# CSDD: Directors' Duties and Climate Remuneration

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- Duties: proposed law
- Duties: calibrating liability risk
- Duties: normative considerations
- Remuneration
- Takeaways

# Directors' CSDD duties: proposed law

**Proposal for a Directive on Corporate Sustainability Due Diligence**

COM(2022) 71 final, 23 February 2022

# Relevant companies

| | Employees | Turnover | Sector |
|---|---|---|---|
| Large EU company | >500 | >€150m worldwide | Any |
| Substantial EU company in high-risk sector | >250 | >€40m worldwide | primary / extractive industry or textiles / clothing (>50% turnover) |
| Non EU-company with large EU operations | Any | >€150m in EU | Any |
| Non-EU company in high-risk sector with substantial EU operations | Any | >€40m in EU | primary / extractive industry or textiles / clothing (>50% worldwide turnover) |

# Corporate DD obligations

- Art 5: Integrate DD into **corporate policies** (code of conduct, compliance measures)
- Art 6: **Identify actual and potential adverse impacts** on human rights and environment (entity + subs + established business relationships)
- Art 7: **Preventing/mitigating potential adverse impacts** (including seeking and monitoring compliance with contractual undertakings by direct business partners in value chain)
- Art 8: **Ending/minimising actual adverse impacts** (including seeking and monitoring compliance with contractual undertakings by direct business partners in value chain)
- Art 9: **Complaints process** for individuals (reasonably believing) adversely affected / unions/worker reps / civil society organisations
- Art 10: **Monitoring effectiveness** of policies and actions
- Art 11: **Reporting** annually on due diligence

**"Adverse impacts"** only encompass those flowing from violation of specific HR and environmental obligations set out in Annex to CSDD Directive

# Corporate transition plans

- Art 15(1) requires large EU companies to draw up transition plans compatible with limiting global warming to 1.5C
- Art 15(2) plan must include emission reduction objectives where climate change is a principal risk for, or impact of, the company's operations.

# Enforcement vs company

- Supervisory Authorities (Arts 17-20)
  - MS to designate NSA for supervising compliance: complaints, investigations, inspections, administrative sanctions for violations of national provisions implementing Arts 6-11 and 15(1)-(2)
- Civil liability (Art 22)
  - Corporate liability for failures to prevent/end (Arts 7/8) adverse impacts
- Compliance incentives (Arts 20(2), 22(2))
  - "due account shall be taken of the company's efforts … to comply with any remedial action required of them by a supervisory authority, any investments made and any targeted support provided pursuant to Articles 7 and 8, as well as collaboration with other entities to address adverse impacts in its value chains…"
  - 'Carrot' to disambiguate compliance incentives (Arlen, 1994)

# Directors' responsibility for DD oversight

Art 26

1. Member States shall ensure that directors of companies referred to in Article 2(1) are responsible for putting in place and overseeing the **due diligence actions** referred to in Article 4 and in particular the **due diligence policy** referred to in Article 5, with due consideration for relevant input from stakeholders and civil society organisations. The directors shall report to the [supervisory] board of directors in that respect.

2. Member States shall ensure that directors take steps to adapt the corporate strategy to take into account the actual and potential adverse impacts identified pursuant to Article 6 and any measures taken pursuant to Articles 7 to 9.

# Directors' duty to consider sustainability

Art 25

1. Member States shall ensure that, when fulfilling their duty to act in the best interest of the company, directors of companies referred to in Article 2(1) take into account the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term.

2. Member States shall ensure that their laws, regulations and administrative provisions providing for a breach of directors' duties apply also to the provisions of this Article.

# Calibrating liability risk

"The bottom line is that, despite the litigious environment in which [US] public companies function, outside director [out-of-pocket] liability is ... a rare occurrence"
(Black, Cheffins & Klausner, 2005)

# Who can enforce?

- Unlike corporate liability (cf Arts 20, 22), no provision is made for enforcement of directors' duties by harmed parties / NSAs
- Directors' duties are owed *to the company* and enforceable *by shareholders collectively.*
- Need to show *loss* to company/shareholders…

# Scope of liability: finding corporate loss

Because directors' liability is *to the company*, only triggered if company suffers *loss* through lack of directors' care in sustainability review.

Directors will only face liability for lack of care causing corporate liability or other loss:

- Corporate liability:
  - Failures of due diligence → "adverse impacts" under Art 3 → sanctions/liability for company under Arts 20, 22
  - Failures to implement corporate climate change plans under Art 15 where this attracts sanctions under Art 20
- No corporate liability: harms to third parties caused otherwise than through violation of rights/obligations listed in Annex Part I (human rights) or Part II (environment) or under Art 15: usually no loss to company

# Reputational losses?

"Reputation" as willingness to trade

- Reputational losses usually triggered by finding of corporate violation of law
- Literature reports that harms to persons other than customers or investors generally do not have adverse reputational impacts

Karpoff and Lott (1993), Alexander (1999); Karpoff, Lott and Wehrly (2005), Karpoff, Lee and Marin (2008), Armour, Mayer and Polo (2017)

"Reputation" as political backlash

"They decided they could just pay their way out of breaking the law by paying off their sacked workers" Darren Jones MP

Peter Hebblethwaite, CEO of P&O Ferries, facing heavy weather at HC Business, Energy and Industrial Select Cee

# Climate plans and loss

- Corporate transition plans may be consistent with firm value maximization - depend on perceived pace of change of renewables technology, carbon taxes; also on preferences of ESG investors etc
- Art 15 creates a “push” to develop a Paris-compatible transition plan apparently regardless of impact on value; failure to do so may trigger corporate sanctions from NSAs (Art 20)
- But implementation of a Paris-compatible plan may itself trigger a bigger decline in value through operating losses.
- Art 25 implies a balancing of these considerations: Art 15 tips scales in favour of transition to the expected extent of liability under Art 20.

# Causation

- Was loss to company *caused* by directors' sustainability review failures?
- DD: Challenging factors for causation
  - Omissions – must identify counterfactual in which action was performed and loss avoided: major obstacle to liability for UK bank directors after financial crisis
  - Acts of third parties (business partners)– must establish that D's (in)actions would have made a difference
  - Scale –how much difference does directors' macro oversight make for micro instances of misconduct?

# Example

- Company's supplier is found to have HR violations in its employment practices => adverse impact on its workers
- Company had DD policy, with code of conduct for suppliers; supplier signed standard-form undertaking to comply with DD policy; concealed its misconduct.
- Company is ordered to make remediation payment of $d$; NSA concludes that co's investments in DD processes were insufficient to merit a reduction in penalty of $\theta d$ (where $0 < \theta < d$) .
- Easier to demonstrate that failings in board DD oversight / sustainability review caused "inadequate" DD processes to be in place than to prove they caused the discrete incident of supplier misconduct.

⇒ Corporate loss **caused** by board oversight failings is lost discount $\theta d$, not company's total liability $d$.

# Other factors affecting liability risk

## D&O Insurance

- Will it be permissible for companies to take out D&O insurance against Art 25 liability?
- Nothing in CSDD Directive speaks to this – variation in national laws.
- Insurance removes downside risk for directors but introduces a repeat player with incentives to monitor performance of DD tasks

## Civil procedure rules

- What standing requirements exist for derivative action (eg ownership threshold?)
- What criteria do courts use to determine whether derivative action can proceed?
- How easy is it for claimants to obtain an indemnity from company for fees?

Armour, Black, Cheffins and Nolan (2009)

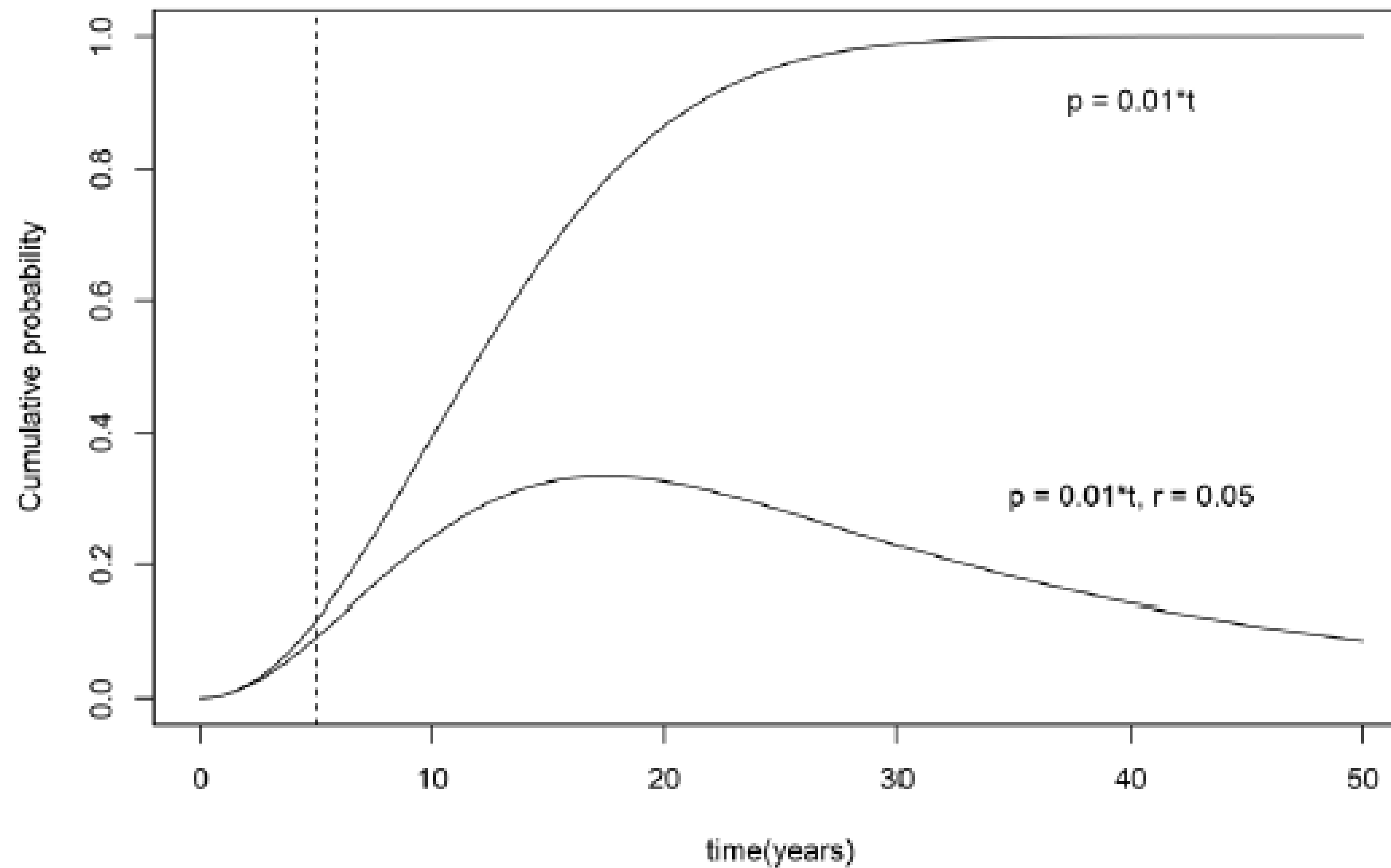
# Directors’ CSDD duties: policy

# The case for personal liability

Armour, Gordon & Min (2020)

- Investment in compliance/DD activity is an immediate cost
- Liabilities for failures in DD/compliance likely to be long-term; “return” on compliance investment depends on cumulative probability of enforcement
- Hard to for investors to verify quality of compliance investment; hence market likely devalues expected return

$\Rightarrow$ Executives maximize stock price in short run by skimping on compliance




Source: Armour, Gordon and Min (2020)

# The case against personal liability

- ⟐ Compliance investment reduces expected personal liability
- ⟐ Corporate funds are invested in compliance

⇒ Overinvestment in compliance to avoid expected liability

Overinvestment concerns can be mitigated by (i) reducing probability of enforcement or (ii) capping liability

# Multiple margins

- Changing liability risk likely impacts multiple margins
  - Heterogenous treatment effects – weakening (increasing) US BJR insulation for directors led to reductions in value for high-growth firms, increases (decreases) in value for low-growth firms (Grinstein & Rossi, 2015, Donelson & Yust, 2014)
  - Weakening US liability risk through introduction of universal demand requirements associated with more staggered boards, greater ownership concentration and weaker operating performance (Crane & Koch, 2016; Appel, 2019)
- Wise policy to adjust liability risk only incrementally

# Climate remuneration

# Climate remuneration

Art 15(3) Director remuneration must take into account "fulfilment of obligations referred to in [Arts 15(1)-(2)] … if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability."

- Sensible interpretation is that this means any variable remuneration scheme
- A largely hortatory provision: scope/extent of "linkage" is not specified; excluded from NSA purview under Art 17(1), no civil liability under Art 22
- Implementation likely to be steered by shareholder say on pay/"say on climate" initiatives

# Takeaways

# Takeaways

- Scope for SDD liability for directors tracks underlying scope for corporate SDD liability
- Directors' liability risk will be very modest; but will focus attention on corporate actions re DD compliance; for climate plans, more of a "nudge" set against other impacts on firm value.
- Desirability depends on whether we think underinvestment or overinvestment in these concerns is currently a bigger problem. The former seems more likely.
- Climate remuneration provisions largely hortatory but may interact with shareholder activism