

Sustainable Corporate Governance

Policy recommendations by Frank Bold

Following the presentation of the Green Deal last December, as part of the [Action Plan on Financing Sustainable Growth](#), the European Commission announced plans to present an initiative on [Sustainable Corporate Governance](#) in 2021.

In January 2020, we asked 80 senior company law scholars and relevant experts to identify how to best steer corporate boards towards giving greater priority to social and environmental sustainability, without making boards and senior managers unaccountable for how they exercise their discretion. The resulting consensus is presented in the form of a [Statement on Corporate Governance for Sustainability](#).

The starting point behind the statement was that legislation provides board members with wide discretion to take account of sustainability. Changing the law to merely require boards to have regard to sustainability or the company's long-term interest is both unnecessary and – in isolation – would be ineffective to guide directors' attention towards these considerations. In order to advance the integration of sustainability in corporate strategies, including respect for human rights, Frank Bold recommends the European Commission to clarify in law procedural obligations to ensure board oversight of corporate sustainability risk management and due diligence obligations. This, in turn, would elevate the consideration of sustainability among managerial priorities and increase the likelihood that sustainability is taken into account in decision-making. Such clarifications will have a significant positive effect on corporate governance, without creating new accountability mechanisms:

- Board members should ensure that the company has a fit-for-purpose sustainability strategy, reflecting the results of the double materiality determination and due diligence processes, including targets relevant for the prevention and mitigation of salient risks and impacts, and oversee progress in its implementation;
- Executive remuneration should be linked to the achievement of sustainability targets;
- The board should have access to relevant expertise to monitor and review the content and implementation of the company's sustainability strategy.

These recommendations would support but also require comprehensive legislation on human rights and environmental due diligence.

CONTEXT

The European Green Deal sets an ambitious plan to achieve no net GHG emissions by 2050 and decouple economic growth from resource use, while leaving no person and no place behind. Meeting its goals will require significant changes in every sector of the economy, [including additional annual investments of 500 billion EUR](#).

Encouraging business to focus on sustainable value creation and ensuring that adverse impacts across the value chain are prevented and mitigated will be critical to achieve the objectives of the European Green Deal and to manage enormous financial risks stemming from climate change, resource depletion, environmental degradation and social issues.

To this end, and as part of its Action Plan on Financing Sustainable Growth, the European Commission has announced an initiative on Sustainable Corporate Governance, which includes the presentation of a legislative proposal in June 2021. For this purpose, the European Commission is assessing how to promote the integration of sustainability in business practice, and is evaluating the needs, objectives and policy options for the area of corporate governance.

Didier Reynders, EU Commissioner for Justice, responsible for this initiative, has [stressed](#) the relevance of the Sustainable Corporate Governance agenda “for the sustainability, competitiveness and resilience of the businesses in the long run as well as for human rights protection and our international commitments, such as the UN Sustainable Development Goals and the goals of the Paris Agreement on climate.”

Directors’ associations, business organisations and investors increasingly recognise the urgency of the climate crisis and the need to fully integrate sustainability and respect for human rights in companies’ business models and risk management. In order for this to happen, the incentives facilitated by corporate governance must be aligned with these objectives.

As highlighted by the assessment of corporate sustainability disclosures, including the [analysis of the non-financial statements of 1000 European large companies by the Alliance for Corporate Transparency](#) coordinated by Frank Bold, current corporate governance practices externalize costs and risks, to the detriment not only of environmental and social sustainability, but also of the long-term, economic sustainability of companies themselves.

The underlying reasons preventing board members and managers to treat sustainability as a key consideration consists of a variety of incentives coming from outside company law, exacerbated by the fact that sustainability challenges are often beyond the horizon and are not reflected in accounts.

Below, we provide recommendations on how to advance the consideration of sustainability at the board and managerial level and increase the likelihood that it is taken into account in decision-making.

This can be achieved primarily by specifying procedural obligations for boards in company law, fully within the framework of existing directors’ duties and accountability mechanisms, rather than by changing directors’ duties or other key aspects of corporate governance.

PRIORITIES FOR SUSTAINABLE CORPORATE GOVERNANCE

1. Clarify the responsibility of directors to ensure that the company has a fit-for-purpose sustainability strategy, reflecting the results of double materiality determination and due diligence, including targets relevant for the prevention and mitigation of salient risks and impacts, and oversee progress in its implementation

Boards’ considerations of salient environmental and human rights issues linked to the company’s business model, as well as their impact on the company, is complicated by pressures coming from outside company law, which draw the attention of boards to short-term financial performance; a further challenge is the lack of meaningful sustainability metrics and clarity on how to appropriately address stakeholder interests.

This is a major problem, because integrating sustainability, including respect for human rights, in corporate strategy requires effective governance and oversight from the company’s most senior governing body. This is particularly relevant where human rights and environmental impacts are connected to the company’s business model, which in turn require changes to the strategy and financial planning.

In order to overcome these barriers, a critical step is to clarify procedural obligations for board members to oversee the adoption of targets by the company to prevent or mitigate its salient sustainability risks, and monitor progress in addressing them. In line with the double materiality principle, such risks include both the issues that have or may lead in the future to financial risks for the company, as well as risk of severe impacts on people and the environment.

This should be implemented in connection with upcoming EU legislation on (a) corporate human rights and environmental due diligence, and (b) sustainability reporting, which will provide criteria that boards can use to assess whether a company’s sustainability strategy and targets are fit for purpose.

To ensure the integration of sustainability and proper management of risks and impacts, board members should have the following roles:

- Oversee the quality of the materiality determination and due diligence and regularly discuss the results of the assessment of risks delivered by these processes. Given the complexity of and specific expertise required to conduct these processes, boards should secure the support of appropriate expertise and ensure that board discussions are informed by the perspective of stakeholders affected by the severe impacts identified through the company's due diligence;
- Approve a forward-looking corporate sustainability strategy, including necessary changes to the company's business model, strategy and financial planning, setting high-level targets that:
 - › Are relevant for the prevention and mitigation of financially material risks as well as salient risks to people and the planet identified through the company's environmental and human rights due diligence;
 - › Allow to assess progress against such risks and impacts;
- Ensure that sufficient financial resources are available for the implementation of the strategy;
- Monitor the progress and challenges linked to the implementation of the strategy and from addressing salient risks; and approve an annual progress report as part of the company's non-financial (sustainability) reporting.

2. Executive remuneration should be linked to the achievement of sustainability targets

To properly incentivise the pursuit of the company's long-term sustainability strategy, a significant percentage of the key performance indicators (KPIs) and remuneration of executive management should be linked to the achievement of measurable targets set in the company's sustainability strategy.

As explained above, such targets should be relevant for the prevention and mitigation of salient risks, rather than merely focused on procedural steps, and as part of the company's non-financial (sustainability) reporting, boards should sign off an annual progress report on their achievement, challenges, and results in terms of the prevention and mitigation of identified risks.

This is critical in order to effectively mitigate incentives to focus on short-term metrics that may be encouraged by other elements of variable remuneration, and to ensure that sustainability KPIs selected by the business for this purpose are meaningful and linked to the economic success of the company itself.

Together with the board's oversight of the sustainability strategy and availability of financial resources for its implementation, performance incentives for company leadership will ensure that sustainability is duly reflected in the decisions on share buybacks and dividends.

3. Ensure the board has access to expertise on sustainability issues

The board as a collective organ needs to have sufficient internal expertise on sustainability matters to be able to review the sustainability strategy and assess progress. In principle, this expectation can be clarified in law, however the legislation should not go as far as to require a specific number of directors and types of expertise, because the needs depend on the nature and diversity of the sustainability challenges facing the company.

As part of the oversight over the materiality determination and due diligence, directors should evaluate the adequacy of their own expertise required to properly take account of sustainability. Based on this evaluation, the board should ensure it has access to relevant expertise.

In the case of large companies, a viable option would be to set up a non-executive committee, composed of independent experts (with expertise relevant to the main sustainability challenges facing the company) and top managers of the company, chaired by a designated board member, and tasked with monitoring and reviewing the content and implementation of the sustainability strategy.