CHAPTER 2

Sustainable Governance and Corporate Due Diligence: The Shifting Balance Between Soft Law and Hard Law

Guido Ferrarini

1 Introduction

I recently argued that sustainability can be seen as a game changer in corporate governance,[1] to the extent that not only regulation but also conduct guidelines and ethical standards operate as sustainability constraints on the behaviour of enterprises and their pursuit of profits. In the present paper, I

[1] G. Ferrarini, 'Redefining Corporate Purpose: Sustainability as a Game Changer', in D. Busch, G. Ferrarini and S. Grünewald (eds.), *Sustainable Finance in Europe*. Corporate Governance, Financial Stability and Financial Markets, Palgrave MacMillan, 2021, Chapter 4. An earlier version of that chapter was published as 'Corporate Purpose and Sustainability' (December 7, 2020), European Corporate Governance Institute - Law Working Paper #559/2020, available at SSRN: https://ssrn.com/abstract=3753594 or http://dx.doi.org/10.2139/ssrn.3753594.

My paper does not consider the proposal for a Directive on corporate sustainability due diligence which was adopted by the Commission on 23 February 2022.

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P. Câmara and F. Morais (eds.), *The Palgrave Handbook of ESG and Corporate Governance*, https://doi.org/10.1007/978-3-030-99468-6_2

further analyse the regulatory and ethical constraints to value maximization motivated by sustainability concerns. In addition, I show that the borders between soft law and hard law in this area are shifting, as a result of EU regulatory initiatives on corporate due diligence which are directed to significantly reduce the impact of business activities on the environment and society. In "Sustainability as a Game Changer" section, I explain the role of regulation and international standards in making firms internalize their negative externalities as to the environment and society. I also highlight the role of non-financial disclosure in promoting compliance with international standards. In "The International Principles on Corporate Responsibility" section, I consider the main standards followed by international firms as to environmental and social sustainability, with particular regard to those on corporate due diligence. In "The European Parliament's Draft Directive on Corporate Due Diligence and Accountability" section, I examine recent EU proposals to transplant some of these standards into hard law through a directive like the one recently suggested by the European Parliament. In "Problems and Limits of the Draft Directive" section, I emphasize the problems and limits of the due diligence obligations envisaged by the proposed directive. In "Concluding Remarks" section I conclude.

2 Sustainability as a Game Changer

In the present section, I summarize the main outcomes of my previous paper by focusing on two topics: the role played by sustainability in the definition of corporate purpose; the regulatory and ethical constraints to shareholder wealth maximization which are motivated by sustainability. In addition, I underline the role of non-financial disclosure in creating incentives to corporate sustainability.

Corporate Purpose and Sustainability

An increasing number of firms make reference to the pursuit of environmental and social goals in the definition of their purpose. This raises important issues with respect to the way in which the trade-offs between profit maximization and social value are solved. As shown in my previous paper, corporate purpose has been analysed from different perspectives with different aims in mind.[2] Lawyers look at corporate purpose mainly to establish for whom the corporation is run and what are the duties of directors. The legal systems diverge on definitions, but not very much on substance, given the limited relevance of

[2] Ibidem. See also E. Rock, For Whom is the Corporation Managed in 2020?: The Debate over Corporate Purpose (May 1, 2020), European Corporate Governance Institute—Law Working Paper No. 515/2020, NYU School of Law, Public Law Research Paper No. 20–16, NYU Law and Economics Research Paper, available at SSRN: https://ssrn.com/abstract=3589951 or http://dx.doi.org/10.2139/ssrn.3589951.

corporate purpose in the practice of law.[3] Moreover, the discussion on corporate purpose generally extends to the definition of the company's interest, which grounds the duty of loyalty of directors and the rules on conflicts of interest.

Economists focus on corporate purpose to define the role of firms in a market economy and the incentives—including the pursuit of profit—through which business corporations efficiently serve their productive function. Finance scholars are especially interested in valuation issues and mainly think of corporate purpose in terms of either shareholder value or firm value maximization.[4] Management studies show how corporate purpose and its derivatives (like corporate mission, vision and values) can be resorted to in orienting the corporate organization towards the goals that the directors and managers choose to follow in the strategy and activities of firms. Clearly these goals are not identified exclusively with the pursuit of profit but extend to social responsibility issues. Moreover, the definition of purpose in detail depends on management style, corporate culture and the specificities of the industry concerned. Recent works by finance and management scholars argue, however, that the value to maximize is not only shareholder value (or firm value), but also (and for some predominantly) social value.[5] Similar works implicitly vindicate the importance of CSR and stakeholder management, which have been largely neglected by economists and finance scholars until the beginning of this century.[6]

Amongst existing theories, presumably the dominant one today is enlightened shareholder value (ESV), which requires stakeholder interests to be satisfied subject to shareholder value maximization.[7] After being suggested by economics and finance scholars, ESV has been widely adopted in policy discussions and in corporate practice, possibly with variations such as those suggested by the theory of 'shared value'.[8] However, ESV needs refinement today to take account of some of the criticisms and insights found in recent

[3] See H. Fleischer, Corporate Purpose: A Management Concept and its Implications for Company Law (January 21, 2021), European Corporate Governance Institute—Law Working Paper No. 561/2021, available at SSRN: https://ssrn.com/abstract=3770656 or http://dx.doi.org/10.2139/ssrn.3770656.

[4] See M. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' (2010) 22 Journal of Applied Corporate Finance 32, and (2002) 12 Business Ethics Quarterly 235.

[5] See C. Mayer, *Prosperity*. Better Business Makes the Greater Good, Oxford University Press, 2018; A. Edmans, *Grow the Pie*. How Great Companies Deliver Both Purpose and Profit, Cambridge University Press, 2020; R. Henderson, *Reimagining Capitalism*. How Business Can Save the World, Penguin Business, 2020.

[6] See O. Hart and L. Zingales, 'Companies Should Maximize Shareholder Welfare not Market Value' (2017) Journal of Law, Finance, and Accounting, 247.

[7] See Jensen, note 194.

[8] M. Porter and M. Kramer, 'Creating Shared Value: How to Reinvent Capitalism—And Unleash a Wave of Innovation and Growth' (2011) Harvard Business Review 3.

scholarly works stressing the social values that should be pursued by corporations.[9] Stakeholder protection should not be seen exclusively as instrumental to long-term value maximization—as narrowly suggested by ESV—but also as an outcome of the compliance with legal rules and ethical standards, which apply to different types of firms and aim at controlling externalities that either directly or indirectly derive from their activities. In a rising number of situations firms internalize externalities not only because it is profitable in the long run or at least suitable to reduce their risk exposures, but also to comply with the regulatory and ethical standards that protect relevant stakeholders.

Interestingly, these regulatory and ethical constraints on firm behaviour do not necessarily determine a reduction in firm value. Some empirical studies on the relationship between CSR and economic performance rather prove the opposite. A. Ferrell, H. Liang and L. Renneboog in particular find that well-governed firms that suffer less from agency concerns engage more in CSR and have higher CSR ratings.[10] They also find that a positive relation exists between CSR and value, suggesting at least that CSR is not inconsistent with shareholder value maximization.[11] Their general argument is interesting for present purposes: 'Corporate social responsibility need not to be inevitably induced by agency problems but can be consistent with a core value of capitalism, generating more returns to investors, through enhancing firm value and shareholder wealth'.[12]

Regulatory and Ethical Constraints to Value Maximization

The role of regulation in constraining shareholder wealth maximization is easily understood. Environmental protection, to make an obvious example, largely depends on government regulation, which is binding on firms and influences their actions. No doubt, firms comply with this type of regulation not only for ethical reasons, but also to avoid the administrative and criminal sanctions which would derive from violations of the relevant rules and would negatively affect their economic value. Stakeholder protection in similar cases cannot be seen as directly instrumental to firm value maximization, for it is primarily required by regulation. No matter what corporate managers think about the merits of regulation and its effectiveness in protecting the relevant stakeholders, they have to comply with the prescriptions in question.

[9] For a recent account of the centrality of value, see M. Carney, Value(s). Building a Better World for All, William Collins, 2021, 379 ff.

[10] A. Ferrell, H. Liang and L. Renneboog, 'Socially Responsible Firms' (2016) 122 Journal of Financial Economics 585. These authors consider well governed firms as represented by lower cash hoarding and capital spending, higher pay-out and leverage ratio and stronger pay-for-performance.

[11] Ibidem, 602.

[12] Ibidem, 605.

In many cases, however, the need to comply generates either organizational or technological innovation, reducing operational costs and enhancing corporate profitability. Moreover, many actions are performed by firms, particularly the largest ones, in compliance with ethical standards that are globally recognized in statements and guidelines issued by international organizations and subscribed by firms for the protection of given stakeholders. These documents are not binding per se, but their principles are often reflected in the applicable national laws and for the rest may be followed voluntarily by the corporations concerned, especially when their managers are officially committed to respect the relevant standards.

Notwithstanding the non-binding nature of similar standards and their limited enforcement, companies' policies and practices increasingly comply with them and respond to investors' growing attention towards the ESG performance of investee companies, including the formal adoption of due diligence, environmental and human rights policies in line with international standards. In the sustainable investment strategies usually followed by institutional investors, the 'norm-based screening'—which screens issuers against minimum standards of business practice based on international frameworks, such as the UN treaties, the UN Global Compact, the OECD Guidelines for Multinational Enterprises and the International Labour Organization standards—is one of the most commonly used for portfolio selection.[13] Moreover, common voluntary standards have been developed targeting investor stewardship obligations (such as the ICGN Global Stewardship principles and the EFAMA Stewardship Code)[14] or sustainable investment (such as the Principles for Responsible Investing),[15] which put further pressure on investors with regard to the sustainability-related initiatives and policies of investee companies.

The voluntary application of international standards might be motivated by reputational concerns or by the personal conviction of the managers about the morality of the actions undertaken. Therefore, like in the case of regulation, the calculus of instrumentalism may be 'indirect' in similar cases and the protection of stakeholders may simply derive from the compliance with

[13] See https://www.unpri.org/an-introduction-to-responsible-investment/an-introduction-to-responsible-investment-screening/5834.article. See also Eurosif, '2018 SRI Study for an overview of trends related to SRI strategies in Europe' (2018). See also ISS ESG, 'Norm-based Research Evaluation of ESG Controversies. Research Methodology' (2020), for an overview on the methodological process adopted by ISS ESG to evaluate corporate compliance/failure to comply with international principles (in particular, the Principles of the UN Global Compact and the OECD Guidelines for Multinational Enterprises).

[14] S. Alvaro, M. Maugeri, and G. Strampelli, 'Institutional Investors, Corporate Governance and Stewardship Codes: Problems and Perspectives' (2019), CONSOB Legal Research Papers (Quaderni Giuridici), 19.

[15] S. Kim and A. Yoon, 'Analyzing Active Managers' Commitment to ESG: Evidence from United Nations Principles for Responsible Investment' (March 17, 2020), available at SSRN: https://ssrn.com/abstract=3555984 or http://dx.doi.org/10.2139/ssrn.3555984.

the relevant standards. As a result, the managers do not compare the shareholders' interests with those of given stakeholders, nor ask to what extent protecting the latter will enhance the long-term value of the firm—as theoretically required under the ESV approach—given that their action is required per se under the international standards. Of course, to the extent that discretion is left to the managers under the individual standard—particularly if the latter is broadly formulated and there are no implementing provisions—the managers will also refer to the impact of their actions on the long-term value of the firm. But they may also decide on similar actions on purely moral grounds, filling their discretion in a way that they deem consistent with the content and spirit of the standard to apply.

Once more, reputational concerns will also be at play, in addition to the ethical beliefs of the managers, to the extent that either the consumers or the investors monitor the firm's compliance with the relevant standards. The increasing importance of sustainability multiplies this type of situations, given that not all aspects of sustainable growth are specifically dealt with by regulation, while the urgency of the problems involved requires the active cooperation of corporations, which increasingly follow (or simply declare to follow) the international guidelines and standards both in environmental and social matters. Sustainability can therefore be seen as a game changer, to the extent that not only regulation, but also conduct guidelines and ethical standards operate as constraints on the behaviour of enterprises and their pursuit of profits.

Non-Financial Disclosure and Incentives

Non-financial disclosure enhances the reputational incentives for firms to follow sustainability standards. Article 2 of the Non-financial Reporting Directive (NFRD) provides that 'the Commission shall prepare non-binding guidelines on methodology for reporting non-financial information, including non-financial KPIs, general and sectoral, with a view to facilitating relevant, useful and comparable disclosure of non-financial information by undertakings'. In addition, Recital 17 of the Directive states that, when preparing the non-binding guidelines, 'the Commission should take into account current best practices, international developments and the results of related Union initiatives'.

To this effect, the Commission issued Communication (2017/C 215/01) including 'Guidelines on non-financial reporting (methodology for reporting non-financial information)'. Under Article 1 a. of the NFRD, the non-financial statement contains information including 'a brief description of the undertaking's business model'. As specified in the Guidelines, 'a company's business model describes how it generates and preserves value through its products or services over the longer term'. Moreover, 'companies may consider including appropriate disclosures relating to their business environment; their organization and structure; the markets where they operate; their objectives

and strategies; and the main trends and factors that may affect their future development'.

Furthermore, under Article 1 b. of the NFRD, the non-financial statement contains information including 'a description of the policies pursued by the undertaking in relation to those matters, including due diligence processes implemented'. According to the Guidelines, 'due diligence processes relate to policies, to risk management and to outcomes... They help identify, prevent and mitigate existing and potential adverse impacts'. Companies should provide material disclosures on due diligence processes implemented, including on its suppliers and subcontracting chains. Companies may also consider providing relevant information on setting targets and measuring progress. The Commission specifies that OECD Guidance documents for several sectors, UN Guiding Principles on Business and Human Rights, the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, or ISO 26000 provide useful guidance on this.

3 The International Principles on Corporate Responsibility

The growing importance and diffusion of the principles and guidelines issued by international organizations and standard setters (including the IMF, the OECD, the World Bank and the United Nations) have led an author to identify a new field of the law significantly dubbed as 'international corporate law' (ICL).[16] The emergence of ICL has partially responded to the 'interjurisdictional externalities and nationalist bias of domestic regimes'. With specific reference to corporate responsibility towards the environment and society, it has the potential to fill the gaps in national legislations, by establishing new standards for corporate behaviour that take into account the negative effects of company activities on third parties.

The UN Guiding Principles on Business and Human Rights

The main guidelines addressing corporate responsibility are the UN Guiding Principles on Business and Human Rights [UN Guiding Principles] which provide standards for both States and business enterprises to prevent, address and remedy human rights abuses committed in business operations. The UN Guiding Principles include 14 principles specifically addressing the responsibilities of business enterprises in relation to the respect of human rights, providing also a set of operational recommendations going from the issuance of a specific policy on human rights to the performance of a human rights due diligence and the provision of remedies to the adverse impacts the company

[16] M. Pargendler, 'The Rise of International Corporate Law' (2020), European Corporate Governance Institute—Law Working Paper, 555/2020, FGV Direito SP Research Paper Series n. Forthcoming.

has caused or has contributed to generate with its actions. The Human Rights Council formally endorsed the Principles in 2011 and to date at least 377 large companies adopted a formal statement explicitly referring to human rights in compliance with Principle 16 of the UN Guiding Principles on Business and Human Rights.[17] Unlike the UN Guiding principles, the UN Global Compact is an initiative that global corporations can commit to by respecting 10 key principles of business behaviour in human rights, labour, the environment and corruption.[18] Currently, the UN Global Compact counts more than 12,000 signatories in over 160 countries covering all business sectors.[19]

The UN Guiding Principles deal extensively with the corporate responsibility to respect human rights. Amongst the 'foundational principles', Principle 11 states that business enterprises should respect human rights, while Principle 12 specifies that their responsibility refers to internationally recognized human rights. Under Principle 13, business enterprises are required to '(a) Avoid causing or contributing to adverse human rights impacts through their own activities, and address such impacts when they occur; (b) Seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products or services by their business relationships, even if they have not contributed to those impacts'. Principle 15 further specifies that 'business enterprises should have in place policies and processes appropriate to their size and circumstances, including: (a) A policy commitment to meet their responsibility to respect human rights; (b) A human rights due diligence process to identify, prevent, mitigate and account for how they address their impacts on human rights; (c) Processes to enable the remediation of any adverse human rights impacts they cause or to which they contribute'.

Amongst the 'operational principles', Principle 16 deals with the 'policy commitment' of business enterprises,[20] while Principle 17 provides for 'human rights due diligence' which is directed to 'identify, prevent, mitigate and account for how [business enterprises] address their adverse human rights impacts'. Human rights due diligence should cover, in particular, 'adverse human rights impacts that the business enterprise may cause or contribute to through its own activities, or which may be directly linked to its operations,

[17] See https://old.business-humanrights.org/en/company-policy-statements-on-human-rights.

[18] See https://www.unglobalcompact.org/what-is-gc/mission/principles.

[19] See https://www.unglobalcompact.org/what-is-gc/participants.

[20] 'As the basis for embedding their responsibility to respect human rights, business enterprises should express their commitment to meet this responsibility through a statement of policy that: (a) Is approved at the most senior level of the business enterprise; (b) Is informed by relevant internal and/or external expertise; (c) Stipulates the enterprise's human rights expectations of personnel, business partners and other parties directly linked to its operations, products or services; (d) Is publicly available and communicated internally and externally to all personnel, business partners and other relevant parties; (e) Is reflected in operational policies and procedures necessary to embed it throughout the business enterprise'.

products or services by its business relationships'. Interestingly, the commentary to this Principle states what follows: 'Human rights due diligence can be included within broader enterprise risk-management systems, provided that it goes beyond simply identifying and managing material risks to the company itself, to include risks to rights-holders'.

The OECD Guiding Principles and the ILO Tripartite Declaration

The OECD Guidelines for Multinational Enterprises, firstly adopted in 1976, are also important. They consist of a set of voluntary standards and principles for responsible business conduct addressed to multinational enterprises operating in or from the adhering countries. Specifically, the latest version of the OECD Guidelines was adopted in 2011 by the 42 OECD and non-OECD governments adhering to the OECD Declaration on International Investment and Multinational Enterprises, and today 49 governments have established a National Contact Point with the duty of ensuring the effectiveness of the OECD Guidelines by undertaking promotional activities, handling enquiries and providing a grievance mechanism to resolve cases with regard to the non-observance of the recommendations. The OECD Guidelines cover a diverse range of topics related to business behaviour, from company disclosure and reporting on financial, social and environmental material information to the respect of employees, human rights, the environment, consumers interest and the fight against bribery and other illicit conducts, as well as the promotion of science and technology development, fair competition and tax compliance. To complement the standards of behaviour established by the OECD Guidelines, in 2018, the OECD Due Diligence Guidance for Responsible Business Conduct was adopted,[21] with the aim of providing practical support to business enterprises on the implementation of the OECD Guidelines. Moreover, the OECD has developed sector-specific due diligence guidance and good practice documents for the minerals,[22] agriculture[23]and garment and footwear supply chains,[24] as well as for the extractive sector.[25]

The OECD Guidelines for Multinational Enterprises rely extensively on the UN Guiding Principles on Business and Human Rights, but have a broader scope also including employment and industrial relations, environment, combating bribery, bribe solicitation and extortion, consumer interests,

[21] OECD (2018), OECD Due Diligence Guidance for Responsible Business Conduct.

[22] OECD (2016), OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas: Third Edition, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264252479-en.

[23] OECD, Recommendation of the Council on the OECD-FAO Guidance for Responsible Agricultural Supply Chains, OECD/LEGAL/0428.

[24] OECD (2017), OECD Due Diligence Guidance for Responsible Supply Chains in the Garment and Footwear Sector.

[25] OECD (2016), Recommendation of the Council on the Due Diligence Guidance for Meaningful Stakeholder Engagement in the Extractive Sector.

science and technology, competition and taxation. In Chapter 2 on General Policies, they state that 'Enterprises should: 11. Avoid causing or contributing to adverse impacts on matters covered by the Guidelines, through their own activities, and address such impacts when they occur. 12. Seek to prevent or mitigate an adverse impact where they have not contributed to that impact, when the impact is nevertheless directly linked to their operations, products or services by a business relationship'. These two paragraphs reflect the 'protect, respect and remedy framework' of the UN Guiding Principles, extending it beyond human rights to areas such as the environment and employment relations. In a similar vein, para. 14 states that 'due diligence is understood as the process through which enterprises can identify, prevent, mitigate and account for how they address their actual and potential adverse impacts as an integral part of business decision-making and risk management systems. Due diligence can be included within broader enterprise risk management systems, provided that it goes beyond simply identifying and managing material risks to the enterprise itself, to include the risks of adverse impacts related to matters covered by the Guidelines. Potential impacts are to be addressed through prevention or mitigation, while actual impacts are to be addressed through remediation'.

The Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (MNE Declaration), which was approved by the International Labour Office (ILO) in 1977 and later amended (the last time in 2017) similarly refers to the UN Guiding Principles on Business and Human Rights, extending however their reach to the fundamental rights set out in the ILO Declaration on Fundamental Principles and Rights at Work.

4 The European Parliament's Draft Directive on Corporate Due Diligence and Accountability

The European Commission recently suggested that legal requirements for corporate due diligence could strengthen a practice already widespread in the market.[26] Moreover, their introduction in EU legislation would be in line with the Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment [Taxonomy Regulation].[27]Article 3 of this Regulation requires business activities to comply with the minimum safeguards set out in Article 18 in order to be considered as 'environmentally sustainable', i.e. to establish procedures 'to ensure the alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set

[26] See Sect. 3 of the Commission's questionnaire on sustainable governance recently submitted to Consultation at https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/public-consultation

[27] 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.

out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights'. All this means that companies should adopt a specific human rights policy, establish human rights due diligence processes and provide a system of remedies for adverse impacts.

The European Parliament's Resolution on Corporate Due Diligence

The European Parliament recently approved a resolution including a draft Directive seeking to transplant international guidelines such as the UN Guiding Principles and the OECD Guidelines at EU level.[28] As stated in the 10th recital of the draft Directive's Preamble, 'in order to ensure a level playing field, the responsibility for undertakings to respect human rights under international standards should be transformed into a legal duty at Union level. By coordinating safeguards for the protection of human rights, the environment and good governance, this Directive should ensure that all Union and non-Union large undertakings and high-risk or publicly listed small and medium-sized undertakings operating in the internal market are subject to harmonized due diligence obligations, which will prevent regulatory fragmentation and improve the functioning of the internal market'.

As a consequence, the draft Directive foresees *due diligence obligations*, which are grounded on the duty of undertakings to respect human rights, the environment and good governance (Art. 1 (1)). The draft Directive leaves the obligations to comply with under the due diligence procedures regulated by the Directive to different legal texts of either hard law or soft law. It is different therefore to the UN Guiding Principles, where the 'duty to respect' includes both the duty to avoid infringements of human rights and the duty to prevent them. Indeed, under Principle 13 the responsibility to respect human rights requires that business enterprises (a) avoid causing or contributing to adverse human rights impacts through their own activities, and (b) seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products or services by their business relationships. Letter (b) essentially refers to the due diligence duty, while letter (a) includes the duty not to cause adverse human rights impacts. The proposed Directive is not directly concerned with (a). The reason for its more limited scope may depend on the fact that it aims to transform soft law of international origin into hard law of the Union and the Member States. This makes it more difficult to define the duties of enterprises—other than the due diligence ones—and the responsibility deriving from their infringement. Moreover, in the case of

[28] See European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)), available at https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.html. The resolution carries an Annex including recommendations for drawing up a Directive of the European Parliament and of the Council on Corporate due diligence and corporate accountability.

human rights it is relatively easy to define them with respect to international law, whereas it is more difficult to do something similar with respect to the environment and the harms which may be caused to it by business activities.

Therefore, the draft Directive is mainly concerned with the preventative measures required for companies to avoid adverse impacts and with the remedies applicable if such impacts materialize. Indeed, according to Art. 4 (1) the Member States 'shall lay down rules to ensure that undertakings carry out effective due diligence with respect to potential or actual adverse impacts on human rights, the environment and good governance in their operations and business relationships'. Under these rules, the undertakings concerned shall 'take all proportionate and commensurate measures and make efforts within their means to prevent adverse impacts on human rights, the environment and good governance from occurring in their value chains', and shall be required 'to identify, assess, prevent, cease, mitigate, monitor, communicate, account for, address and remediate the potential and/or actual adverse impacts on human rights, the environment and good governance that their own activities and those of their value chains and business relationships may pose' (Art. 1 (2)).

Due Diligence Strategy

In order to comply with their due diligence duty, undertakings shall adopt a 'due diligence strategy', which includes some of the key characteristics of a compliance and risk management programme. Under this strategy, undertakings shall 'in an ongoing manner make all efforts within their means to identify and assess, by means of a risk based monitoring methodology that takes into account the likelihood, severity and urgency of potential or actual impacts on human rights, the environment or good governance, the nature and context of their operations, including geographic, and whether their operations and business relationships cause or contribute to or are directly linked to any of those potential or actual adverse impact'(Art. 4 (1)). However, if a large undertaking, whose direct business relationships are all domiciled within the Union, or a small or medium-sized undertaking concludes that it does not cause, contribute to, or that it is not directly linked to any potential or actual adverse impact on human rights, the environment or good governance, it shall publish a statement to that effect and shall include its risk assessment containing the relevant data, information and methodology that led to this conclusion (Art. 4 (3)). Otherwise, it shall establish and effectively implement a due diligence strategy (Art. 4 (3)).

As part of their due diligence strategy, undertakings shall: (i) specify their potential or actual adverse impacts on human rights, the environment and good governance identified and assessed in conformity with Art. 4 (2); (ii) map their value chain and publicly disclose relevant information about it; (iii) adopt and indicate all proportionate and commensurate policies and measures with a view to ceasing, preventing or mitigating potential or actual adverse

impacts on human rights, the environment or good governance; (iv) set up a prioritization strategy in the event that they are not in a position to deal with all the potential or actual adverse impacts at the same time. As to value chain due diligence, undertakings shall ensure that their business relationships put in place and carry out human rights, environmental and good governance policies that are in line with their due diligence strategy. Undertakings shall ensure that their purchase policies do not cause or contribute to potential or actual adverse impacts on human rights, the environment or good governance (Art. 4 (7) and (8)).

Adverse Impact, Business Relationships and Value Chain

One of the core concepts of the draft Directive is that of 'potential or actual adverse impact' of business activities. The relevant definitions are offered in Art. 3 of the draft with regard to the different types of harm which can be caused by companies to society and the environment. Firstly, '"potential or actual adverse impact on human rights" means any potential or actual adverse impact that may impair the full enjoyment of human rights by individuals or groups of individuals in relation to human rights, including social, worker and trade union rights, as set out in Annex xx to this Directive'. Secondly, '"potential or actual adverse impact on the environment" means any violation of internationally recognised and Union environmental standards, as set out in Annex xxx to this Directive'. Thirdly, '"potential or actual adverse impact on good governance" means any potential or actual adverse impact on the good governance of a country, region or territory, as set in Annex xxxx to this Directive'. The three Annexes shall be reviewed on a regular basis by the Commission and be consistent with the Union's objectives on human rights, on environmental protection and climate change mitigation, and on good governance.

Two other core concepts are those of business relationship and value chain, which are also defined in Art. 3 of the draft. The first concept 'means subsidiaries and commercial relationships of an undertaking throughout its value chain, including suppliers and sub-contractors, which are directly linked to the undertaking's business operations, products or services'. The second concept 'means all activities, operations, business relationships and investment chains of an undertaking and includes entities with which the undertaking has a direct or indirect business relationship, upstream and downstream, and which either: (a) supply products, parts of products or services that contribute to the undertaking's own products or services, or (b) receive products or services from the undertaking'. The value chain, therefore, includes the supply chain, but also the customers who buy the firm's products or services.

Enforcement

The draft Directive provides for both public and private enforcement. Art. 18 (1) requires Member States to 'provide for proportionate sanctions applicable to infringements of the national provisions adopted in accordance with this Directive and shall take all the measures necessary to ensure that those sanctions are enforced. The sanctions provided for shall be effective, proportionate and dissuasive and shall take into account the severity of the infringements committed and whether or not the infringement has taken place repeatedly'. Furthermore, Art. 19 (2) requires Member States to adopt a *civil liability regime* for any harm arising out of potential or actual adverse impacts on human rights, the environment or good governance that undertakings have caused or contributed to by acts or omissions. National law should therefore define the wrongs from which the civil liability will arise. It is not clear however if the duties in general to respect human rights, the environment and good governance should be covered, or only the due diligence duties specifically foreseen by the Directive. The text is unclear, but only the latter duties should be relevant for the civil liability regime at issue. Indeed, Art. 19 (1) specifies that 'the fact that an undertaking respects its due diligence obligations shall not absolve the undertaking of any liability which it may incur pursuant to national law'. Moreover, Art. 19 (3) provides that 'undertakings that prove that they took all due care to avoid the harm in question, or that the harm would have occurred even if all due care had been taken, are not held liable for that harm'.

These two provisions appear to contradict each other. In order to solve this potential conflict, one should assume that para. 3 refers to the liability for breach of the due diligence obligations foreseen by the national legislation implementing the Directive, while para. 1 refers to the liability for breach of the legal entitlements foreseen under the substantive law of the Member State. The Directive only specifies the due diligence obligations, so that the States would be free to identify the 'duties to respect' that ground similar obligations through substantive law provisions. Once more, the distinction between organizational law and substantive law provisions is relevant and helps solving the civil liability problems originated by adverse impacts in the areas covered by the draft Directive. However, the draft should be amended to clarify the grounds and scope of the liability provisions that Member States should adopt in implementing the Directive.

5 Problems and Limits of the Draft Directive

The proposed directive is to some extent imprecise and open to criticism from the perspective of legal certainty, as it refers to numerous texts of soft law in a hard law context. No doubt, the directive tries to be specific as to the types of standards with respect to which corporations should be accountable. For instance, Recital 23 clarifies the type of environmental standards that will be

relevant under Art. 3: 'Annex xxx sets out a list of types of business-related adverse impacts on the environment, whether temporary or permanent, that are relevant for undertakings. Such impacts should include, but should not be limited to, production of waste, diffuse pollution and greenhouse emissions that lead to a global warming of more than 1.5 °C above pre-industrial levels, deforestation, and any other impact on the climate, air, soil and water quality, the sustainable use of natural resources, biodiversity and ecosystems. The Commission should ensure that those types of impacts listed are reasonable and achievable. To contribute to the internal coherence of Union legislation and to provide legal certainty, this list is drawn up in line with Regulation (EU) 2020/852 of the European Parliament and of the Council'.

Similarly, Recital 24 circumstantiates adverse impacts on governance such as corruption by reference to several sources of international law and standards: 'Annex xxxx sets out a list of types of business-related adverse impacts on good governance that are relevant for undertakings. They should include non-compliance with OECD Guidelines for Multinational Enterprises, Chapter 7 on Combatting Bribery, Bribe Solicitation and Extortion and the principles of the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and situations of corruption and bribery where an undertaking exercises undue influence on, or channels undue pecuniary advantages to, public officials to obtain privileges or unfair favourable treatment in breach of the law, and including situations in which an undertaking becomes improperly involved in local political activities, makes illegal campaign contributions or fails to comply with the applicable tax legislation. The Commission should ensure that those types of impacts listed are reasonable and achievable'.

Clearly, if all the soft law principles and standards just mentioned were transformed into binding legal rules serious problems would arise at the level of legal certainty and compliance. It is enough to consider that the relevant principles and standards were originally formulated to be included in non-binding legal instruments, so that they often are rather generic and not always rigorous on a technical level. Compliance with them could therefore be difficult to firms and public authorities would encounter serious difficulties in supervising them. However, I think that the directive should not transform soft law standards into hard law obligations. Rather, it should introduce due diligence obligations through hard law and require companies to take preventative measures, mainly of an organizational character, in order to avoid or reduce their adverse impacts. These impacts may consist of breaches of hard law rules by the company, but also of deviations from soft law standards that are general in character. Rather than transforming soft law standards into hard law, the directive should foresee due diligence obligations which expose the company to sanctioning only to the extent that the necessary preventative/organizational measures have not been adopted.

If the applicable standards are not sufficiently defined, the managers should have discretion as to the measures to adopt and should not be sanctioned if

their discretion is reasonably exercised. Otherwise, the rule of law would be violated. Art. 1 of the proposed directive consistently distinguishes between the compliance with the substantive rules (e.g. protecting human rights under either European or national law) and that with organizational rules such as the due diligence obligations. Para. 1 of this Article specifies that the 'Directive is aimed at ensuring that undertakings under its scope operating in the internal market fulfil their duty to respect human rights, the environment and good governance …', while para. 2 provides: 'This Directive lays down the value chain due diligence obligations of undertakings under its scope, namely to take all proportionate and commensurate measures and make efforts within their means to prevent adverse impacts …'. These two paragraphs should be read in the sense that the directive does not create new substantive rules, which only derive from existing texts of international, European or national law. Rather it gives rise to organizational rules, which mainly require risk management measures and activities.

Nonetheless, I believe that the above issues should be made more explicit in the final text of the Directive and that a clearer distinction should be made between what I have called as substantive rules and organizational ones. In other words, companies should be subject to sanctions for failing to abide by their own due diligence strategy, but not for failing to abide by the international standards themselves.[29]

6 Concluding Remarks

As shown in this paper, regulation and international standards constrain value maximization on sustainability grounds by requiring firms to internalize their negative externalities as to the environment and society. In addition, the borders between soft law and hard law in this area are shifting as a result of legislative initiatives of the EU Commission and the European Parliament, which aim to transplant the international standards on corporate due diligence into EU law so as to reduce the impact of business activities on the environment and society. A similar shift towards public regulation will improve firms' compliance with international sustainability standards but may cause uncertainty as to the firms' precise obligations. A clearer distinction should therefore be made in the proposed directive between general standards, substantive law rules that companies should comply with and organizational rules which serve the purposes of risk management and compliance. However, the Directive should be focused on corporate due diligence obligations and accountability, while the substantive law rules that firms must comply with should be left

[29] See, for a wider treatment, The ECLE Group (P. Davies, S. Emmenegger, G. Ferrarini, K. Hopt, A. Opalski, A. Pietrancosta, A. Recalde Castells, M. Roth, M. Schouten, R. Skog, M. Winner, E. Wymeersch), Commentary: The European Parliament's Draft Directive on Corporate Due Diligence and Corporate Accountability, available at https://ecgi.global/news/commentary-european-parliament's-draft-directive-corporate-due-diligence-and-corporate.

to other texts of either European or national law. Furthermore, the Directive should specify that the due diligence obligations do not per se transform the international soft law standards into binding prescriptions, except to the extent that such standards are referred to and possibly specified in the company's due diligence strategy.