow of sustainability-related information throughout the capital markets. These legislations have some positive impact on large and listed companies improving investor awareness. Nonetheless, they only indirectly regulate companies' behaviour from the *ex-post* perspective of disclosure obligations. Neither of these measures impose material duties on companies other than public reporting requirements.

In particular, although the Corporate Sustainability Reporting Directive is expected to bring about a significant improvement in sustainability-related disclosure, clarifying the requirement to report on sustainability aspects and ensuring better access to comparable, relevant and reliable sustainability information, it would still not be underpinned by any substantial corporate obligation to carry out due diligence or consider sustainability issues in the decision-making process.

Given the limited effect of voluntary or soft law initiatives and public reporting requirements in mainstreaming corporate practices towards sustainability, the Commission began to develop (yet before the spread of Covid-19 pandemic, then reinforced by the consequent crisis)[27] complementary initiatives in the field of company law to tackle the problem form an *ex-ante* perspective. The aim is to directly affect companies' behaviour and business strategies to generate meaningful changes in the way companies manage their negative impacts on the society. A second shift thus occurred within the context of hard law. From (mainly) disclosure regulations, the

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[26] On the necessity to define common metrics for sustainable value creation see *e.g.*, World Economic Forum, *Measuring Stakeholder Capitalism. Towards Common Metrics and Consistent Reporting of Sustainable Value Creation*, White Paper (September 2020). To meet the demand of high quality, transparent, reliable and comparable reporting on environmental, social and governance matters, in November 2021, the International Financial Reporting Standards Foundation announced the creation of the new International Sustainability Standards Board (ISSB), which has been established at COP26 to develop a comprehensive global baseline of sustainability disclosures.

[27] See Commission Communication *Europe's Moment: Repair and Prepare for the Next Generation* of 27 May 2020, COM(2020) 456 that confirmed the Commission's intention to put forward an initiative on sustainable corporate governance with the objective to "ensure environmental and social interests are fully embedded into business strategies" to strengthening corporate resilience, improving predictability and management of risks, dependencies and disruptions including in the supply chains.

focus moved to the production of rules aimed at directly affecting company law, providing sustainability obligations impacting companies' activities, decision-making, risk management and liability regimes.

The Council[28] and the European Parliament[29] both called on the Commission to present a legislative proposal on the issues. As part of the European Green Deal and according to Action 10 of the Action Plan on Financing Sustainable Growth,[30] initiatives on directors' duties and due diligence obligations were lunched in 2020 and included in the 2021 Commission Work Programme.[31]

In 2020, the EU Commission published two different studies, one on mandatory due diligence requirements through the supply chain[32] and the other on directors' duties and sustainable corporate governance.[33] The studies covered two different but strictly interrelated areas.

As for the first on supply chain, the aim was to investigate the effectiveness of requiring companies to take measures to address their adverse impacts on human rights and the environment in their own operations and value chains. Among the various options, was clearly highlighted the possibility of establishing a mandatory due diligence as a standard of care based on international instruments, such as the UN

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[28] Council Conclusions on Human Rights and Decent Work in Global Supply Chains of 1 December 2020 (13512/20).

[29] See European Parliament resolution of 29 May 2018 on *Sustainable Finance* (2018/2007(INI)) calling for a proposal to clarify "European companies' directors' duties concerning long-term sustainable value creation, ESG matters, and systemic risks, as part of the directors' overarching duty to promote the success of the company". See also the European Parliament resolution of 17 April 2020 on EU coordinated action to combat the COVID-19 pandemic and its consequences (2020/2616(RSP)) at No. 68; the European Parliament resolution of 17 December 2020 on sustainable corporate governance (2020/2137(INI)); and the European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)) [hereinafter European Parliament resolution of 10 March 2021].

[30] See the Communication on *Action Plan: Financing Sustainable Growth* of 8 March 2018, COM/2018/097, which mandates to carry out "analytical and consultative work with relevant stakeholders to assess: (i) the possible need to require corporate boards to develop and disclose a sustainability strategy, including appropriate due diligence throughout the supply chain, and measurable sustainability targets; and (ii) the possible need to clarify the rules according to which directors are expected to act in the company's long- term interest.".

[31] Communication on *Work Programme 2021. A Union of Vitality in a World of Fragility*, of 19 October 2020, COM(2020) 690, that include in the deliveries in the area of an economy that works for people a legislation on sustainable corporate governance to foster long-term sustainable and responsible corporate behaviour.

[32] See the *Study on Due Diligence Requirements Through the Supply Chain: Final Report* (2020), published on 20 February 2020, https://op.europa.eu/en/publication-detail/-/publication/8ba0a8fd-4c83-11ea-b8b7-01aa75ed71a1/language-en.

[33] See the *Study on Directors' Duties and Sustainable Corporate Governance: Final Report* (2020), published on 29 July 2020, https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en [hereinafter the EY Study].

Guiding Principles on Business and Human Rights (UNGPs),[34] the OECD Guidelines[35] and the ILO Tripartite declaration of principles concerning multinational enterprises and social policy.[36]

As for the study on governance and directors' duties, the aim was to investigate how to enable companies to focus on long-term sustainable value creation rather than short-term benefits, aligning the interests of companies, their shareholders, managers, stakeholders and society. The policy options provided were generally based on requiring directors to take into account all stakeholders' interests as part of their duty of care to promote the interests of the company, integrating stakeholders' interests and corporate sustainability risks, impacts and opportunities into the corporate strategy, with measurable and time-bound, science-based targets. The strengthening of the link between remuneration policies and sustainability targets has also been considered.

To gather data and collect the views of stakeholders regarding possible legislations, at the end of 2020 the European Commission launched an open public consultation on what was labelled the "sustainable corporate governance" initiative, comprising both directors' duties and due diligence duties. From both the preliminary studies and the public consultation emerged that the majority of participants agreed that a harmonized EU legal framework on such issues was needed. However, the proposed harmonisation of due diligence received a higher support than the one related to directors' duties.[37]

The lower level of support is probably linked, on one side, to the numerous criticisms raised by academics,[38] business organisations, institutional investors and

[34] UN Office of the High Commissioner for Human Rights (OHCHR), *Guiding Principles on Business and Human Rights: Implementing the 'Protect, Respect and Remedy' Framework*, HR/PUB/11/04, 2011 (UNGPs).

[35] See *OECD Guidelines for Multinational Enterprises* (2011); *OECD Due Diligence Guidance for Responsible Business Conduct* (2018); and *OECD Guidelines for Responsible Business Conduct for Institutional Investors* (2017).

[36] ILO, Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, adopted by the Governing Body of the International Labour Office at its 204th Session (Geneva, November 1977) and amended at is 279th (November 2000), 295th (March 2006) and 329th (March 2017) Sessions ("ILO MNE Declaration").

[37] See *Sustainable Corporate Governance Initiative. Summary Report – Public Consultation*, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/public-consultation_en; Impact Assessment Report, Annexes Accompanying the Proposal for a Directive on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, of 28 March 2022, SWD(2022) 42, Part 2/2, Corrigendum document SWD(2022) 42 of 23.02.2022, [hereinafter Impact Assessment Report Annexes] p. 16-20.

[38] See Mark J. Roe, Holger Spamann, Jesse M. Fried, Charles C.Y. Wang, *The European Commission's Sustainable Corporate Governance Report: A Critique, European Corporate Governance Institute*, Law Working Paper 553/2020, Harvard Public Law Working Paper No. 20-30, https://ssrn.com/abstract=3711652 (2020). The article criticizes the EY Study because, according to the authors: i) it fails to define the problem properly (focusing only on short-termism as the main corporate governance problem without taking into consideration other aspects such as negative externalities and distributional concerns); ii) it presents inapposite evidence (focusing on rising gross payouts to shareholders while the more relevant payout measure to assess corporations' ability to fund long-term investment is net payouts); iii) it fails to address the relevant academic research (only picking studies supporting its

self-regulation bodies about the preparatory study commissioned to Ernst & Young.[39] On the other, to the general difficulty of the European legislator in taking statutory action in the field of corporate governance given the widespread path dependence of Member States in that field, as demonstrated by the withdrawal of the proposal for the Fifth Company Law Directive after several years of attempt to harmonise the corporate governance framework.

It is not clear whether the original intention of the Commission was to regulate the two areas with two different initiatives or with a single legislative instrument. Given the difficulties on the governance issue, it might have been better for the Commission to proceed with two separate initiatives on due diligence and directors' duties, as also suggested by some Member States (*i.e.*, Denmark and Sweden) as well as other respondents to the public consultation,[40] and backed by the European Parliament. According to the latter indeed, in case the two areas would have been covered by a single legislative instrument, they should have been "clearly separated in two different parts, considering that those obligations and duties are complementary but not interchangeable, and nor is one subordinate to the other".[41]

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views on short-termism); and iv) it neglects problems with its policy proposals. For other academic contributions concerning the Study on directors' duties see Paul Krüger Andersen, et al., *Response to the Study on Directors' Duties and Sustainable Corporate Governance by Nordic Company Law Scholars*, Nordic & European Company Law Working Paper No. 20-12, University of Copenhagen Faculty of Law Research Paper No. 100, https://ssrn.com/abstract=3709762; Alexander Bassen, Kerstin Lopatta, Wolf-Georg Ringe, *The EU Sustainable Corporate Governance Initiative – Room for Improvement*, Oxford Business Law Blog, 15 October 2020, https://www.law.ox.ac.uk/business-law-blog/blog/2020/10/ec-corporate-governance-initiative-series-eu-sustainable-corporate; Alex Edmans, *Diagnosis Before Treatment: The Use and Misuse of Evidence in Policymaking*, Oxford Business Law Blog, 30 Oct 2020, https://www.law.ox.ac.uk/business-law-blog/blog/2020/10/ec-corporate-governance-initiative-series-diagnosis-treatment-use-and; John C. Coffee Jr, *The European Commission Considers 'Short-Termism' (and 'What Do You Mean by That?')*, Oxford Business Law Blog, 17 November 2020, https://www.law.ox.ac.uk/business-law-blog/blog/2020/11/ec-corporate-governance-initiative-series-european-commission; Alex Edmans, Luca Enriques, Steen Thomsen, *Call for Reflection on Sustainable Corporate Governance*, Oxford Business Law Blog, 9 April 2021, https://www.law.ox.ac.uk/business-law-blog/blog/2021/04/ec-corporate-governance-initiative-series-call-reflection-sustainable; Jesse M. Fried, Charles C.Y. Wang, *Short-Termism, Shareholder Payouts, and Investment in the EU* 27 European Financial Management 389 (2021).

[39] See Impact Assessment Report Annexes p. 12-13, 25, 27. In particular, the EY Study identifies several policy proposals to foster the development of sustainable corporate governance and sustainable value creation, including: the extension of directors' duties to include the interests of stakeholders, the increase in long-term shareholders' voting rights, the need for sustainability planning and disclosure, tying executive compensation to sustainability metrics, considering sustainability in board nominations, requiring mechanisms for engaging with stakeholders in dealing with sustainability risks, and allowing stakeholders to bring suits in courts for alleged violations by directors of the duty of care and loyalty.

[40] Impact Assessment Report Annexes p. 26, 29.

[41] European Parliament resolution of 17 December 2020 on sustainable corporate governance (2020/2137(INI)), whereas S.

4. The Corporate Sustainability Due Diligence Directive Proposal

One year after the closure of the public consultation, on the 23rd of February 2022, the European Commission adopted a proposal for a directive on "Corporate Sustainability Due Diligence".[42]

The core of the proposal is to foster sustainable and responsible corporate behaviour throughout global value chain providing a general due diligence duty for companies and directors, but it also includes a few other provisions that were absent in the Parliament proposal of May 2021[43] and that seems to be linked to the broader sustainable corporate governance project.[44] In particular, the proposal includes in article 15 provisions imposing certain obligations related to climate change targets to large companies and, in articles 25 and 26, provisions aimed at harmonising some aspects of directors' fiduciary duties in European companies.

It is worth noting that the proposal can be subject to further amendments by European Parliament and the Council during its adoption through the co-decision process. In case of approval, Member States will have two years to transpose its content into national law, an activity that will represents a further critical step towards the concrete implementation and specification of the obligations laid down in the directive. In fact, the process of national implementation may lead, especially in case of unclear and ambiguous normative provisions, to divergences and inconsistencies between member states, which may also embrace regulatory competition policies.

4.1. Corporate Due Diligence

Over the past years, the European Union already adopted binding legislations to spread sustainable business practices across the supply chain in sectors traditionally worst affected by the violations of human rights and environmental harms, but such requirements only apply to a limited number of sectors, such as timber[45] and four minerals (tin, tantalum, tungsten, and gold) included in the Conflict Minerals Regulation.[46] In addition, more general regulation on due diligence have recently been adopted (or are in the process of being adopted) by some Member States.[47]

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[42] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, of 23 February 2022, COM(2022) 71, 2022/0051 (COD) [hereinafter Proposal for a Directive on Corporate Sustainability Due Diligence].

[43] European Parliament resolution of 10 March 2021.

[44] European Parliament resolution of 10 March 2021.

[45] Regulation (EU) No. 995/2010 of 20 October 2010 laying down the obligations of operators who place timber and timber products on the market.

[46] Regulation (EU) No. 2017/821 of 17 May 2017 laying down supply chain due diligence obligations for Union importers of tin, tantalum and tungsten, their ores, and gold originating from conflict-affected and high-risk areas. A proposal as regards other minerals used for electric vehicle and industrial batteries is pending, see Commission Proposal for a Regulation concerning batteries and waste batteries (COM(2020) 798/3).

[47] See, e.g., France (Law No. 2017-399, 27 March 2017, on the "Duty of Care of Parent Companies and Ordering Companies"); Netherlands (Kamerstukken I, 2016/17, 34 506, the Child Labour Due

To overcome the sectorial limits and to ensure legal certainty and a level playing field among all companies operating on the EU market, the proposal provides for a mandatory general (covering a wide spectrum of human rights and environmental harms) and horizontal due diligence requirement (applicable to all business sectors).

As mentioned before indeed, the key objective of the directive proposal is to provide obligations for companies regarding actual and potential human rights and environmental adverse impacts. The adverse impacts covered are the ones resulting from the violation of rights, prohibitions and obligations provided by selected international human rights and environmental conventions explicitly listed in the Annex of the proposal,[48] which includes specific rights and obligations that are to be respected by companies. Some uncertainties remain about violations of Part I, Section 2 of the Annex, which lists some international conventions on human rights and fundamental freedom without any reference to specific provisions to which companies must pay attention.[49]

The proposal, thus, on one side spreads in third countries European accepted legal standards in the field and, on the other, makes legally binding for companies under the scope of the directive international standards that are usually directed to states,

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Diligence Law); and Germany (Act on Corporate Due Diligence Obligations in Supply Chains, BGBl I 2021, 2959, of 16 June 2021).

[48] See Proposal for a Directive on Corporate Sustainability Due Diligence art. 3 b) and c). Annex Part I, Section 1 refers to internationally recognised human rights contained in the Universal Declaration of Human Rights of 1948, the International Covenant on Civil and Political Rights of 1966, the International Covenant on Economic, Social and Cultural Rights of 1966, the Convention of the Rights of the Child of 1989, as well as to the principles concerning the fundamental rights provided in the International Labour Organization (ILO)'s Declaration on Fundamental Principles and Rights at Work, also included in several ILO conventions (on freedom of association and effective recognition of the right to collective bargaining; elimination of all forms of forced or compulsory labour; effective abolition of child labour; elimination of discrimination in respect of employment and occupation). As for environmental conventions indicated in Annex Part II, the list includes agreements creating specific obligations, such as the Convention on International Trade in Endangered Species of Wild Fauna and Flora of 1973; the Vienna Convention for the protection of the Ozone Layer of 1985 and its Montreal Protocol on substances that deplete the Ozone Layer; the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal of 1989; the Convention on Biological Diversity of 1992; Convention on the Prior Informed Consent Procedure for Certain Hazardous Chemicals and Pesticides in International Trade of 1998; the Stockholm Convention on Persistent Organic Pollutants of 2001; the Minamata Convention on Mercury of 2013.

[49] On the issue, see the Follow-up to the second opinion of the Regulatory Scrutiny Board Accompanying the document Proposal for a Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, of 23 February 2022, SWD(2022) 39 [hereinafter Follow-up to the second opinion of the Regulatory Scrutiny Board], p. 8, according to which violations of a right not listed in Annex, Part I, Section 1, but protected by the human rights agreements listed in Annex, Part I, Section 2, are also covered if they are directly capable of impairing a protected legal position in a particularly serious manner, and if the impairment of the protected right is obvious upon reasonable assessment of all circumstances in question.

regardless of whether the jurisdictions in which the alleged violations take place have ratified the international conventions listed.[50]

A relevant measure provided by the proposal is the extension of the boundaries of a company in terms of both obligations and liability. The due diligence obligations are actually linked to the adverse impacts caused not only by the company own operations, but also by the operations of its subsidiaries[51] and the value chain operations carried out by entities with whom the company has an "established business relationship".

The nature of an "established business relationship" is subject to evaluation and the exact identification of its boundaries is essential, considering that from this definition follows the extension of the liability of the company. The proposal recognises the existence of an established business relationship in respect to a business partner with which a company cooperates, directly or indirectly, on a regular and frequent basis, and where the relationship is, or is expected to be lasting (in view of its intensity or duration), and which does not represent a negligible or merely ancillary part of the value chain. The reference is to the performance of activities related to the company's production of goods or provision of services.[52] The nature of an established business relationship, therefore, is intrinsically flexible and its existence shall be reassessed periodically, at least every 12 months.

The proposal thus, as will be batter explained dealing with the private enforcement provision, in certain conditions extends the obligation of a company beyond those entities with whom it has a direct contractual relationship to other relevant value chain participants. Despite some criticism related to the uncertain extent of a company's boundaries and responsibility towards suppliers that are not under its direct control, the European legislator decided to broaden the scope of mandatory due diligence in accordance with the concept of due diligence already shaped by international standards (such as OECD guidelines, and the United Nations Guiding Principles on

[50] On the issue, with regards to the U.S., see Luca Enriques, Matteo Gatti, *The Extraterritorial Impact of the Proposed EU Directive on Corporate Sustainability Due Diligence: Why Corporate America Should Pay Attention*, Oxford Business Law Blog, 21 April 2022, https://www.law.ox.ac.uk/business-law-blog/blog/2022/04/extraterritorial-impact-proposed-eu-directive-corporate.

[51] A subsidiary is a 'controlled undertaking' as defined in Article 2(1)(f) of Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC. In particular, the reference is to an undertaking (i) in which a natural person or legal entity has a majority of the voting rights; or (ii) of which a natural person or legal entity has the right to appoint or remove a majority of the members of the administrative, management or supervisory body and is at the same time a shareholder in, or member of, the undertaking in question; or (iii) of which a natural person or legal entity is a shareholder or member and alone controls a majority of the shareholders' or members' voting rights, respectively, pursuant to an agreement entered into with other shareholders or members of the undertaking in question; or (iv) over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control.

[52] Proposal for a Directive on Corporate Sustainability Due Diligence art. 3 f).

Business and Human Rights) and with the observation that significant risks of adverse impacts usually materialise beyond tier one suppliers.[53]

The problem is that the definition of established business relationships proposed by the directive is broad and uncertain, thus difficult to apply. It resumes the definition provided by the French Law on the Duty of Vigilance,[54] which also caused interpretative problems. However, under French law the concept seems to have clearer boundaries as it has been defined by French courts in several cases, even if the different context of the protection of commercial parties in the event of abrupt termination of established commercial relationships.[55] In the European context, would be useful to more clearly defined the notion during the co-decision process giving that there can be the risk of diverse interpretations from Member States' supervisory authorities and courts.[56] Moreover, this represents a novelty for companies because the concept is not outlined in the major international instruments regulating the issue.

4.1.1. Scope of Due Diligence Duties

The personal scope of the due diligence, in terms of companies to which the obligations apply, has been narrowed down with regard to companies' size compared to what was suggested in Parliament's resolution of March 2021.[57] Moreover, differently from the Non-Financial Reporting Directive, the relevant thresholds are measured not at the group level but at the *entity* level. The proposal is applicable to European companies, but it also has an extraterritorial application given that it covers companies formed in accordance with the legislation of a third country operating in the European internal market.

As for European companies,[58] the proposal is applicable on one side to "large companies" with more than 500 employees and a net worldwide turnover of more than EUR 150 million in the last financial year. On the other, to companies carrying out activities in "high impact sectors". The reference is to companies with more than

[53] Verónica H. Villena, Dennis A. Gioia, *On the Riskiness of Lower-tier Suppliers: Managing Sustainability in Supply Networks* 64 Journal of Operations Management 65 (2018).

[54] Law No. 2017-399, 27 March 2017.

[55] See Stéphane Brabant, Charlotte Michon, Elsa Savourey, *The Vigilance Plan, Cornerstone of the Law on the Corporate Duty of Vigilance* 50 International Review of Compliance and Business Ethics 1, 3–4 (2017); Elsa Savourey, Stéphane Brabant, *The French Law on the Duty of Vigilance: Theoretical and Practical Challenges Since its Adoption* 6 Business and Human Rights Journal 141, 145 (2021).

[56] For some criticism of the concept of established business relationships see The European Company Law Experts Group (ECLE), *Legal Certainty and the Directive on Corporate Sustainability Due Diligence*, ECGI Blog, 2 August 2022, https://ecgi.global/blog/legal-certainty-and-directive-corporate-sustainability-due-diligence; Alessio Pacces, *Supply Chain Liability in the Corporate Sustainability Due Diligence Directive Proposal*, ECGI Blog, 12 April 2022, https://ecgi.global/blog/supply-chain-liability-corporate-sustainability-due-diligence-directive-proposal; Anne Lafarre, *Mandatory Corporate Sustainability Due Diligence in Europe: The Way Forward*, ECGI Blog, 12 April 2022, https://ecgi.global/blog/mandatory-corporate-sustainability-due-diligence-europe-way-forward; Paul Davies, *Ending Human Rights Abuses in which Companies and States are Complicit*, ECGI Blog, 7 April 2022, https://ecgi.global/blog/ending-human-rights-abuses-which-companies-and-states-are-complicit.

[57] European Parliament resolution of 10 March 2021.

[58] Proposal for a Directive on Corporate Sustainability Due Diligence art. 2.1.

250 employees and a net worldwide turnover of more than EUR 40 million, the 50% of which is generated in sectors with a high risk of adverse impacts. Such sectors (for which OECD sectorial guidance also exists)[59] are explicitly indicated in the proposal and are textiles and leather, agriculture, forestry and fisheries, and minerals with their related products and activities.

As for non-European companies, the turnover is the only threshold taken into consideration given difficulties in calculating the number of employees due to the absence of a common definition at international level. The rules will be applicable to foreign companies with a turnover threshold generated in the European Union aligned with the ones provided for European companies: EUR 150 million for companies regardless of the sector, and EUR 40 million for companies operating in high impact sectors.[60]

Both, European and non-European companies operating in high impact sectors that do not reach the size of large enterprises are subject to a longer transition period (new rules will start to apply after 4 years from the entry into force of the Directive)[61] and to limited due diligence obligations (they will only be required to identify actual and potential severe adverse impacts relevant to the respective sector).[62]

According to European Commission approximately 13,000 companies in the European Union and 4,000 non-EU companies will be under the scope of the directive.[63] As mentioned, the personal scope of the proposal has been restricted and SMEs are not included. Nonetheless, they can be indirectly affected as a result of the large and high impact sectors companies' actions across their value chains. For these reasons, considering the possible trickle-down effect, the proposal prescribes that a fair, reasonable and non-discriminatory treatment must be guaranteed in respect of SMEs, and that companies provide support for an SME with which they have an established business relationship.[64] Specific support from both, the Commission and Member States, shall also be provided through guidelines or other technical tools to help SMEs gradually integrate sustainability considerations in their business operations.[65]

It must be noted that the underinclusion of small companies could undermine the European Commission effort to mainstream the corporate behavior' change. However, the involvement of SMEs in the value chain of enterprises to which the regulations apply will indirectly broaden its scope. In addition, in this case as well, as with regulations on non-financial information, there is the possibility of a gradual

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[59] See the *OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas* (3rd ed, 2016.); the *OECD-FAO Guidance for Responsible Agricultural Supply Chains 2016; the OECD Due Diligence Guidance for Responsible Supply Chains in the Garment and Footwear Sector* (2017); the *Practical Actions for Companies to Identify and Address the Worst Forms of Child Labour in Mineral Supply Chains* (2017).

[60] Proposal for a Directive on Corporate Sustainability Due Diligence art. 2.2.

[61] Proposal for a Directive on Corporate Sustainability Due Diligence art. 30.1.

[62] Proposal for a Directive on Corporate Sustainability Due Diligence art. 6.2.

[63] See information available at https://ec.europa.eu/info/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en.

[64] See Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.2; art. 8.3.

[65] See Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.4; art. 8.5; art. 14.

implementation, and the scope of the legislation could be extended to include smaller enterprises at a later stage.

Finally, the proposal also applies to regulated financial undertakings, irrespective of their legal form, and specific provisions are given to identify their value chain and the length of their obligations.[66] The analysis of these rules is not covered in this paper, but it is worth pointing out the difficult application of these due diligence obligations in the context of financial institutions' value chains.

4.1.2. The Due Diligence Policy

The due diligence policy that companies must implement covers several steps and is inspired by international standards, such as the UN Guiding Principles on Business and Human Rights, and the OECD Due Diligence Guidance for Responsible Business.[67]

The first step is the integration of the due diligence into all corporate policies and management systems. Due diligence policy shall contain a description of the company's approach to due diligence, a code of conduct for company's employees and subsidiaries, and a description of the processes put in place to implement due diligence, verify the compliance with the code of conduct, and extend its application to the established business relationships.[68]

The second is to identify, through an appropriate access to quantitative and qualitative information, as well as through consultations with potentially affected groups, the actual or potential human rights and environmental adverse impacts arising from the companies' own operations or those of their subsidiaries or established business relationships.[69] Once identified, companies shall take appropriate measures to prevent or mitigate potential adverse impacts,[70] and to end or minimise actual adverse impacts.[71]

The monitoring (and the eventual updating) of the effectiveness of the due diligence process, through an annual (or whenever necessary) assessments of the company's own operations, as well as subsidiaries and value chains operations is also essential.[72]

Moreover, companies shall establish and maintain internal complaints procedure, so that third parties affected (or potentially affected), workers' representatives and civil society organisations can raise their concerns regarding actual or potential adverse impacts directly to the company.[73] This internal complaint mechanism will allow the companies to be aware of possible risks of adverse impacts and of how their impact mitigation strategy works on the ground.

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[66] Proposal for a Directive on Corporate Sustainability Due Diligence art. 3 a) iv); art. 3 g); art. 6.3; art. 7.6; art. 8.7.

[67] Proposal for a Directive on Corporate Sustainability Due Diligence art. 4.

[68] Proposal for a Directive on Corporate Sustainability Due Diligence art. 5.

[69] Proposal for a Directive on Corporate Sustainability Due Diligence art. 6.

[70] Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.

[71] Proposal for a Directive on Corporate Sustainability Due Diligence art. 8.

[72] Proposal for a Directive on Corporate Sustainability Due Diligence art. 10.

[73] Proposal for a Directive on Corporate Sustainability Due Diligence art. 9.

Finally, companies shall publicly communicate on due diligence plan. This communication should be covered by the future EU Sustainability Reporting Standards for companies under the scope of the Corporate Sustainability Reporting Directive. However, also companies not subject to reporting requirements must publish an annual statement according to specific guidelines that will be identified by the Commission in future delegated acts.[74]

4.1.3. Content of Due Diligence Duties

As confirmed by the Recital 15 of the proposal, companies are not required to guarantee in all circumstances that adverse impacts will be avoided. They have an "obligations of means", not an "obligation of results". Their duty is to take all the appropriate (preventive and remedial) measures, proportionate with the degree of severity and the likelihood of the adverse impact, that are reasonably available to the company (also from an economic perspective) considering all the specificities of the case. In this evaluation, several factors could be considered, such as the extent and geographical location of the value chain, the sector of activity, and the power of the company to influence its direct and indirect partners.

In particular, to comply with due diligence obligations to prevent, mitigate, end or minimise adverse impacts[75] that have been – or should have been – identified through the due diligence policy, companies shall develop and implement, also in consultation with affected stakeholders, a prevention action plan (for potential adverse impacts) or corrective action plan (for actual adverse impacts) with a clear timeline for actions and qualitative and quantitative indicators for measuring the improvement of the plan.[76]

Moreover, companies should make all the necessary investments, for example into management or production processes and infrastructures to support the achievement of sustainability targets and requirements of their policy.[77] Special support for SMEs with which the company has an established business relationship is also essential to ensure that their compliance with the due diligence requirements would not jeopardise the viability of SMEs involved in the value chain.[78]

In case of actual adverse impacts, to neutralise or minimize its extent, companies must be prepared to pay damages and compensation to affected persons and communities that are proportionate to the impact itself and the company's contribution to it.[79]

Finally, a special measure that companies can take is the establishment of a contractual assurances mechanism, accompanied by the appropriate systems to verify the

[74] Proposal for a Directive on Corporate Sustainability Due Diligence art. 11.
[75] Proposal for a Directive on Corporate Sustainability Due Diligence art. 7 and 8.
[76] Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.2 a) and 8.3 b).
[77] Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.2 c) and 8.3 d).
[78] Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.2 d) and 8.3 e).
[79] Proposal for a Directive on Corporate Sustainability Due Diligence art. 8.3 a).

compliance of suppliers with such contractual obligations.[80] In this regard, the directive suggests, through an overly general reference, the use of existing suitable industry initiatives or independent third-party verification.[81]

The contractual assurances system is relevant because it can have a material impact in the appreciation of the liability of a company for an adverse impact caused by its indirect partners.

First, companies may include in a contract with a direct partner a clause to seek contractual assurances that it will comply with the company's code of conduct, or prevention or correction action plan. Companies may also establish a "contractual cascading" system, including in such contract another clause, seeking corresponding contractual assurances from its direct partner's partners to the extent that they are part of the company's value chain.[82]

Additionally, for those adverse impacts that could not be prevented, mitigated or ended through all the above-mentioned measures, a company may also decide to directly conclude a contract with an indirect partner to contractually ensure its compliance with the company's code of conduct or the prevention or correction action plan.[83]

In case of the occurrence of an adverse impact a company shall forgo from entering into new contract or extending existing business relationships with the partner in connection with, or in the value chain of which the adverse impact has arisen. Moreover, if entitled in accordance with the law governing their business relationship, the company should temporarily suspend the commercial relation with such partner, while pursuing efforts to prevent, mitigate or end the adverse impact.

While, in case of "severe" adverse impact,[84] the company shall terminate the business relationship and Member States are required to provide for the availability of such cause of termination in their domestic contract law.[85] Thus, also contract law of Member States will be affected by the directive in case domestic law does not allow,

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[80] Voluntary model contractual clauses will be developed by the Commission to provide support to companies and facilitate the compliance with the contractual assurances mechanism provided by the Directive proposal, see Proposal for a Directive on Corporate Sustainability Due Diligence art. 12. Specific contractual model clauses to be included in contracts with suppliers to ensure compliance with sustainability requirements have also been developed within the context of the project on the Human-Centred Business Model, lunched by the Global Forum on Law Justice and Development and then coordinated by the OECD's Development Centre, see Livia Ventura, *Supply Chain and Sustainability. A Research for the Human-Centred Business Model Project*, Comparazione e diritto civile 583, 613-614 (2020).

[81] Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.4 and 8.5.

[82] Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.2 b) and 8.3 c).

[83] Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.3 and 8.4.

[84] Art. 3 l) of the Proposal for a Directive on Corporate Sustainability Due Diligence defined a "severe adverse impact" as an adverse environmental or human rights impact that is especially significant by its nature or affects a large number of persons or a large area of the environment, or which is irreversible, or is particularly difficult to remedy as a result of the measures necessary to restore the situation prevailing prior to the impact.

[85] Proposal for a Directive on Corporate Sustainability Due Diligence art. 7.5 and 8.6.

through already existing rules, the possibility to terminate a contract in case of the occurrence of a severe adverse impact.

Generally speaking, it seems that the due diligence polices designed by the proposal are heavily based on procedural activities. Considering that sustainability aims need goal-oriented solutions, and sustainability-related risks need a principle-based evaluation, there can be the danger of a box ticking approach, insufficient for obtaining tangible results. However, such proceduralisation, balanced by the existence of substantial duties for directors to put in place, integrate and oversee the implementation of the due diligence policy (provided by article 26), could be necessary to create a path through which strategic decisions can be taken and assessed, and the company's commitment can be evaluated through tangible processes.

However, the main problem of the due diligence polices described by the proposal is related to the functioning of the contractual assurance mechanism. The introduction of an exemption from liability linked to the existence of specific contractual clauses and mechanisms for verifying compliance with those clauses contributes to a box thickening compliance. Probably, this part of the proposal providing an exception from liability (yet subject to a "reasonableness" standard) would deserve to be revised or better defined by the European institutions in the legislative process.

4.2. Climate Change Obligations

Looking at the other obligations imposed by the proposal falling outside its core, the first is the one related to combating climate change, a risk that, together with other environmental risks, can be nowadays considered one of the highest likelihood and impact risks to businesses in the five to ten years horizon.[86]

The aim is to incorporate the European Green Deal goals into the daily governance of large companies operating in Europe. That provisions indeed, only apply to European and foreign large companies under the scope of the directive (*i.e.*, companies with respectively, more than 500 employees and a net worldwide turnover of more than EUR 150 million, or a net worldwide turnover of more than EUR 150 million generated in the EU).

Those companies are required to adopt a plan (hereinafter the "climate change plan") to ensure that their business model and strategy is compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 degrees Celsius compared to pre-industrial levels. The proposal places directly on companies the implementation of the international climate targets envisaged by the Paris Agreement.[87] This interpretation of the Paris Agreement targets as directly applicable to companies is also supported by an emerging case law that seems to confirm the

[86] World Economic Forum, *The Global Risks Report 2021* (16th Edition, 2021).

[87] Art. 2.1 (a) of the Paris Agreement to the United Nations Framework Convention on Climate Change, 12 Dec. 2015, T.I.A.S. No. 16-1104

possible liability of companies for failing to mitigate climate harms as a result of their standard of care under tortious liability vis-a-vis others and the society.[88]

The climate change plan shall also identify the extent to which climate change is a risk for, or an impact of, the company's operations based on information reasonably available to the company, and in that case, it shall include emission reduction objectives.

From the analysis of article 15, paragraphs 1 and 2, and articles 17 and 22 of the proposal, the latter dedicated to the oversight activities of supervisory authorities and civil liability, it is possible to affirm that companies have the duty to adopt a climate change plan and to include in it emission reduction objectives, if appropriate, but the achievement of this objectives is not a legally binding obligation and does not lead to liability under the due diligence obligations.

However, the request for a climate change plan and, eventually, emission reduction goals is in any case relevant because it does not represent just a reporting obligation.[89] It could help companies themselves to think about their strategies vis-à-vis climate change, commit to it, and to elaborate their policy in a specific document, which has its significance in the decision making. If publicly available, it could also help third parties (investors, consumers) to understand how seriously a company is taking actions in that field, encapsulating climate targets into its strategies.

Together with these provisions related to the contribution to climate change targets, article 15 paragraph 3 of the proposal try to establish a link between climate change obligations and variable remuneration of directors. It provides that when setting variable remuneration, "if linked to the contribution of a director to the company's business strategy and long-term interests and sustainability", companies duly take into account the fulfilment of such climate change obligations.

The provision is not supported by enforcement measures (either private or public) and is not sufficiently clear about the mandatory nature of the climate target as part of variable remunerations. From the text it seems that the fulfilment of such climate change obligations should be considered only in the hypotheses indicated, *i.e.*, when the variable remuneration of a director is linked to her/his contribution to the company's business strategy, to long-term interests, and to sustainability. Further clarification on the general binding nature of this provision for all variable remunerations would be necessary during the approval process to make sure the legislation has a real impact on linking compensation to sustainability objectives, thus mandatorily integrating into short-term governance tools long-term sustainability objectives.

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[88] See the *Vereniging Milieudefensie et al. v. Royal Dutch Shell PLC*, Hague District Court, Decision of May 26, 2021, requiring to the global energy company Royal Dutch Shell to bring its CO_2 reduction target in line with the 1.5°C climate scenario, reducing its group-wide CO_2 emissions by 45 percent (net) compared to 2019 levels, by the end of 2030.

[89] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting, art. 1, n. (4) (on raplacing art. 19a of Directive 2013/34/EU), paragraph 2, (a)(iii).

4.3. Directors' Duties

The third area of obligations provided by the proposal aims at harmonising some aspects of directors' duties in European companies (both, large and high impact sector companies) falling under the scope of the directive. The extent of this provisions has been scaled down with respect to the policy options initially planned and indicated as the preferred ones by the European Commission.[90] Most duties identified in the proposal indeed, are inherently linked to the core of the directive, *i.e.*, the implementation of the due diligence process.

In accordance with international voluntary due diligence frameworks and standards,[91] article 26 affirms that directors are responsible for putting in place and overseeing the implementation of the due diligence policy and its integration into all corporate policies. The inclusion of this specific duty as well as the provision of directors' responsibility in this respect allows due diligence to become strategic and to penetrate relevant corporate functions.

In performing this activity, directors shall also take into due consideration relevant input received from stakeholders and civil society organisations. It is not clear whether this is a duty or, in accordance with a comply or explain approach, directors only have to report to the board on this issue.

Moreover, directors are required to adapt the corporate strategy to consider actual and potential adverse impacts identified through the due diligence policy, as well as to take the consequent necessary measures to prevent, mitigate, end or minimize their extents.

On the other side, reflecting the comments of the Regulatory Scrutiny Board, the initial plan for a general harmonisation of directors' duties towards a stakeholder approach has been changed to be more focused in content and targeted in scope. Article 25 of the proposal only comprises a general obligation related to the duty of care, affirming that directors, in fulfilling their duty to act in the "best interest of the company", must consider the consequences of their decisions for sustainability matters (including, human rights, climate change and environmental consequences) in the short, medium and long term. The breach of this enlarged *duty of care* – as defined by the proposal – leads to the application of the domestic provisions for breach of directors' duties.

As for the other specific duties envisaged by the original preferred policy options presented by the Commission, it is possible to highlight that the duty to identify stakeholders' interests and dependencies of the company on such interests, even if not specified as a separate duty, can be considered implicitly included in the

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[90] See Impact Assessment Report Accompanying the Proposal for a Directive on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, of 23 February 2022, SWD(2022) 42 [hereinafter Impact Assessment Report], p. 33-50; and Impact Assessment Report Annexes, p. 191-209.

[91] Such as the *UN Guiding Principles on Business and Human Rights*, and the *OECD Due Diligence Guidance for Responsible Business Conduct*, cit.

abovementioned duty of care. While the duty to manage risks to the company related to stakeholders and their dependencies, the duty to include the management of sustainability risks in the corporate strategy, and the mandatory adoption and disclosure of science-based targets were not retained in the final text.[92]

The request to consider sustainability matters provided by the proposal, which seems to be the result of a downward compromise, may sound undefined and vague, but it is not possible to ignore the fact that such considerations have become essential nowadays given the disruption caused to natural, economic and social systems by climate change. Board members must be able to ask the right questions and devise the right strategies to cope with the demands of modern society to ensure the survival of our society itself, and thus of the company they serve in the medium to long term. Their activity must be evaluated in compliance with a renew "sustainable business" judgment rule.[93]

Thus, the broadening of directors' duty of care to include sustainability factors could be regarded as a toll that allow or mandate (depending on how the law is implemented at domestic level) further consideration than just profit in the decision-making process. The problem is that the way this is outlined in the proposal does not lead to substantial effects or to a general redefinition of the legal purpose of the corporations. Looking at the wording of the provision, it must be emphasised that this is a bare and isolated rule within the context of the directive. Its specific implementation is left to the Member States, each characterised by its peculiarities and driven by underlying cultural and institutional differences in that matter. Thus, it will be difficult to have a real harmonised regime with sufficient strength to bring about a redefinition of the purpose of the corporation and directors' duties at European level.

While duties provided in article 26 are perfectly consistent with the core of the directive, it would be probably better to expunge from the final text article 25 providing the reformulation of the general duty of care. It seems out of context and not sufficiently structured to have a real regulatory impact. Rather than a general reformulation of the duties of directors through a top-down intervention, around which it would be difficult to catalyse consensus – considering that it involves one of the most debated topics in the history of corporate law, *i.e.* that of the nature and the purpose of a corporation[94] – it would perhaps be more appropriate to start creating

[92] Follow-up to the second opinion of the Regulatory Scrutiny Board, p. 8.

[93] For similar considerations in the context of the benefit corporation (*i.e.*, on the "benefit judgment rule") see Giorgio Resta, Cecilia Sertoli, *Società commerciali e finalità di beneficio comune*, *Enti del Terzo Settore e Impresa Sociale: la nuova disciplina* (*Part II – Atti del convegno tenutosi a Genova il 6 aprile 2019*), Biblioteca online della Fondazione Italiana del Notariato – 2 Percorsi giuridici tra tradizione e innovazione (2019), https://biblioteca.fondazionenotariato.it/art/societa-commerciali-beneficio-comune.html.

[94] Among the seminal papers on the issue, see Adolf A. Berle, *Corporate Powers as Powers in Trust* 44 Harv. L. Rev. 1049 (1931); Edwin M. Dodd, *For Whom Are Corporate Managers Trustees?* 45 Harv. L. Rev. 1145 (1932); Adolf A. Berle, *For Whom Corporate Managers Are Trustees: A Note* 45 Harv. L. Rev. 1365 (1932); Alphonse A. Sommer, Jr., *Who Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later* 16 Del. J. Corp. L. 33 (1991); Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century* 51 U. Kan. L. Rev. 77 (2002); William W. Bratton, Michael L. Wachter, *Shareholder Primacy's Corporatist Origins:*

a clear "legal path" for responsible companies regulating at the European level an additional hybrid organizational form modelled on the existing dual-purpose company experiences,[95] such as the benefit corporation,[96] the *société à mission*[97] and the *società benefit.*[98] Such a hybrid model, applicable regardless of the company's size, could also be used by companies to date excluded from the application of European regulations directed to large companies and aimed at greater integration of sustainability into business operations.

The introduction in the Member States of a harmonised dual-purpose company structure could be easier to realise in terms of consensus because it just expands entrepreneurs/investors' private ordering providing them with further and more tailored options among the existing entities. Policy makers indeed, should promote the existence of companies of varied legal structures and let them compete in the market,[99] currently increasingly concerned about environmental and social performance. Such companies indeed, could gain better access to capital,[100] build investor confidence

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Adolf Berle and the Modern Corporation 34 J. Corp. L. 99 (2008); Adolf A. Berle, Jr, *The 20th Century Capitalist Revolutio*n (New York; Harcourt, Brace and Company, 1954); David Millon, *Theories of the Corporation* 1990 Duke L. J. 201 (1990); Henry Hansmann, Reinier Kraakman, *The End of History for Corporate Law* 89 Geo Law J. 439 (2001). For the recent evolution of the debate on corporate purpuse see, *e.g*., Colin Mayer, *Firm Commitment* (Oxford; Oxford University Press, 2013); Colin Mayer, *Prosperity. Better Business Makes the Greater Good* (Oxford; Oxford University Press, 2018); The British Academy*, The Future of the Corporation: Principles for Purposeful Business* (Nov. 2019), https://www.thebritishacademy.ac.uk/publications/future-of-the-corporation-principles-for-purposeful-business; Lucian A. Bebchuk, Roberto Tallarita, *The Illusory Promise of Stakeholder Governance* 106 Cornell L. Rev. 91 (2020); Colin Mayer, *Shareholderism versus Stakeholderism – A Misconceived Contradiction: A Comment on "The Illusory Promise of Stakeholder Governance" by Lucian Bebchuk and Roberto Tallarita* 106 Cornell L. Rev. 1859 (2020); Edward B. Rock, *For Whom Is The Corporation Managed in 2020?: The Debate Over Corporate Purpose*, European Corporate Governance Institute, Law Working Paper No. 515/2020; Jill E. Fisch, Steven Davidoff Solomon, *Should Corporations Have a Purpose?* 99 Tex. L. Rev. 1309 (2020); Alex Edmans, *Grow the Pie. How Great Companies Deliver Both Purpose and Profit* (2nd., Cambridge University Press, 2021); Dorothy S. Lund, Elizabeth Pollman*, The Corporate Governance Machine*, European Corporate Governance Institute, Law Working Paper No. 564/2021; Holger Fleischer, *Corporate Purpose: A Management Concept and its Implications for Company Law*, European Corporate Governance Institute, Law Working Paper No. 561/2021.

[95] Livia Ventura, *The Essential Role of Enterprises for an Inclusive and Sustainable Development: Towards a New Uniform Model Law for the Social Enterprise?* 17 European Company Law 7 (2020).

[96] See the Model Benefit Corporation Legislation drafted by William H. Clark, Jr. (Drinker Biddle, Philadelphia) with the support of B Lab and the American Sustainable Business Council*,* implemented for the first time in Maryland in 2010 (Md. Code Ann., Corps. & Ass'ns §5-6C-01 – 5-6C-08). Currently, 36 states plus Washington DC regulate the benefit corporation model, among them Delaware that in 2013 enacted the Public Benefit Corporation Act (Del. Code Ann. Tit. 8, §§361-368).

[97] Introduced in France through Law 2019-486 of 22 May 2019, n. 486, "*Loi relative à la croissance et la transformation des entreprises*" (*Loi Pacte*), artt. 169-176.

[98] Introduced in Italy through Law 28 December 2015, n. 208 on "*Disposizioni per la formazione del bilancio annuale e pluriennale dello Stato* (*Legge di stabilità 2016*)", art. 1, paragraphs 376-384.

[99] Colin Mayer, *Prosperity. Better Business Makes the Greater Good*, cit., p. 201.

[100] See e.g., Carlo Bellavite Pellegrini, Laura Pellegrini, Massimo Catizone, *Climate Change Adaptation, Governance and New Issues of Value. Measuring the Impact of ESG Scores on CoE and Firm Performance,* 127 (Palgrave Macmillan Cham, 2022).

and develop the ability to attract sustainability aware customers[101] owing to their 'uptick' in perceived trustworthiness.

4.4. Enforcement Mechanisms

The second part of the proposal is mainly dedicated to enforcement mechanisms. To ensure access to effective remedy, both public and private enforcement systems are provided.[102]

The public enforcement is assigned to national supervisory authorities appointed by Member States. These authorities are responsible for oversight the application of rules related to due diligence duties (pursuant to articles 6-11) and climate change obligations (articles 15 (1) and (2)) but with the exclusion of rules on directors' variable remunerations.[103]

To ensure a uniform transnational application of the rules, the Commission will set up a European Network of Supervisory Authorities to facilitate the cooperation and coordination of regulatory, investigative, sanctioning and supervisory practices, as well as the appropriate sharing of information among national authorities.[104]

The Directive leave to Member States the indication of the public authority with supervisory powers. Supervision can also be carried out by pre-existing authorities, such as the securities and markets authorities. However, considering on one side that the directive will be applicable to listed and unlisted companies meeting the indicated thresholds and, on the other, that controls will require specific competences, a new supervisory authority dedicated to the substantive assessment of sustainability obligations under this, or future legislations could be envisaged.[105] Another option could be the establishment of dedicated offices within existing national competition authorities, which are already linked through the European Competition Network and work to ensure a level playing field for all enterprises operating on Europeans markets.

Each national supervisory authority should have the power to request information, carry out investigations (on its own motion or as a result of substantiated concerns raised by third parties),[106] and conduct inspections in compliance with the applicable national law. In case of non-compliance with national provisions adopted in

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[101] See e.g., *The Global Sustainability Study 2021: Consumer Products and Retail: How Sustainability is Fundamentally Changing Consumer Preferences* (Capgemini Research Institute, 2020); *Consumers are Key Players for a Sustainable Future* (Simon-Kucher & Partners, July 2021).

[102] The necessity of both, civil liability and administrative supervision in enforcement approaches has recently been highlighted as a key element by the UN Working Group on Business and Human Rights, see UN Working Group on Business and Human Rights, *UNGPs 10+. A Roadmap for The Next Decade of Business and Human Rights* (2021), p. 19-20.

[103] Proposal for a Directive on Corporate Sustainability Due Diligence art. 17.

[104] Proposal for a Directive on Corporate Sustainability Due Diligence art. 21.

[105] See e.g., the Independent Anti-Slavery Commissioner created by Part 4 of the 2015 Modern Slavery Act.

[106] Proposal for a Directive on Corporate Sustainability Due Diligence art. 19.

accordance with the Directive, supervisory authorities could issue orders requiring a company to end any infringements and, where appropriate, take remedial action, granting it a suitable period of time to act.[107]

Authorities will also have the power to impose the sanctions indicated by Member States.[108] The proposal leaves the exact design of sanctions to states but provides that they shall be effective, proportionate and dissuasive. To that end, in deciding whether to impose sanctions and in determining their nature and level, authorities need to consider the company's efforts to comply with any remedial actions required by a supervisory authority, any investments made, any support provided to SMEs, as well as the collaboration with other entities to address adverse impacts in its value chains. In particular, pecuniary sanctions should be based on the company's turnover. However, each subject affected by a legally binding decision of a supervisory authority shall have the right to an effective judicial remedy against such decision in accordance with applicable domestic law.

As for private enforcement, the proposal recognises a specific hypothesis of civil liability in case of failure of a company to comply with due diligence obligations (in particular to take action to address actual or potential adverse impacts pursuant to articles 7 and 8 of the proposal), and such failure leading to adverse impact and damages that could have been avoided if all necessary measures have been taken.[109] In that perspective, only foreseeable risks can trigger liability.

The proposal, therefore, does not affect only company law and contract law but it also has an impact on tort law of Member States that will have to adapt their rules, if necessary, to the directive requirements.[110] The provisions seem to be in line with civil liability rules already existing at the domestic level (the person who commits a civil wrong that causes loss or harm to another person has to repair that harm). They do not intervene on key elements such as the subject legitimated to bring an action or the burden of proof, whose definition – essential for the effective functioning of the private enforcement system – is left to state law. It must be observed that this national implementation of essential rules could give rise to cases of regulatory arbitrage and result in the ineffectiveness of the victim protection system.

The interesting part of the proposal is that such civil liability concerns *(i)* companies' own operations, *(ii)* its subsidiaries and *(iii)* its "established business relationships". Moreover, civil liability of a company is without prejudice to civil liability of its subsidiaries or any direct and indirect business partners in the value chain.

A company, thus, will be liable for the harms that could have been prevented, mitigated or ended in its own operations and in its subsidiary's operations. In particular, the liability of the parent company for subsidiaries' operations seems to diverge

[107] Proposal for a Directive on Corporate Sustainability Due Diligence art. 18.

[108] Proposal for a Directive on Corporate Sustainability Due Diligence art. 20.

[109] Proposal for a Directive on Corporate Sustainability Due Diligence art. 22.

[110] Moreover, it is expressly stated that civil liability rules provided by the directive should be without prejudice to other EU or national rules that provide for liability in situations not covered by or providing for stricter liability than the directive, see Proposal for a Directive on Corporate Sustainability Due Diligence art. 22, paragraph 4.

from one of the fundamental concepts of corporate law, that of the separate legal personality, thus "piercing the corporate veil" to a certain extent. This enlarged civil liability system could also affect corporate group structuring even if groups of companies are not expressly covered by the directive, contrary to what is prescribed by non-financial disclosure and reporting regulations that provide for consolidated sustainability reporting.

Regarding harms linked to a company's suppliers, it is necessary to distinguish between direct and indirect suppliers. A company will be liable for direct suppliers' operations, where it has control through contract or financing. While the liability for indirect partners' operations requires specific conditions to apply due to the lack of direct control and the necessity of a clear delimitation of the scope of the liability of a firm beyond its legal boundaries on grounds of legal certainty.

First, liability for indirect partners only applies with respect to established business relationships and will not cover harm occurring at the level of one-off suppliers. Moreover, a company can be held liable if it did not take appropriate measures required by the directive and not in case the measures taken would be unsuccessful, despite the company's reasonable efforts.

In particular, the proposal provides for an exclusion of liability in case contractual assurances and contractual cascading mechanisms have been put in place, together with the appropriate measure to verify the compliance with such contractual obligations. However, that exclusion from liability has limits. The proposal introduces a "reasonableness" standard providing that such exclusion from liability can apply unless it was unreasonable, in the circumstances of the case, to expect that the action taken would be adequate to influence the occurrence of the adverse impact (in particular, to prevent, mitigate, bring to an end, or minimise the extent of the adverse impact).

Other reasonable activities that competent court should evaluate in assessing the company's reasonable efforts and thus, the existence and the actual extent of a company's liability, are – also in this case – the company's efforts to comply with remedial action required by a supervisory authority, the investments made and the collaboration with other entities to address adverse impacts, as well as any targeted support provided by the company.

It is not particularly clear from the text if this fault-based liability approach is applicable only towards indirect partners (as it would appear from the current text of the proposal),[111] thus imposing a peculiar form of vicarious strict liability in the other cases. The contours of liability scenarios should be better clarified during the legislative process to avoid different implementation by Member States.

Finally, to guarantee victims the protection granted by the directive and the access to effective remedy, the proposal requires Member States to take the appropriate legislative action to ensure that such civil liability hypothesis is of overriding mandatory application in cases the law applicable to claims is not the law of a Member State (*e.g.*, when damages occur outside the European Union). This broad and transnational

[111] Proposal for a Directive on Corporate Sustainability Due Diligence art. 22, paragraph 2.

application of civil liability rules will provide legal certainty and facilitate the courts of the European Union because they can apply the *lex fori,* the law of their own country, in which the action is brought, instead of foreign law.

A private enforcement mechanism based on civil liability is essential. Together with administrative supervision, it can be the appropriate tool to increases the effectiveness of the enforcement and help driving good corporate behaviour.[112] It also provides legal certainty for both, companies – through an oversight independent from national authorities' capacity – and affected persons – victims can obtain different remedies, financial compensation and remedial orders (*e.g*., clean-up orders or restitution of land).[113] An effective enforcement mechanism indeed, requires both, a civil liability regime to ensure victims access to remedy, and an administrative oversight. They are based on different assumptions and can mutually supplement each other. Such a double level of control can strengthen not only compliance by companies but also the credibility of their due diligence policies and disclosure.

5. Sustainability Due Diligence and the New Boundaries of the Firm

Considering the core of the proposal, the introduction of harmonized rules on due diligence obligations will have the positive effect of bringing legal certainty and a level playing field for European and foreign companies operating in the Union, preventing the legal fragmentation arising from national rules and the spread of voluntary due diligence sustainability tools.

With regards to the impact of the new rules, it is worth noting that the personal scope of the directive has been limited to large firms (and medium companies operating in high impact sectors), narrowing the total number of companies to which new rules will apply, considering that micro, small and medium enterprises represent the majority of European companies.[114]

Despite all the limits here highlighted, the European proposed regulation represents a relevant step in increasing awareness and advancing a higher integration of sustainability requirements in corporate strategies and decision-making process.

[112] On the issue, Genevieve Le Baron, Andreas Rühmkorf, *Steering CSR Through Home State Regulation: A Comparison of the Impact of the UK Bribery Act and Modern Slavery Act on Global Supply Chain Governance* 8 Global Policy – Supplement 3, 15 (2017); Judith Schrempf-Stirling, Florian Wettstein, *Beyond Guilty Verdicts: Human Rights Litigation and its Impact on Corporations' Human Rights Policies* 145 J. Bus Ethics 545 (2017).

[113] Follow-up to the second opinion of the Regulatory Scrutiny Board, p. 14-15.

[114] Impact Assessment Report Annexes, p. 155-156. It is worth noting that SMEs can be indirectly affected because of other companies' actions across their value chains and that the number of companies covered by the new rules can be increased in the future by amending the personal scope of the directive, as occurred with the Corporate Sustainability Reporting Directive amending the Non-Financial Reporting Directive.

From a general perspective, it is possible to stress the policy shift from self-regulation to statutory law in the private procurement framework.[115] The private sector indeed has so far relied primarily on voluntary standards and self-regulation (*e.g.*, codes of ethics, procurement guidelines, supplier codes of conduct, sustainability tools and third party certification, standards drawn by the UN Guiding Principles on Business and Human Rights, OECD Guidelines for Multinational Enterprises, and OECD Due Diligence Guidance for Responsible Business Conduct) to address a range of issues, including human rights, environmental harms and sustainability goals.

Globalisation created a complex supply chain process[116] where potential exploitation of workers and harmful effects on the environment are difficult to monitor. Companies can avoid liability for their negative impacts on local communities and the environment by hiding behind the corporate veil of their subsidiaries (traditionally treated as separate legal entities), or by exploiting weak and inadequately enforced domestic regulation (especially in developing countries), or by abusing the international investors' protection system.[117]

In the last years, the crisis triggered by the Covid-19 pandemic had severe effects on global value chain, revealing its fragility and exacerbating existing problems. The crisis accelerated a process already underway and made even more necessary an effective intervention to overcome the traditional approach based on enterprises' voluntary actions and to introduce a mandatory human rights and environmental due diligence's duty. The European proposal on corporate sustainability due diligence is a great example of this emerging policy shift from self-regulation towards statutes in the private procurement framework.

Moreover, it is interesting to observe how to overcome limits of states' regulatory power due to globalisation, corporate mobility, and forum and legal system shopping, the European proposal is intended to have some form of extraterritorial application. In fact, it provides human rights and environmental due diligence obligations for companies established in third countries but operating (over certain thresholds) in the

[115] Examples of such a transition from self-regulation to statute law can be found in both civil and common law countries. The earliest examples of sector-specific statutes in the field of supply chain monitoring occurred in common law countries like California (with the 2010 Transparency in Supply Chains Act), United Kingdom (with the Modern Slavery Act of 2015), and Australia (with the 2018 Commonwealth Government Modern Slavery Act). But civil law systems seem to follow this direction. In this regard, France has been the first country worldwide to provide a general and comprehensive duty of due diligence for human rights and environmental harms with the enactment of the Duty of Vigilance Law in 2017.

[116] With regards to the complex governance patterns in global value chains see Gary Gereffi, John Humphrey, Timothy Sturgeon, *The Governance of Global Value Chains* 12 Review of international Political Economy 78 (2005), in which the authors identify three variables that play a large role in determining how global value chains are governed and change, *i.e.,* (1) the complexity of transactions, (2) the ability to codify transactions, and (3) the capabilities in the supply-base. In particular, according to the authors, five types of global value chain governance – characterized by different levels of explicit coordination and power asymmetry – can be categorize: hierarchy, captive, relational, modular, and market.

[117] Citing the European Parliamentary Research Service, *Towards a Mandatory EU System of Due Diligence for Supply Chains* (October 2020), p. 2.

Union. Moreover, it requires both, European and foreign companies under the scope of the directive to include in their due diligence polices (and to be responsible for) all their subsidiaries as well as direct and (certain) indirect suppliers, wherever located, in the EU or third countries. This helps making companies accountable for what occurs in the overall development of their services or products, even outside their state of incorporation. Finally, it provides for the overriding mandatory application of civil liability rules, beyond the usual identification of the applicable law provided for by private international law.

This transnational application of the European rules will require the Commission to provide accompanying measures to mitigate potential negative effects on trading partners located in developing countries caused by the withdrawal of companies under the scope of the directive from risky territories, where is difficult, or not possible to mitigate harms to the environment and human rights due to systemic issues.

Finally, looking at the proposal from a theoretical perspective, it is possible to affirm that through the extension of civil liability firms become "responsible" for the behaviour of their subsidiaries and suppliers. They internalise their suppliers' externalities. This results in an expansion of the firm's boundaries[118] beyond the limits traditionally identified by twentieth century's economic theories, centred on the assumption that the boundaries of the firm are defined by the relative costs of two methods of co-ordination: markets and the price mechanism, versus central direction and management hierarchies.[119]

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[118] On the boundaries of the firm form a contracts law perspective see Fabrizio Cafaggi, Paola Iamiceli, *Regulating Contracting in Global Value Chains. Institutional Alternatives and their Implications for Transnational Contract Law* 16 European Review of Contract Law 44 (2020).

[119] In his seminal articles on the theory of the firm Coase submits that the main reason to establish a firm as well as the setting of its boundaries is a result of the transaction costs involved in the price mechanism, *i.e.*, a firm is established when transaction costs of coordinating production through the market exchange are greater than within the firm; accordingly, the size of the firm depends on the amount of costs of internalizing a transaction or making that transaction in the market (see Ronald H. *Coase, The Nature of the Firm* 4 Economica 386 (1937); Ronald H. Coase, *The Nature of the Firm: Influence* 4 J. L. Econ. & Org. 33 (1988)). On the neoclassical theory of the firm as a productive function, according to which organizing production within the firm is more efficient than organizing production through independent parties and for the idea that the firm is a black box, without links with the external environment see Armen A. Alchian, Harold Demsetz, *Production, Information Costs and Economic Organization* 62 Am. Econ. Rev. 777 (1972); Michael C. Jensen, William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure* 3 J. Financ. Econ. 305 (1976). For further analysis of the theory of firm see also Oliver E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (New York; Free Press, 1985); Oliver E. Williamson*, The Theory of the Firm as Governance Structure: From Choice to Contract* 16 The Journal of Economic Perspectives 171 (2002); Bengt Holmström, John Roberts, *The Boundaries of the Firm Revisited* 12 The Journal of Economic Perspectives 73 (1998); Edward M. Iacobucci, George G. Triantis, *Economic and Legal Boundaries of Firms* 93 Va. L. Rev. 515 (2007); Raghuram G. Rajan, Luigi Zingales, *The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms* 116 The Quarterly Journal of Economics 805 (2001); Raghuram G. Rajan, Luigi Zingales, *The Influence of the Financial Revolution on the Nature of Firms* 91 The American Economic Review 206 (2001); Luigi Zingales, *Towards a Political Theory of the Firm* 31 The Journal of Economic Perspectives 113 (2017).

Moreover, for firms under the scope of the directive, the firm's boundaries are no longer the legal boundaries linked to ownership rights[120] or the chain of control.[121] They move along with sustainability due diligence requirements provided by the law.

Theories based on the idea of the firm as a "black box", without any link with the external environment in which it operates,[122] disregard the impact of the firm's activities beyond its traditional boundaries and appear to be no longer able to capture the contemporary realty and legal emerging trends, which impose to consider one of the key challenges of the twenty-first century, sustainability in all its dimensions: economic, social and environmental.

The European Commission proposal for a Corporate Sustainability Due Diligence Directive represents an attempt at regional harmonization of the issue that may contribute to position the EU as a global leader in the transition to a sustainable economy and could help foster the emergence of a global legal standard for responsible business conduct.

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[120] See Harold Demsetz, *Toward a Theory of Property Rights* 57 Am. Econ. Rev. 347 (1967).

[121] Among others, see Edith Penrose, *The Theory of the Growth of the Firm* (Oxford; Blackwell, 1959); Karl E. Weick*, Educational Organizations as Loosely Coupled Systems* 21 Adm. Sci. Q. 1 (1976); Michael E. Porter, *Competitive strategy. Techniques for Analyzing Industries and Competitors* (New York; Free Press, 1980); Ron Ashkenas, Dave Ulrich, Todd Jick, Steve Kerr, *The Boundaryless Organization, Breaking the Chains of Organizational Structure* (Jossey-Bass, 1995).

[122] As proposed by the neoclassical theory of firm, see *e.g.*, Alchian, Demsetz, *Production, Information Costs and Economic Organization,* cit.; Jensen, Meckling, *Theory of the Firm,* cit. For modern theories "opening" the firm's "black box" see *e.g.*, the capabilities-based approach (Edith Penrose, *The Theory of the Growth of the firm,* cit.; George B. Richardson, *The Organisation of Industry* 82 Economic Journal 883 (1972)) and the resource-based theory (Scott L. Newbert, *Empirical Research on the Resource-Based View of the Firm: An Assessment and Suggestions for Future Research* 28 Strategic Management Journal 121 (2007); Margaret A. Peteraf, Jay B. Barney, *Unravelling the Resource-Based Tangle* 24 Manage. Decis. Econ. 309 (2003)), which used the concept of capabilities to explain the growth, scope, and boundaries of firms. On the idea of the absence of a clear delimitation of the concept of the firm and its boundaries See Edith Penrose, *The Theory of the Growth of the Firm*, cit., p. 10, according to which "A firm is by no means an unambiguous clear-cut entity. It is not a physically observable object separable from other objects"; and Larry Hirschhorn, Thomas Gilmore, *The New Boundaries of the "Boundaryless" Company* 70 Harv. Bus. Rev. 104 (1992).