Kluwer Competition Law Blog

Diligence is Due Indeed: Competition Law as a Barrier to Sustainable Supply Chains?

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In European competition law, both Article 101 and 102 TFEU inquiries require a contextual approach to the dispute at hand. Since enforcers must consider any agreement or business activity within the economic, legal, and factual context of which it forms part, regulatory regimes become important guideposts for any competition analysis. This point has been emphasized repeatedly by the Court in its recent rulings. For instance, we know from *Lietuvos gelezinkeliai* that requirements of a regulation may alter the application of a legal test. Similarly, in *Slovak Telekom*, we learned that regulatory obligations are relevant for determining whether a dominant undertaking abused its strong market position. In *Google (Shopping)*, we even saw that the regulatory regime in question (the net neutrality obligations incumbent upon internet service providers) need not readily apply to the undertaking(s) under scrutiny to maintain relevance. Therefore, it seems inconceivable to insulate competition enforcement from the impact of applicable regulations.

In light of this state-of-play, it is only natural to conclude that, so long as a regulation concerned with environmental protection or sustainability influences an agreement or practice, it should be considered in prospective competition law analyses. This blogpost discusses some examples in which such a situation may materialize. In a nutshell, the recent Proposal for a Corporate Due Diligence Directive creates several instances where interactions with competition law may occur. Given contemporary European political economy, the scenarios presented below seem likely to take place in near future.

Amplifying the Pressure on Sustainable Supply Chains

One of the goals adopted by the EU for its common commercial policy is the propagation of its values. As the flagship project of the von der Leyen Commission, the Green Deal occupies the center stage of the Union's economic activities. In addition, as a Union forged in crises, the EU does not wish to let the sanitary crisis "go to waste". Accordingly, several of the newly introduced legislative proposals desire to imbue economic ends with sustainability aspirations. Among these exist mechanisms like carbon border adjustment tools, circular economy regulations, and the recently unveiled Directive on Corporate Due Diligence ("**CDD**", "**the Proposal**", or "**the Directive**").

CDD is a textbook example of stakeholder capitalism. Unlike Milton Friedman, the EU believes companies can do more than to simply follow profits. In a study calling for the introduction of a CDD mechanism, the European Parliament argues that multinational companies should do more to contribute to sustainability, such as by improving labor rights or protecting the environment better. Although these statements are commendable, is there anything new under the sun for undertakings that also produce implications for competition law? After all, numerous Member States have already enacted rules that deal with reporting sustainable business practices, in laws concerning unfair competition, public procurement, or environmental protection. The EU also has in place adjacent rules, such as the Sustainable Finance Disclosure Regulation and Non-Financial Reporting Directive.

Until now, the existing mechanisms at both the EU and Member State levels have mandated that companies satisfying a few criteria had the obligation to report on their corporate due diligence activities relating to sustainability. By contrast, the newly proposed Directive complements these obligations by imposing substantive duties on companies, who will have to monitor, detect, prevent, and mitigate practices in their supply chain that cause human rights abuses or environmental degradation. In other words, companies falling within the scope of the CDD will have to actively participate in the transformation of their supply chains into environmentally friendly networks. These obligations create several junctures where CDD may touch upon EU competition laws.

Competition Law as Naysayer

There are at least three instances where CDD may interact vis-à-vis EU competition law.

First, the proposal includes several allusions to making companies modify their business models and strategies in accordance with the objectives of both the EU Green Deal and the Paris Climate Agreement. In this manner, the Directive complements the General Court’s view in *Google (Shopping)* that business models are not invincible to antitrust enforcement. Correspondingly, both environmental regulations and competition enforcement may demand that undertakings alter their business models if found undesirable.

Second, some of the Proposal’s provisions may clash with Article 101 and 102 TFEU specifically. The Directive’s scope includes large companies (those with a worldwide turnover in excess of EUR 150 million and 500 employees in the latest fiscal year) and excludes small and medium-sized enterprises. However, SMEs will be indirectly affected, since they comprise 99% of the Union economy, with many of them acting as business partners of larger undertakings. Since SMEs may lack the human, legal, and financial capabilities to quickly adapt to changing business scenarios, large businesses are to assist them with compliance. These efforts will likely materialize in the form of agreements. In fact, the Directive itself highlights that companies should seek contractual assurances from their business partners in their supply chain. Hence sustainability-related mandates imposed by the Directive will mostly be observed via vertical contracts between large companies (directly affected by the Directive) and SMEs (indirectly affected). These vertical contracts may pose risks vis-à-vis competition laws.

As an example, take Article 7 of the Directive. The provision states that vertical contracts with SMEs seeking the prevention of environmental damage should be fair, reasonable, and non-discriminatory. This FRAND obligation may clash with a selective distribution system designed on the basis of sustainability compliance of a local distributor. Such a system may run afoul of both the Directive (discriminatory treatment) and competition laws. Here, an objection may contend that the new Vertical Block Exemption Regulation enables the Commission to consider sustainability concerns in its assessments of vertical agreements. Such contention has merit. However, it is also important to keep in mind that, as Recital 29 of the Proposal suggests, the level of action expected from a covered company in terms of keeping its supply chain sustainable is positively correlated with market power. In other words, companies with a stronger market position may need to act more aggressively in their supply chain surveillance duties (e.g., detection and prevention of unsustainable practices). In such instances, the VBER (whose market share thresholds have also been lowered) may not apply, making it necessary to rely on an individual exemption.

If companies risk breaching either the Directive or competition law, surely, they can rather terminate their business relationships (with partners not so keen on adopting sustainable practices) instead, right? Not so fast. The Directive itself is stingy with contractual terminations. Accordingly, terminating agreements with an (unsustainable) business partner should be a measure of last resort. At the same time, to effectuate that option, Member States should confer the ability on companies to terminate agreements with such partners. Notwithstanding the commercial infeasibility of such a move, it may also run afoul Article 102 TFEU. In cases where the larger company is dominant, we may construct a viable theory of harm based on a refusal/disruption of supply. Against such charges, a dominant company may invoke an argument that its conduct is objectively justified, in light of its regulatory obligations. The chances of success for that defense are slim. The Court of Justice's approach towards profit-seeking, private enterprises appealing to public policy aspirations have been inimical since the days of *Tetra Pak*. Quite the opposite, the Commission may actually step up and override the application of national law (transposing the Directive), using competition law as a vehicle.

Third, the Proposal and EU law may conflict at a more fundamental level. In a market economy, regulatory measures are typically adopted as a second-best measure. In principle, regulations are only to be enacted insofar as, and to the extent which, the market is unable to generate the desired outcome. The Proposal generally observes that prevailing competitive dynamics have been unable to induce companies towards adopting sustainable practices, including in due diligence activities.[1] This lamentation materializes in the form of a disdain towards short-termism. Indeed, in a Staff Working Document, the Commission regrets that companies in the EU suffer from short-sightedness when it comes to opting for sustainable business choices. For instance, instead of long-term goals, company directors focus on short-term aims. Overcoming this bias would entail benefits for undertakings, such as long-term profitability, reputational gains, and better financial prospects. Moreover, as environmental awareness grows, European companies may reap first-mover advantages by greening their supply chains earlier. Eliminating short-termism in European corporate life would also form a key component of the Green Deal.

If EU law wants companies to let go of their fixations on short-term gains, it first needs to pay attention to the plank in its own eyes. It would be unacceptable for competition law to observe short-term welfare gains whilst regulatory measures demand undertakings abandon their short-termism. The first victim of such a scenario would be European industry and competitiveness, as well as trust in the rule of law. Thankfully, since competition laws employ generalized rules with room for judicial interpretation and therefore evolution, they may rise to the cause. While recent HBER and VBER modifications are a good start, they present their own challenges. For instance, the 7-step cumulative criteria imposed upon undertakings risk turning into *probatio diabolica*. More effort is therefore needed. In that regard, there are promising cues for action in the Directive itself. For instance, Article 12 sets out that the Commission will be empowered to adopt "voluntary model contractual clauses" to guide companies seeking contractual assurances from their business partners. Similarly, the Proposal acknowledges that the Commission will be able to issue Guidelines to clarify how companies can comply with their due diligence obligations. These measures should be supported.

Conclusion

The EU cannot hope to unlock the full potential of its regulatory apparatus as long as a competition policy fixated on short-term goals desecrates other legitimate aims. To be fair, there seems to be a move towards a wider accommodation of non-economic goals in competition enforcement, and the recent revisions of Block Exemption Regulations come to mind. Still, unless this trend accelerates, it would be rather unrealistic to expect much compliance with the likes of CDD when undertakings are in serious doubt regarding the compatibility of their activities with competition laws. Since the latter carries heftier penalties, a prudent company will risk breaching the CDD rather than Article 101/102 TFEU. The Union needs to ensure that ambitious companies, having been urged to contribute to the sustainability of the planet, are not turned back upon once they do so.

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[1] The Regulatory Scrutiny Board disagreed with this assessment. It was essentially sceptical of the argument that the market provides insufficient incentives for businesses to act sustainably. The Board's contention was so profound that it rejected the Commission's justifications twice in a row. Ultimately, the Commission decided to override the Board's opinion, citing "political urgency" as rationale. This anecdote also highlights the appetite of the EU to instrumentalize crises for reform purposes.

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