The new European Directive on Corporate Sustainability Due Diligence

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Today, on Wednesday, 23 February 2022, the European Commission released its highly anticipated Draft Directive on Corporate Sustainability Due Diligence, also known as the mandatory human rights and environmental due diligence Directive (mHREDD). This is a historic moment for the field of business and human rights, ESGs and the strive towards sustainable and responsible business conduct that upholds respect for human rights, decent work and environmental standards throughout the entire global value chain.

The Directive is based on the BIICL-led Study on due diligence requirements through the supply chain (the EC study), published on 24 February 2020, exactly two years minus one day before the Draft Directive. This was also followed by a Resolution of the European Parliament with recommendations to the European Commission on corporate due diligence and corporate accountability which included a Draft Directive in March 2021.

The EC study underlined the limited uptake of voluntary due diligence expectations by companies in Europe: just over one-third of business respondents indicated that their companies undertake due diligence which takes into account all human rights and environmental impacts, and for the vast majority of these, the due diligence exercise was limited to first tier suppliers. It also highlighted the appetite for regulation at the EU level across stakeholders, including companies themselves: 70% of business respondents anticipated that the introduction of mandatory human rights and environmental due diligence at the EU level (mHREDD) would benefit business insofar as it would increase legal certainty, avoid fragmentation by creating a unified standard at the EU level rather than a plethora of diverging standards at the domestic level, and provide a level-playing field. The Draft Directive responds to these findings in its objectives and articles.

We set out below a few selected aspects of the draft law. For further detail please see the full text. Key overview points include:

- The Draft Directive sets out duties for companies to undertake due diligence for actual or potential adverse human rights and environmental impacts in their own operations, those of their subsidiaries and established business relationships in their value chains. It largely builds on existing international standards such as the UN Guiding Principles on

Business and Human Rights (UNGPs) and the OECD Guidelines for Multinational Enterprises and related guidance.

- It applies to certain large European and non-European companies that operate in the single market, and within two years will expand to mid-cap companies that operate in certain 'high impact' sectors.
- Adverse human rights and environmental impact are defined with reference to a list of international conventions contained in an Annex.
- It provides for administrative oversight by public bodies, which includes powers to investigate and impose sanctions.
- It provides for civil remedies for victims.
- It requires large companies to set out plans to combat climate change.
- It sets out a duty of care for directors requiring them to take into account the consequences of their decisions for sustainability matters, including human rights, climate change and environmental consequences in the short, medium and long term.
- It also contains provisions in relation to voluntary model contractual clauses, and public support by Member States.

1. Objectives

The Directive sets out five objectives: (1) **improving corporate governance practices;** (2) **avoiding fragmentation** of due diligence requirements in the single market and creating **legal certainty** for businesses and stakeholders; (3) **increasing corporate accountability** for adverse impacts, and ensuring coherence for companies regarding obligations; (4) **improving access to remedy** for those affected by adverse corporate human rights and environmental impacts; (5) **complement other measures in force or proposed** within the EU through an overarching horizontal framework.

2. Scope

The Directive applies to both European and non-European companies above a certain threshold:

a) **Large European companies**: European companies which have more than 500 employees on average; <u>and</u> a worldwide net turnover exceeding €150 million in the last financial year.

b) *After two years the scope will extend to* **mid-cap European companies in certain sectors:** European companies that have more than 250 employees on average and a net turnover of over EUR 40 million, provided that at least 50% of this turnover was generated in one or more of three 'high impact' sectors:

   i) Manufacture of textiles, leather and related products (including footwear) and wholesale trade of textiles, clothing and footwear
   ii) Agriculture, forestry, fisheries (including aquaculture), the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food, and beverages;

iii) Extraction of mineral resources regardless from where they are extracted (including crude petroleum, natural gas, coal, lignite, metals and metal ores, as well as all other, non-metallic minerals and quarry products), the manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (except machinery and equipment), and the wholesale trade of mineral resources, basic and intermediate mineral products (including metals and metal ores, construction materials, fuels, chemicals and other intermediate products).

c) **Non-European companies**: Companies formed in third countries that:

a) generate a net turnover of more than EUR 150 million will be included,
b) And after two years this will be extended to non-European companies or that generated a net turnover of more than EUR 40 million, of which 50% was in the above-listed 'high impact' sectors.

Adverse human rights and environmental impact are defined with reference to a list of international conventions contained in an Annex.

A few notes:

- SMEs (including micro companies) which account for the vast majority (99%) of all companies in the EU, are excluded from the duties imposed by the Directive. In this respect, the Directive departs from the UN Guiding Principles on Business and Human Rights (UNGPs) which provides that the corporate responsibility to respect human rights 'applies to all enterprises regardless of their size, sector, operational context, ownership and structure', whilst acknowledging that 'the scale and complexity of the means through which enterprises meet that responsibility may vary according to these factors and with the severity of the enterprise's adverse human rights impacts' (Guiding Principle 14).

- However, the Directive does provide for support and financial aid (including from Member States) for SMEs that fall within relevant value chains. This is based on evidence that SMEs are affected by laws that apply only to large companies, as the explanatory memorandum notes that SMEs will 'be exposed to some of the costs and burden through business relationships with companies in scope as large companies are expected to pass on demands to their suppliers.' In this respect, it is interesting to make a reference to a PwC-Orse-Bpifrance on the impact of the French Duty of Vigilance Law which showed that nearly 80% of French SMEs (which are not covered by the French Law) are being required to take certain steps in relation to human rights and the environment by their larger buying companies, without receiving support (financial or otherwise) to meet these requirements. *[Update:]* In light of these findings, it is anticipated that, through its application to the harms caused by indirect partners throughout the value chain, the Directive's due diligence obligations may cover the activities of a significant number of companies, including SMEs, within global value chains: Almost three quarters of business respondents (73.18%; made up of 65.9% of respondents with over 1000 employees and 7.28% with over 500 employees) in the EC Study would fall within the scope of the Directive on day one - extending further after two years - and overall business respondents indicated that they have over 1 billion suppliers in their upstream supply chains alone. This does not yet include the other business partners downstream and in the value chain, whose harmful activities would also caught by the due diligence obligations imposed by the Directive on their large business partners that are within scope.

- The Directive provides for a review clause (Article 29) which makes explicit reference to the personal scope of the Directive and whether the thresholds regarding the number of employees and net turnover should be lowered. As a result, it is not to be excluded that the Directive may be extended to SMEs in the future.

- In contrast to the criteria used in relation to EU companies, the number of employees of third-country companies are not relevant. The explanatory memorandum notes the difficulties experienced in calculating the number of worldwide employees under the French Duty of Vigilance Law, but also highlights that methods for calculating the net turnover of third-country companies have already been developed under the Country-by-Country Reporting Directive (an amendment to the Accounting Directive), whilst such methodology does not exist for calculating the number of employees of third-country companies.

- The relevant turnover must have been **generated in the EU** which 'creates a territorial connection between the third-country companies and the EU territory by the effects that the activities of these companies may have on the EU internal market.' Paragraph 25 of the preamble explains that 'such link is required for EU law to apply to third-country companies'.

- According to the estimates of the European Commission, approximately 13 000 EU companies and 4000 third-country companies will be covered by the Directive.

- The rules concerning the duties of directors are limited to EU companies falling within the scope of the law and do not extend to third-country companies.

3. Obligation

The Draft Directive imposes a duty on Member States to ensure that companies carry out human rights and environmental due diligence, by carrying out the following actions:

a) Integrating due diligence into policies;
b) Identifying actual or potential adverse impacts;
c) Preventing potential adverse impact, bringing actual adverse impacts to an end; and mitigating their extent;

d) Establishing and maintaining a complaints procedure;
e) Monitoring the effectiveness of the due diligence policy and measures;
f) Publicly communicating on due diligence.

These concepts follow closely the definition of human rights due diligence (HRDD) and its essential components as set out in the UN Guiding Principles.

Articles 5 to 11 elaborate further on each of the above components of the due diligence duty. In particular:

- **Integrating due diligence into companies' policies (Art 5):** The policy should include a description of the company's approach, including in the long term, to due diligence, its code of conduct, and a description of the processes put in place to implement due diligence. Policies will need to be updated and published annually.

- **Identifying actual and potential adverse impacts (Art 6):** This will apply to companies' own operations, those of their subsidiaries and of their established business relationships in their value chains. Companies that are only included within scope due to having turnover in 'high impact' sectors will only need to identify their impacts relevant to the respective sector. Companies providing credit, loan, or other financial services will need to identify actual and potential adverse impacts only before providing these services.

- **Preventing potential adverse impacts (Art 7):** Companies will be required to 'prevent, or where prevention is not possible or not immediately possible, adequately mitigate' potential adverse impacts that 'have been, or should have been, identified pursuant to Article 6'. Required actions include, where relevant:

    - implementing a prevention action plan, with clearly defined timelines and indicators,
    - seeking contractual assurances from business partners with whom the company has a direct business relationship that it will ensure compliance with the company's code of conduct, including contractual cascading, and putting in place appropriate measures to verity compliance.
    - making necessary investments, including into management, production processes and infrastructure,
    - providing 'targeted and proportionate support for SMES with which the company has established business relationships, where compliance…would jeopordise the viability of the SME', and
    - collaborating with other entities, 'where relevant, to increase the company's ability to bring the adverse impact to an end.'

- **Bringing actual adverse impacts to an end (Art 8):** Companies will be required to take appropriate measures to bring actual adverse impacts that have been, or should have been identified, to an end. Where it cannot be brought to an end, companies will be require to mitigate the extent of the impact. Required actions include, where relevant:

- neutralising the impact including by the payment of damages to the affected persons or communities,
- developing a corrective action plan, including timelines and indicators,
- seeking contractual assurances from direct partners with whom the company has a direct business relationship that it will ensure compliance with the company's code of conduct, including contractual cascading, and putting in place appropriate measures to verify compliance.
- making necessary investments, including into management, production processes and infrastructure, providing 'targeted and proportionate support for SMES with which the company has established business relationships, where compliance…would jeopordise the viability of the SME', and
- collaborating with other entities to increase the company's ability to bring the adverse impact to an end.

- **Complaints procedure (Art 9)**: Companies need to provide the possibility for the following persons to bring complaints: 'persons who are affected or have reasonable grounds to believe that they might be affected by an adverse impact, (b) trade unions and other workers' representatives representing individuals working in the value chain concerned, [and] (c) civil society organisations active in the areas related to the value chain concerned.'

- **Monitoring (Art 10):** Companies should periodically, and at least every 12 months or 'whenever there are reasonable grounds to believe that significant new risks' may arise, monitor the effectiveness of monitor the effectiveness of 'the identification, prevention, mitigation, bringing to an end and minimisation of the extent of human rights and environmental adverse impacts.'

- **Communicating (Art 11):** Companies that are not already required to report in accordance with Articles 19a and 29a of Directive 2013/34/EU shall report on the matters covered in this Directive by 30 April each year.

A few notes:

- Both the prevention and ceasing and mitigating requirements include an assumed knowledge of adverse impacts that the company should have known about, in the event that the company failed to adequately identify these impacts. In this way, companies cannot escape liability by turning a 'blind eye' to adverse impacts.

- The preamble clarifies that the due diligence obligations are 'obligations of means' and that 'the company should take the appropriate measures which can reasonably be expected to result in prevention or minimisation of the adverse impact under the circumstances of the specific case (paragraph 15). As such, it refers to due diligence as a standard of case, in line with the way the concept is envisaged in the UNGPs.

- As highlighted by the UNGPs, stakeholder engagement is key throughout the HRDD process. In the Directive, consultation with stakeholders is encouraged 'where relevant' throughout the various components of HRDD but it is not made compulsory. Unlike the Draft Directive of the European Parliament, it does not contain a dedicated article on 'stakeholder engagement'.

- Interestingly, where companies are not able to prevent, adequately minimise, put an end to or mitigate the extent of adverse impacts connected to a business partners, Article 8(6) requires that the company 'refrain[s] from entering into new or extending existing relations' with the relevant partner and either:

    a) temporarily suspect commercial relations with the partner in question, while pursuing prevention and minimisation efforts, *if there is reasonable expectation that these efforts will succeed in the short-term*'; or
    b) terminate the business relationship if the potential adverse impact is severe.

- (The exception to this is that companies that provide credit, loan or other financial services will not be required to terminate these financial services contracts 'when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided.')

- This is a surprising clause, given the position in the UNGPs that termination should be last resort, and that leverage should first be exercised and increased before termination is considered. It is also not clear what whether b) will trump a) in the event where an adverse impact is severe but there is a reasonable expectation that efforts will success in the short-term in improving conditions, as have been evidenced to be the case in many real-life case studies. There is a likelihood that such a legal requirement on business to terminate relationships will have a counter-productive effect, lead to 'hiding' of issues and diminished transparency, divestment from high-risk areas, irresponsible knee-jerk (but legally required) exits, accompanying loss of livelihoods and other harms to rights-holders and similar impacts that could have been prevented had the company been allowed to stay in the relationship and proactively engage.

- Companies may use third-party verification methods to check for compliance with its code of conduct.

- The provisions relating to contractual obligations stipulate that the terms of contracts with SMEs shall be 'fair, reasonable and non-discriminatory'. Where third party verifications are carried out in relation to SMEs, the company shall bear the costs of these verifications.

- Companies may rely on industry schemes and multi-stakeholder initiatives to support the implementation of their due diligence obligations 'to the extent that such schemes and initiatives are appropriate to support the fulfilment of those obligations' (Article 14(4)).

4. 'Established relationships' in the value chain

The Directive lays down due diligence obligations with respect to actual or potential adverse human rights and environmental impacts in companies' own operations, the operations of subsidiaries, and value chain operations that are carried out by 'entities within whom the company has an established relationship'.

'Established relationship' is defined as a 'business relationship, whether direct or indirect, which is, or which is expected to be lasting, in view of its intensity or duration and which does not represent a negligible or merely ancillary part of the value chain'. A 'business relationship', in turn, is defined as a relationship with a contractor, subcontractor or any other legal entity with which the company has 'a commercial agreement or to whom the company provides financing, insurance or reinsurance', or that 'performs business operations related to the products or services of the company for, or on behalf of the company'.

Accordingly, upstream and downstream business relationships fall within scope, even when there is no direct (contractual) relationship, where the business partner is performing operations related to the company's products or services in a manner that is intended to be lasting.

The nature of whether a business relationship is viewed as 'established' will need to be 'reassessed periodically, and at least every 12 months' (Article 1(1)(b)). Ultimately, it is assumed, the company's assessment of whether a specific business relationship qualifies as 'established' for the purposes of undertaking due diligence could be tested before a court or by the public administrative body, where this is in dispute.

5. Enforcement mechanisms

The Directive provides for enforcement through both a public supervisory authority in each Member State and through judicial remedies in courts.

5.1 Public enforcement mechanism

Under Article 17, Member States are to designate one or more supervisory authorities to supervise compliance with the obligations set forth in the Directive. The powers of the supervisory authority are described in Article 18. In particular, it may initiate an investigation on its own motion or as a result of 'substantiated concerns' communicated to it. The concept of 'substantiated concerns' is defined in Article 19 as covering the situations in which natural and legal persons 'have reasons to believe, on the basis of objective circumstances, that a company is failing to comply with the national provisions adopted pursuant to this Directive'.

Where the supervisory authority identifies a failure to comply with the obligations set forth in the Directive, it shall grant the company concerned an appropriate period of time to the company to take remedial action where possible. Importantly, Article 18(4) specifies that 'taking remedial action does not preclude the imposition of administrative sanctions or the triggering of civil liability in case of damages'.

The powers of the supervisory authority should include, at minimum, the possibility to order the cessation of the infringements of the relevant provisions, the imposition of pecuniary sanctions and the adoption of interim measures to avoid the risk of severe and irreparable harm. Article 20 is dedicated to sanctions which must be 'effective proportionate and dissuasive'. It specifies that pecuniary sanctions shall be based on the company's turnover.

5.2. The Civil Liability Provision

Article 22, which is entitled 'Civil liability', requires Member States to ensure that companies are liable for damages if they failed to comply with the obligations laid down in Articles 7 and 8 (regarding preventing, bringing to an end and mitigating the extent of adverse impacts) and if this failure led to damage.

The article also provides that companies will not held liable for 'damages caused by an adverse impact arising as a result of the activities of an *indirect partner* with whom it has an established business relationship' provided that the company has taken the relevant required actions related to contractual assurances set out in Articles 7(2)(b), 7(4) and 8(3)(c) and 8(5), unless 'it was unreasonable, in the circumstances of the case, to expect that the action actually taken, including as regards verifying compliance, would be adequate to prevent, minimise, bring to an end or mitigate the adverse impact.' Presumably this would apply to circumstances where companies should have known that simply having a contractual clause in place, or a social audit undertaken, would not be sufficient to prevent, mitigate or address the human rights harms.

The provision also requires Member States to ensure that the liability provided for in provisions of national law transposing Article 22 is of overriding mandatory application' in cases where the law applicable is that of a third country.

6. Combating climate change

Article 15, entitled 'Combating climate change', sets out specific duties for large companies in relation to climate change. These companies will be required to 'adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement'. The plan should identify 'the extent to which climate change is a risk for, or an impact of, the company's operations'. Where climate change 'is or should have been identified as a principal risk for, or a principal impact of, the company's operations', the plan needs to include emission reduction objectives. These obligations should be considered in determining any 'variable remuneration' that is 'linked to the contribution of a director to the company's business strategy and long-term interests and sustainability.'

Other relevant points:

- The Directive also provides for certain **directors' duties,** including to 'ensure that, when fulfilling their duty to act in the best interest of the company, directors of companies [...] 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' (Art 25).

- The Directive will take effect twenty days after publication in the *Office Journal of the European Union* and Member States will be required to adopt incorporating legislation within two years. The Directive will be reviewed in seven years' time.