Business and Human Rights

Response to the European Commission's Consultation for an Initiative on Sustainable Corporate Governance

Hogan Lovells

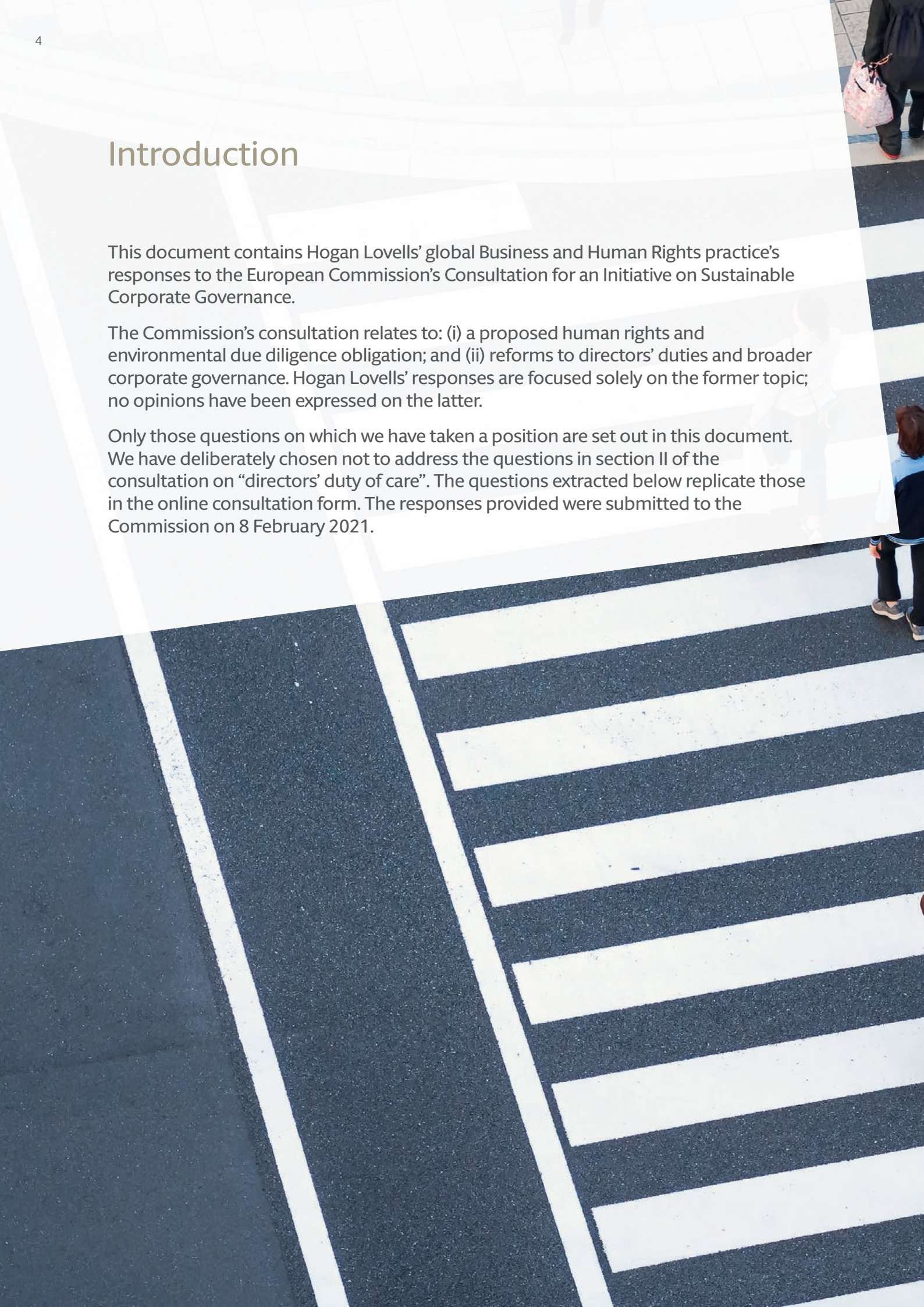
Contents

Introduction

This document contains Hogan Lovells' global Business and Human Rights practice's responses to the European Commission's Consultation for an Initiative on Sustainable Corporate Governance.

The Commission's consultation relates to: (i) a proposed human rights and environmental due diligence obligation; and (ii) reforms to directors' duties and broader corporate governance. Hogan Lovells' responses are focused solely on the former topic; no opinions have been expressed on the latter.

Only those questions on which we have taken a position are set out in this document. We have deliberately chosen not to address the questions in section II of the consultation on "directors' duty of care". The questions extracted below replicate those in the online consultation form. The responses provided were submitted to the Commission on 8 February 2021.



Consultation section I:

Need and objectives for EU intervention on Sustainable Corporate Governance

Consultation Question 1 – Taking account of stakeholder interests

Due regard for stakeholder interests, such as the interests of employees, customers, etc., is expected of companies. In recent years, interests have expanded to include issues such as human rights violations, environmental pollution and climate change. Do you think companies and their directors should take account of these interests in corporate decisions alongside financial interests of shareholders, beyond what is currently required by EU law?

- ☑ **Yes, a more holistic approach should favour the maximisation of social, environmental, as well as economic/financial performance.**
- ⊗ No, companies and their directors should not take account of these sorts of interests.
- ⊗ Do not know.

Please provide reasons for your answer:

Hogan Lovells' responses to this European Commission consultation are focused on the consultation questions relating to the possible implementation of human rights, social and environmental due diligence requirements at an EU level. We express no opinion with regard to the questions concerning possible reforms to directors' duties and broader corporate governance.

To the extent this question relates to human rights, social and environmental due diligence, both we and companies we have spoken to are broadly supportive of proposals under consideration, subject to the points made in response to later questions in this consultation.

Consultation Question 2 – Necessity of an EU framework

Human rights, social and environmental due diligence requires companies to put in place continuous processes to identify risks and adverse impacts on human rights, health and safety and environment and prevent, mitigate and account for such risks and impacts in their operations and through their value chain.

In the survey conducted in the context of the study on due diligence requirements through the supply chain, a broad range of respondents expressed their preference for a policy change, with an overall preference for establishing a mandatory duty at EU level.

Do you think that an EU legal framework for supply chain due diligence to address adverse impacts on human rights and environmental issues should be developed?

- ☑ **Yes, a more holistic approach should favour the maximisation of social, environmental, as well as economic/financial performance.**
- ⊗ No, it should be enough to focus on asking companies to follow existing guidelines and standards.
- ⊗ No action is necessary.
- ⊗ Do not know.

Please explain:

Hogan Lovells is an international law firm that advises many of the largest multinational corporations globally. Our clients span every industry sector and operate throughout the EU and across the world.

Our market-leading global Business and Human Rights practice supports businesses to help them prevent, address and mitigate potential adverse human rights impacts and the associated legal risks. Based on our expertise in this area, we have been discussing the possibility of the EU establishing human rights, social and environmental due diligence obligations with a group of key clients and companies. Discussions have included a private roundtable event, which was well attended by senior executives from a range of industries, as well as numerous individual client calls. Companies whose views we have canvassed included multinational corporations in the following sectors: automotive; chemical production; construction; finance; manufacturing; pharmaceuticals; private equity; and technology.

Companies' representatives we have spoken to have given us permission to share their anonymised views with the European Commission. Though this response predominantly reflects the views we collected, we have also sought to supplement those views with our own expertise (for example, on the operation of relevant national regimes) where appropriate.

The companies we surveyed broadly support the development of an EU legal framework for supply chain due diligence to address adverse impacts on human rights and environmental issues. Companies see important benefits arising from an EU framework, including: a level playing field; harmonisation across the EU; increased legal certainty in a fast-developing area of law; and the support in dealings with companies operating in third countries of a non-negotiable standard.

However, while companies support the principle of supply chain due diligence as proposed, there are concerns relating to the scope of the potential duty, and the practical and financial implications for businesses of all sizes.

In particular, some are apprehensive about how a new legal due diligence framework will accommodate companies working with vast and complex supply chains. If the proposal is to be workable, companies feel strongly that the European Commission will need to work with stakeholders to support their compliance. Companies we spoke to cautioned the need for a balanced, risk-based approach to supply chain due diligence. They consider pragmatism to be essential. Any new requirements should be developed with due regard paid to companies' existing obligations to undertake due diligence in other areas (e.g. with respect to bribery, money laundering, modern slavery, online content regulation, etc.) on a risk-proportionate basis. One suggestion is that due diligence should only be required with respect to third parties that meet certain financial thresholds, though that may not be a one-size-fits-all solution.

Companies recognise that transparency requirements will form an important part of any new due diligence framework. However, those we spoke to raised concerns that any obligations should not require the disclosure of commercially sensitive information. An appropriate balance will need to be struck.

In order to provide legal certainty and minimise complexity, the framework should be accompanied by clear guidance on exactly what sort of due diligence will be required in respect of different types of third parties in companies' supply chains.

Some companies also consider it essential that independent support structures (such as auditing bodies to carry out standardised due diligence checks across potential suppliers) are put in place to facilitate the due diligence process. Without such structures, some caution that it would be administratively impossible to carry out the requisite due diligence on the (possibly tens of thousands of) companies in their supply chain. Any such auditing bodies might best be managed by national authorities, to mitigate the risks posed by unreliable and unaccountable third parties.

Another suggestion raised is that, where suppliers operating in low or medium-risk sectors and/or jurisdictions form part of multiple companies' supply chains, some form of certification process could ensure companies need not duplicate due diligence already conducted by others. National auditing bodies could play a role in such a process.

Companies are also worried about the potential impact of having to undertake due diligence on third-country companies in their supply chains whose compliance approaches are based on local laws. It was felt that this issue could be particularly acute in respect of social or environmental harms, where businesses expect that it will be difficult to ensure that companies in their supply chains comply with standards imposed by the EU where those standards are far more stringent, or even conflict with, requirements under local laws.

Consultation Question 3 – Benefits and drawbacks

Benefits

If you think that an EU legal framework should be developed, please indicate which among the following possible benefits of an EU due diligence duty is important for you?

- ☑ **Ensuring that the company is aware of its adverse human rights, social and environmental impacts and risks related to human rights violations other social issues and the environment and that it is in a better position to mitigate these risks and impacts.**
- ☑ **Contribute effectively to a more sustainable development, including in non-EU countries.**
- ☑ **Levelling the playing field, avoiding that some companies freeride on the efforts of others.**
- ☑ **Increasing legal certainty about how companies should tackle their impacts, including in their value chain.**
- ☑ **A non-negotiable standard would help companies increase their leverage in the value chain.**
- ☑ **Harmonisation to avoid fragmentation in the EU, as emerging national laws are different.**
- ⊗ SMEs would have better chances to be part of EU supply chains.
- ⊗ Other.

Drawbacks

Please indicate which among the following possible risks/drawbacks linked to the introduction of an EU due diligence duty are more important for you?

- **Increased administrative costs and procedural burden.**
- **Penalisation of smaller companies with fewer resources.**
- Competitive disadvantage vis-à-vis third country companies not subject to a similar duty.
- **Responsibility for damages that the EU company cannot control.**
- Decreased attention to core corporate activities which might lead to increased turnover of employees and negative stock performance.
- **Difficulty for buyers to find suitable suppliers which may cause lock-in effects (e.g. exclusivity period/no shop clause) and have also negative impact on business performance of suppliers.**
- **Disengagement from risky markets, which might be detrimental for local economies.**
- **Other.**

Other, please specify:

There is a risk that potential inconsistencies between the proposed human rights and environmental due diligence duty and equivalent national legislation addressing other harms (e.g. bribery, money laundering, modern slavery, online content regulation, etc.) may undercut established regimes and business practices. This would be a significant drawback. This may, to some extent, be addressed by the European Commission implementing a duty that is risk-proportionate in scope, as discussed in our response to Question 2 above.

Consultation section III:

Due diligence duty

Consultation Question 14 – Defining "due diligence duty"

For the purposes of this consultation, "due diligence duty" refers to a legal requirement for companies to establish and implement adequate processes with a view to prevent, mitigate and account for human rights (including labour rights and working conditions), health and environmental impacts, including relating to climate change, both in the company's own operations and in the company's supply chain. "Supply chain" is understood within the broad definition of a company's "business relationships" and includes subsidiaries as well as suppliers and subcontractors. The company is expected to make reasonable efforts for example with respect to identifying suppliers and subcontractors. Furthermore, due diligence is inherently risk-based, proportionate and context specific. This implies that the extent of implementing actions should depend on the risks of adverse impacts the company is possibly causing, contributing to or should foresee.

Please explain whether you agree with this definition and provide reasons for your answer:

This definition of "due diligence duty" goes beyond the traditional view of due diligence as being information gathering, in that it would require companies to "prevent" and "mitigate" risks. This divergence from traditional definitions highlights the need for any new legal framework imposing obligations of the kind described to be set out in very clear terms and to be accompanied by clear, practical guidance on exactly what is expected of companies.

Consultation Question 15 – Content of the duty

Please indicate your preference as regards the content of such possible corporate due diligence duty (tick the box, only one answer possible). Please note that all approaches are meant to rely on existing due diligence standards, such as the OECD guidance on due diligence or the UNGPs. Please note that Options 1, 2 and 3 are horizontal (i.e. cross-sectoral and cross-thematic, covering human rights, social and environmental matters). They are mutually exclusive. Options 4 and 5 are not horizontal, but theme or sector-specific approaches. Such theme-specific or sectoral approaches can be combined with a horizontal approach. If you are in favour of a combination of a horizontal approach with a theme or sector-specific approach, you are requested to choose one horizontal approach (Option 1, 2 or 3) in this question.

- ☑ **Option 1: "Principles-based approach": A general due diligence duty based on key process requirements (such as for example identification and assessment of risks, evaluation of the operations and of the supply chain, risk and impact mitigation actions, alert mechanism, evaluation of the effectiveness of measures, grievance mechanism, etc.) should be defined at EU level regarding identification, prevention and mitigation of relevant human rights, social and environmental risks and negative impact. These should be applicable across all sectors. This could be complemented by EU-level general or sector-specific guidance or rules, where necessary.**
- ⊗ Option 2: "Minimum process and definitions approach": The EU should define a minimum set of requirements with regard to the necessary processes (see in Option 1) which should be applicable across all sectors. Furthermore, this approach would provide harmonised definitions for example as regards the coverage of adverse impacts that should be the subject of the due diligence obligation and could rely on EU and international human rights conventions, including ILO labour conventions, or other conventions, where relevant. Minimum requirements could be complemented by sector-specific guidance or further rules, where necessary.
- ⊗ Option 3: "Minimum process and definitions approach as presented in Option 2 complemented with further requirements in particular for environmental issues". This approach would largely encompass what is included in Option 2 but would complement it as regards, in particular, environmental issues. It could require alignment with the goals of international treaties and conventions based on the agreement of scientific communities, where relevant and where they exist, on certain key environmental sustainability matters, such as for example the 2050 climate neutrality objective, or the net zero biodiversity loss objective and could reflect also EU goals. Further guidance and sector-specific rules could complement the due diligence duty, where necessary.
- ⊗ Option 4: "Sector-specific approach": The EU should continue focusing on adopting due diligence requirements for key sectors only.
- ⊗ Option 5: "Thematic approach": The EU should focus on certain key themes only, such as for example slavery or child labour.
- ⊗ None of the above, please specify.

Please provide explanations as regards your preferred option, including whether it would bring the necessary legal certainty and whether complementary guidance would also be necessary:

Companies we have spoken to generally support a "principles-based" approach based on a standard of care. It is felt that a cross-sectoral approach is preferable, not least for the sake of harmonisation for companies whose operations span multiple sectors and who deal with businesses in their supply chains across a range of different industries.

A "principles-based" approach is particularly preferable for a duty that is to apply across sectors, since relevant "minimum processes" might vary significantly depending on the type of commercial entity implementing them. "Principles-based" due diligence is sufficiently flexible to allow for a context-specific and risk-based approach (i.e. the same duty could cover companies of different sizes, operating in different sectors, dealing with different types of suppliers and facing different kinds of risks).

This approach would provide important legal certainty, in that it would enable a company to demonstrate, in its defence of any legal action, that it has met the requisite legal standard by undertaking the level of due diligence required in the particular circumstances.

In order to ensure a "principles-based" approach is workable, it is vital that clear and specific guidance accompanies any legislative initiative. Though companies we have surveyed favour a cross-sectoral approach that will harmonise their business operations, it is clear that sector and/or issue-specific guidance will be necessary to support compliance. It is important to be mindful that companies may face very different challenges depending on the sector they operate in (e.g. tech companies are confronted with issues that differ greatly from those encountered by manufacturing companies).

Adopting a "principles-based" approach, companies see the possible benefits – in terms of legal certainty and harmonisation – of adverse human rights impacts being defined in relation to international human rights conventions. However, it is felt among companies that aligning any definitions of adverse environmental impacts to relevant international conventions would not work, since these conventions by their nature set national and/or international goals, which cannot clearly translate to the level of individual commercial entities.

In comparison to a "principles-based" approach, companies generally feel that a "minimum processes" approach risks becoming a box-ticking exercise, which would be less likely to achieve the goals underlying the proposals.

Consultation Question 16 – Reducing due diligence burdens

How could companies' – In particular smaller ones' – burden be reduced with respect to due diligence? Please indicate the most effective options.

This question is being asked in addition to question 48 of the Consultation on the Renewed Sustainable Finance Strategy, the answers to which the Commission is currently analysing.

- ⊗ All SMEs should be excluded.
- ⊗ SMEs should be excluded with some exceptions (e.g. most risky sectors or other).
- ✓ **Micro and small sized enterprises (less than 50 people employed) should be excluded.**
- ✓ **Micro-enterprises (less than 10 people employed) should be excluded.**
- ✓ **SMEs should be subject to lighter requirements ("principles-based" or "minimum process and definitions" approaches as indicated in Question 15).**
- ✓ **SMEs should have lighter reporting requirements.**
- ✓ **Capacity building support, including funding.**
- ✓ **Detailed non-binding guidelines catering for the needs of SMEs in particular.**
- ✓ **Toolbox/dedicated national helpdesk for companies to translate due diligence criteria into business practices.**
- ✓ **Other option, please specify.**
- ⊗ None of these options should be pursued.

Other option, please specify:

Companies we have spoken to are concerned that the framework may be particularly burdensome for SMEs, and the consensus is that a proportionate approach will be necessary to protect smaller businesses. In recognition of the fact that SMEs may have neither the resources nor the leverage to fulfil the requirements under the framework, legislation will either have to be restricted to businesses of a certain size, or appropriately simplified and/or reduced according to company size.

If smaller businesses are captured by the legislation, then the view is that they should be supported in carrying out due diligence processes. In addition to the suggestions identified directly above, the impact upon these businesses could also be mitigated, to an extent, by a transition period, which enables SMEs additional time to adapt, and potentially to follow some of the procedures being adopted by larger companies. Sector-specific guidance could also be effective. National helpdesks, while potentially of assistance, would need to be well-resourced in order to have a significant impact.

Another way of lightening the burden on SMEs – as well as on third-country companies with limited operations in the EU – would be to apply exclusions to certain companies based on market measures (e.g. companies could be excluded where the annual turnover they derive from business in the EU falls below a certain threshold, or where they have fewer than a specified number of employees in the EU). In developing any new due diligence framework, the European Commission should be mindful of equivalent thresholds under national legislation of EU member states (e.g. Loi Sapin II, the French Law on the Duty of Vigilance, etc.).

Consultation Question 17 – Third-country companies

In your view, should the due diligence rules apply also to certain third-country companies which are not established in the EU but carry out (certain) activities in the EU?

- ☑ **Yes**
- ⊗ No
- ⊗ I do not know

What link should be required to make these companies subject to those obligations and how (e.g. what activities should be in the EU, could it be linked to certain turnover generated in the EU, other)? Please specify:

In circumstances where a third-country company is carrying on a business in the EU, the application of new due diligence rules to such a company will help to ensure a level playing field for businesses operating in the same market. Indeed, if the proposed due diligence framework were to apply to third-country companies operating in the EU, this would mirror the jurisdictional tests of other relevant and comparable national legislative regimes (including the UK Bribery Act and the UK Modern Slavery Act).

Companies we have spoken to expressed concerns about third-country companies with very limited operations in the EU falling subject to a new due diligence duty of the type proposed. We think this could be dealt with by applying exclusions to certain companies based on market measures. For further detail, please refer to our response to Question 16 above.

Please also explain what kind of obligations could be imposed on these companies and how they would be enforced.

The same due diligence obligations imposed on EU companies could be imposed on third-country companies operating in the EU. Due diligence obligations could be enforced in the same way that any EU law requirements are enforced against third-country companies operating in the EU (i.e. through national courts, with the intervention of the Court of Justice of the European Union when necessary).

Consultation Question 18 – Additional measures to foster a level playing field

Should the EU due diligence duty be accompanied by other measures to foster a more level playing field between EU and third-country companies?

- ✓ **Yes**
- ⊗ No
- ⊗ I do not know

Please explain:

While the proposed due diligence duty would impose certain burdens on companies operating in the EU, there may also be some competitive advantage for companies required to comply as first movers in the broader sustainability transition.

Though third-country companies unaffected by a new EU due diligence duty may eventually adapt their business practices to align with the EU standard, the European Commission should also engage with third countries, and encourage them to adopt complementary national measures that address human rights violations and environmental harms. Direct implementation of similar standards in third countries may help to address some harms at an earlier stage, and will aid the development of the harmonised framework that businesses are seeking.

Consultation Question 19 – Enforcement

If a mandatory due diligence duty is to be introduced, it should be accompanied by an enforcement mechanism to make it effective. In your view, which of the following mechanisms would be the most appropriate one(s) to enforce the possible obligation?

- ⊗ Option 1: Judicial enforcement with liability and compensation in case of harm caused by not fulfilling the due diligence obligations.
- ⊗ Option 2: Supervision by competent national authorities based on complaints (and/or reporting, where relevant) about non-compliance with setting up and implementing due diligence measures, etc. with effective sanctions (such as for example fines).
- ✓ **Option 3: Supervision by competent national authorities (Option 2) with a mechanism of EU cooperation/coordination to ensure consistency throughout the EU.**
- ⊗ Other, please specify.

Please provide an explanation:

Companies we have spoken to feel the most effective mechanism for enforcement is supervision by competent national authorities. A mechanism for EU cooperation and coordination is considered essential to ensure a level playing field.

The alternative – judicial enforcement with liability and compensation in case of harm caused through due diligence failings – is undesirable given the varying liability regimes across the EU's member states. This approach would potentially lead to "forum shopping", where potential claimants would seek to bring claims in EU member states with the widest liability laws. This would undermine the principle of harmonisation, which is a key attraction of an EU-level due diligence obligation. A further difficulty with judicial enforcement is that it would inevitably be expensive and place an additional burden on national courts.

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