EUROPEAN COMMISSION PUBLISHES PROPOSED DIRECTIVE ON CORPORATE SUSTAINABILITY DUE DILIGENCE

In February, the European Commission, after significant delays, proposed a draft Directive on corporate sustainability due diligence, focused on human rights abuses and environmental harms. The draft Directive is part of the European Union's sustainable corporate governance initiative. Key takeaways from the draft are that the obligations would be mandatory, would reach well down the supply chain, would impose duties on directors and would, in addition to covering large EU companies, also have extra-territorial effect by applying to non-EU companies meeting EU revenue criteria.

In brief:

- The Directive would establish a duty of due diligence for companies within its scope. The core elements of the corporate duty are to identify, end, prevent, mitigate and account for "adverse human rights" and "adverse environmental" impacts of the operations of a consolidated group (company and subsidiaries) and the value chain with which the group has an "established business relationship."

  Certain companies would be required to have a plan to ensure their strategy is compatible with limiting global warming to 1.5˚C (in line with the Paris Agreement).

- The Directive also would introduce duties of directors of covered companies to set up and oversee implementation of the due diligence process and integrate the process into the corporate strategy. In addition, directors, when fulfilling their duty to act in the best interest of their companies, would be required to take into account the human rights, climate change and environmental consequences of their decisions.

The draft Directive has gone to the co-legislative bodies (the European Parliament and the European Council), and is subject to amendment. Once approved by these two bodies, Member States would have two years in which to transpose the Directive into national law (in the case of Group 1 companies) and four years (in the case of Group 2 companies), in each case referred to below. (In contrast to EU Regulations, EU Directives are not self-executing; rather, they serve as directions to Member States as to the content required to be incorporated into national law. References in this briefing note to requirements of the Directive ultimately will be to requirements of national law.)

Background

The European Union has for some time been focused on delivering on the UN Sustainable Development Goals and on facilitating the transition to a climate-neutral and sustainable economy in line with its European Green Deal. Success in these related areas, in the words of the European Commission, depends on mitigating adverse human rights and environmental impacts in corporate value chains, integrating sustainability into corporate governance and management systems, and framing business decisions in terms of human rights, climate and environmental impacts, as well as long-term corporate sustainability. Due diligence on value chains is viewed as a critical component of the effort.

While the European Commission recognizes that an increasing number of EU companies are focused on value chain due diligence, it also recognizes that voluntary efforts have failed to result in large scale improvement across sectors and, as a result, EU production and consumption continue to be associated with adverse human rights and environmental impacts, including:

- in the case of human rights, forced labor, child labor, inadequate workplace health and safety, and worker exploitation; and
- in the case of the environment, GHG emissions, pollution, biodiversity loss and ecosystem degradation.

(*See generally*, Final Report: Study on due diligence requirements through the supply chain (European Commission, undertaken by the British Institute of International and Comparative Law, in partnership with Civic Consulting and LSE Consulting).)

The Directive, the launch of which was announced in April 2020, is presented as an effort:

- to improve corporate governance practices to better integrate risk management and mitigation processes of human rights and environmental risks and impacts, including those stemming from value chains, into corporate strategies;
- to avoid fragmentation of due diligence requirements in the EU single market and create legal certainty for businesses/stakeholders as to expected behaviour and liability;
- to increase corporate accountability for adverse impacts, and ensure coherence for companies regarding obligations under existing and proposed EU initiatives on responsible business conduct;
- to improve access to remedies for those affected by adverse human rights and environmental impacts of corporate behaviour; and
- by virtue of being a horizontal instrument focused on business processes, applying also to the value chain, to complement other measures in force or proposed, which directly address some specific sustainability challenges or apply in some specific sectors, mostly within the European Union.

Prior EU efforts to increase transparency around business practices include the Non-Financial Reporting Directive, and parallel efforts include the proposed Corporate Sustainability Reporting Directive. The Directive would also underpin the Sustainable Finance Disclosure Regulation and complement the recent Taxonomy Regulation. (See my prior briefing note, available here). Other related EU efforts include the Directive on preventing and combating trafficking and the Conflict Minerals Regulation.

Efforts at the global level to promote human rights through national legislation aimed at business practices include the non-binding UN Guiding Principles on Business and Human Rights (2011) ("UN Guiding Principles").

The Directive reflects consideration of two negative opinions issued by the European Commission's Regulatory Scrutiny Board. See also the Staff Working Document addressing certain Board concerns.

It is noteworthy that there are laws in certain individual Member State that address human rights due diligence (together with penalties for violations), including the French Law 2017-399 relating to the duty of vigilance (currently in effect), the German Act on Corporate Due Diligence in Supply Chains (enters into force January 1, 2023), and the Norwegian Act relating to enterprises' transparency and work on fundamental human rights and decent working conditions (Transparency Act) (enters into force July 1, 2022). The Dutch Minister for Foreign Trade and Development Cooperation announced in December 2021 that the Dutch government would begin work on mandatory national corporate due diligence legislation due to delays at the EU level. The promotion

of human rights was a key component of the national commitments submitted as part of the US-sponsored Summit on Democracy.

The European Commission issued a Q&A on the proposed Directive (available here) as well as a Fact Sheet (available here).

Scope

EU companies. The Directive would apply to companies ***organized in the European Union*** with more than 500 employees on average and net worldwide turnover (revenue) of more than €150 million (Group 1 companies), as well as EU companies that do not reach the foregoing threshold but had more than 250 employees on average and net worldwide turnover of more than €40 million (Group 2 companies), of which at least 50% is derived from one or more of the following sectors ("High Impact Sectors"): the manufacture of textiles, leather and related products, the wholesale trade of textiles, clothing or footwear; agriculture, forestry, fisheries (including aquaculture), the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food, and beverages; or mineral extraction, manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (other than machinery and equipment) and wholesale trade of mineral resources, and basic and intermediate mineral products.

Non-EU companies. The Directive also would apply to companies ***organized outside the European Union*** with net turnover in the European Union of more than €150 million (Group 1 companies) or with net turnover in the European Union of more than €40 million (but not more than €150 million), of which at least 50% is derived from one or more High Impact Sectors (Group 2 companies). There is no employee test for non-EU companies.

The Directive set outs a comprehensive list of legal persons and regulated financial undertakings (regardless of form) that would be included in the term "company" for purposes of being covered by the Directive. Regulated financial undertakings would include, among others, credit institutions, investment forms, AIFMs, AIFs managed by an AIFM, UCIT management companies, UCITSs, insurance and reinsurance companies, social security schemes, central counterparties, central securities depositaries, securitization SPVs, crowdfunding service providers and crypto-asset service providers (all as defined).

The Commission estimates that there are approximately 9,400 EU Group 1 companies and 3,400 EU Group 2 companies, and approximately 2,600 non-EU Group 1 companies and 1,400 non-EU Group 2 companies. SMEs are excluded from the scope of the Directive.

Further Details on Coverage

The term "adverse environmental impact" is defined by reference to a series of obligations and prohibitions set out in environmental conventions listed in an Annex that accompanies the Directive, and the term "adverse human rights impact" is defined by reference to violations of rights or prohibitions listed in the Annex that are enshrined in international conventions that also are set out in the Annex.

A "business relationship" is defined as relationship with a contractor, subcontractor or any other legal entities ('partner') with whom 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. The relationship is deemed "established" if, whether directly or indirectly, it is expected to be lasting, in view of its intensity or duration and does not represent a negligible or merely ancillary part of the value chain.

"Value chain" is defined as activities related to the production of goods or the provision of services by a company, including the development of the product or the service and the use and disposal of the product as well as the related activities of upstream and downstream established business relationships of the company. In the case of regulated financial undertakings, the term would cover the activities of clients receiving loans, credit and other financial services and of other companies belonging to the same group whose activities are linked to the contract in question. The value chain of regulated financial undertakings would not cover SMEs receiving loans, credit, financing, insurance or reinsurance.

Further Details on Obligations

Diligence policies. Covered companies would have an affirmative obligation to integrate human rights and environmental due diligence (collectively, "due diligence") into their corporate policies and, separately, to have in place a due diligence policy. The policy would need to include a description of the company's approach to the due diligence; a code of conduct for employees and a description of processes to implement the due diligence, including measures to verify compliance with the code of conduct and measures to extend application of the code to established business relationships. Policies would have to be updated annually.

Identification. Covered companies would have to take "appropriate measures" (as defined) to identify actual and potential adverse human rights and environmental impacts from their own operations, the operations of their subsidiaries and, in respect of their value chains, their established business relationships. Group 2 companies would only be required to identify "severe" adverse impacts. In the case of regulated financial undertakings, the identification would have to precede providing the relevant services.

Prevention. Covered companies would need to take "appropriate measures" to prevent or, where prevention is not possible or not immediately possible, adequately mitigate potential adverse human rights impacts and adverse environmental impacts that have been, or should have been, identified. Actions would include:

- where necessary due to the nature or complexity of the measures required for prevention, develop (in consultation with affected stakeholders) and implement a prevention action plan, with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement;
- seek contractual assurances (with appropriate verification measures) from a business partner with whom it has a direct business relationship that it will ensure compliance with the company's code of conduct and, as necessary, a prevention action plan, including by seeking corresponding contractual assurances from its partners, to the extent that their activities are part of the company's value chain (contractual cascading);
- make necessary investments, such as into management or production processes and infrastructures;
- provide targeted and proportionate support for an SME with which the company has an established business relationship, where compliance with the code of conduct or the prevention action plan would jeopardize the viability of the SME; and
- in compliance with EU law, including competition law, collaborate with other entities, including, where relevant, to increase the company's ability to bring the adverse impact to an end, in particular where no other action is suitable or effective.

Where prevention or adequate mitigation is not possible, the company may seek to conclude a contract with a partner (a "contractual alternative") with whom it has an indirect relationship, with a view to achieving compliance with the company's code of conduct or prevention action plan. The contractual assurances or the contract are to be accompanied by the appropriate measures to verify compliance, which may include "suitable industry initiatives" or "independent third-party verification."

Where prevention or adequate mitigation is not possible, and achieving compliance via the contract alternative also is not possible, a company would need to refrain from entering into new or extending existing relations with the partner in connection with or in the value chain of which the impact has arisen and would, where the law governing their relations so entitles them to, temporarily suspend 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 terminate the business relationship with respect to the activities concerned if the potential adverse impact is severe ("Fallback Obligations"). Member States are to provide for the availability of an option to terminate the business relationship in contracts governed by their laws.

Removal of real negative impacts. Covered companies would need to take "appropriate measures" to bring actual adverse impacts that have been, or should have been, identified to an end. If the adverse impact cannot be ended, companies would have to minimize the impact. Required actions would include:

- neutralize the adverse impact or minimize its extent, including by the payment of damages to the affected persons and financial compensation to the affected communities;
- where necessary due to the fact that the adverse impact cannot be immediately brought to an end, develop (where relevant, in consultation with affected stakeholders) and implement a corrective action plan with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement;
- seek contractual assurances from a direct partner with whom it has an established business relationship that it will ensure compliance with the code of conduct and, as necessary, a corrective action plan, including by seeking corresponding contractual assurances from its partners, to the extent that they are part of the value chain (contractual cascading);
- make necessary investments (*e.g.,* into management or production processes and infrastructures);
- provide targeted and proportionate support for an SME with which the company has an established business relationship, where compliance with the code of conduct or the corrective action plan would jeopardize the viability of the SME; and
- in compliance with EU law, including competition law, collaborate with other entities, including, where relevant, to increase the company's ability to bring the adverse impact to an end, in particular where no other action is suitable or effective.

Where impacts cannot be ended or adequately mitigated, the company may seek to conclude a contract similar to the contractual alternative described above. Failing these, the company would be subject to similar Fallback Obligations to temporarily suspend commercial relationships with the partner in question, while pursuing efforts to bring to an end or minimize the extent of the adverse impact, or terminate the business relationship with respect to the activities concerned, if the

adverse impact is considered severe. Similarly, Member States are to provide for the availability of an option to terminate the business relationship in contracts governed by their laws.

Additional Procedures

The Directive also provides for complaint procedures, periodic assessments of operations and measures to monitor effectiveness of the obligations and communication of matters covered by the Directive.

Combating Climate Change

Group 1 companies are to adopt a plan to ensure that their business model and strategy are compatible with the transition to a sustainable economy and with limiting global warming to 1.5°C. The plan, in particular, is to identify, on the basis of information reasonably available to the company, the extent to which climate change is a risk for, or an impact of, the company's operations. Member States are to ensure that, in case climate change is or should have been identified as a principal risk for, or a principal impact of, the company's operations, the company includes emission reduction objectives in its plan. Member States also are to ensure that companies duly take account of these obligations when setting variable remuneration, if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability.

Non-EU Companies

Non-EU companies covered by the Directive must appoint an agent in the European Union. For these companies, the relevant competent authority for purposes of the Directive will be the authority of the Member State where it has a branch, or in the case of companies with branches in multiple Member States, the Member State with the greatest turnover.

Sanctions

The Directive provides for civil liability, as well as administrative sanctions to be determined by national law, for failures to comply with the Directive.

Guidance

The European Commission would be directed to adopt guidance about voluntary model contract clauses. It may also issue guidelines, including for specific sectors or specific adverse impacts.

Concluding Thoughts

The draft Directive has prompted a host of questions, including whether:

- the scope should be broadened to directly cover more companies (*e.g.,* SMEs);
- the scope should be broadened to reach further down value chains (for example, is the definition of "established business relationships" too narrow, for omitting short or informal relationships);
- responsible purchasing practices (including pricing) and responsible disengagement should be specifically referenced;
- the proposed civil liability provisions should be broadened;
- the proposed liability provisions would in fact be effective in providing access to judicial remedies;

- there are more effective alternatives to verification than through the contemplated industry initiatives and third-party audits; and
- stakeholder engagement should be given greater prominence (the draft standard is "where relevant").

Commentators have pointed to the UN Guiding Principles and the various guidelines for due diligence for multinational enterprises published by the OECD (*see, e.g.,* Institutional Investor guidelines and Responsible Lending and Underwriting guidelines) as examples of more comprehensive standards. It remains to be seen where the co-legislators will come out on key questions.

On the question of scope, while the draft Directive does not ban forced labor, a separate effort is expected to prohibit the import into EU markets of goods manufactured with forced labor, including child labor. (*See* Commission Communication on decent work worldwide for a global just transition and sustainable recovery, available here). Note though that forced labor would be covered from a due diligence perspective as having an adverse human rights impact.

As with climate and ESG metrics, it is critical that standard setters are able to set standards for human rights and environmental harms due diligence that are comparable and consistent. As noted, there are various national human rights due diligence regimes in the European Union that are, or are about to be, effective, which undermines the goal of establishing comparable and consistent standards.

There are notable omissions in the human rights due diligence landscape, including the United States. Particularly in light of the extra-territorial effect of emerging standards, avoiding a patchwork of different standards will be critical. It will be equally important for companies outside the European Union to recognize, and prepare for compliance with, emerging EU standards to the extent they trigger the relevant thresholds. It will also be important for companies subject to the other related EU sustainability regimes (which are principally focused on disclosure/reporting) to understand how the Directive (which goes well beyond reporting) and these other regimes will work in tandem.

The key message of all of the foregoing is that the direction travel (to borrow from some of my prior ESG briefing notes) in mitigating human rights and environmental harms is unmistakable.

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May 11, 2022