Harvard Law School Forum on Corporate Governance

EU Publishes Draft Corporate Sustainability Due Diligence Directive

Posted by Dr. Johannes Weichbrodt, James Ford, and Libby Reynolds, Mayer Brown LLP, on Tuesday, March 15, 2022

Editor's note: Dr. Johannes Weichbrodt is partner and James Ford and Libby Reynolds are associates at Mayer Brown LLP. This post is based on a Mayer Brown memorandum by Dr. Weichbrodt, Mr. Ford, Ms. Reynolds, Sam Eastwood, Musonda Kapotwe and Peter Pears. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver Value to All Stakeholders?, both by Lucian A. Bebchuk and Roberto Tallarita; and For Whom Corporate Leaders Bargain (discussed on the Forum here); and Stakeholder Capitalism in the Time of COVID, both by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here).

On 23 February 2022, the European Commission published its much-anticipated draft corporate sustainability and due diligence directive (the **Draft Directive**), after a number of delays (see our Previous Blog). The Draft Directive sets out a proposed EU standard for human rights and environmental due diligence (**HREDD**). This includes an obligation for companies to take appropriate measures to identify actual and potential adverse human rights and environmental impacts arising from their own operations or those of their subsidiaries and, where related to their value chains, from their "established business relationships". The Draft Directive also provides a mechanism for sanctions to be imposed for non-compliance with the due diligence obligations and provides for director responsibility and accountability in relation to a company's HREDD programme.

Whilst the Draft Directive remains subject to further legislative scrutiny and approval, it provides the most detailed insight yet as to the scope and form of the prospective EU HREDD obligations, and it provides a helpful template for corporates to continue developing their due diligence policies and procedures designed to identify, assess and mitigate adverse human rights and environmental impacts—both in their operations and in their supply chains.

Furthermore, the Draft Directive will have implications for banks, insurers and other financial institutions, which will have to undertake further due diligence on clients and their subsidiaries to whom they extend loans, credit and other financial services [1] in light of the obligations set out therein.

As to timing and implementation, the Draft Directive will now be presented to the European Parliament and the Council for approval. Once adopted, Member States will have two years to transpose the Directive into national law. However, the overall message remains clear: mandatory HREDD is coming (see our Past Blogs on national HREDD movements in Germany and the Netherlands, for example), and companies should already be anticipating

upcoming HREDD legal obligations and responding to increasing stakeholder expectations in this area.

The Draft Directive

Scope

Key Takeaway

In addition to covering large EU companies, the Draft Directive will have extraterritorial effect. Non-EU companies that meet the applicable turnover criteria in the EU set out below will fall within scope even if they do not have a physical presence in the EU. This could have significant implications for multinational groups based in the US, UK and Asia that meet this turnover test.

The Draft Directive applies to certain large EU and non-EU companies that meet the criteria set out below (per Article 2):

- **EU-companies** which have:
  - more than 500 employees and a net worldwide turnover of more than EUR 150 million; or
  - more than 250 employees and a net worldwide turnover of more than EUR 40 million—provided that at least 50% of this net turnover was generated in a "high-risk" sector (which includes textiles, clothing and footwear, agriculture, forestry, fisheries, food and extractives).
- **Non-EU companies** which have:
  - net turnover of more than EUR 150 million in the EU; or
  - net turnover of more than EUR 40 million but not more than EUR 150 million, provided that at least 50% of its net worldwide turnover was generated in one of the "high-risk" sectors noted above.

It appears that around 13,000 EU companies and 4,000 non-EU companies would fall within the above criteria. It is worth noting that small and medium sized enterprises (SMEs) are excluded from the due diligence obligations set out in the Draft Directive.

The extraterritorial scope of the Draft Directive is of particular note: non-EU companies that meet the applicable turnover criteria in the EU will fall within scope *even if they do not have a physical presence in the EU*. This could have significant implications for multinational groups based in the US, UK and Asia that meet this turnover test. In scope non-EU companies are also required to appoint an EU-based representative to liaise with EU supervisory authorities (Article 15).

Due diligence obligations

Key Takeaway

Fundamentally, the Draft Directive requires in scope companies to implement HREDD measures that cover their entire supply chains, looking beyond Tier 1 suppliers to include "established business relationships" throughout the value chain. This includes

contractors, subcontractors and other entities in the supply chain. This will add further complexity to supply chain risk assessments and ongoing supply chain risk management in practice.

In terms of due diligence obligations, the Draft Directive provides that Member States require companies to:

- Integrate due diligence into company policies and ensure such policies are updated annually (Article 5);
- Identify actual or potential adverse human rights and environmental impacts arising from their own operations, those of their subsidiaries and from their established business relationships throughout their value chains (Article 6);
- Prevent potential adverse impacts and bring actual adverse impacts to an end (Articles 7 and 8);
- Establish and maintain a compliant procedure that enables complaints to be submitted by affected persons, representative representing individuals working in the relevant value chain and civil society organisations active in areas related to the relevant value chain (Article 9);
- Monitor the effectiveness of their due diligence policies through reviews that take place at least one every 12 months (Article 10); and
- Publish an annual statement on their website to communicate the relevant due diligence measures taken by the company during the previous calendar year (Article 11).

The Draft Directive requires in scope companies to implement HREDD measures that cover their entire supply chains. This goes beyond assessing Tier 1 suppliers to include assessing "established business relationships" throughout the value chain.

The Draft Directive defines an "established business relationship" as a direct or indirect relationship that is expected to be lasting and "which does not represent a negligible or merely ancillary part of the value chain". This includes contractors, subcontractors and other entities in the supply chain. The Draft Directive places particular emphasis on companies seeking contractual assurances from direct partners with whom they have an established business relationship (recital (34)). Seeking such assurances and conducting due diligence on all of these relationships in practice will add further complexity to companies' supply chain risk assessments and ongoing supply chain risk management.

Directors' Duties

Key Takeaway

The Draft Directive explicitly provides for directors to take into account "human rights, climate and environmental consequences" in acting in the best interest of a company. This includes a requirement to ensure a company's business model and strategy are compatible with the 1.5 °C goal of the Paris Agreement. This appears to be more expansive than existing and anticipated national HREDD laws.

The Draft Directive provides that Member States ensure that company directors:

- take into account human rights, climate and environmental consequences of their decisions in acting in the best interests of the company;
- adopt a plan to ensure a company's business model and strategy is compatible with the transaction to a sustainable economy and with limiting global warming to 1.5°C in line with the Paris Agreement; and
- are responsible for putting in place and overseeing the company's due diligence programme, with due consideration of relevant input from stakeholders and civil society organisations.

Sanctions

Key Takeaway

The Draft Directive provides that Member States enforce sanctions for non-compliance that are "effective, proportionate and dissuasive".

As anticipated, the Draft Directive provides for a mechanism for Member States to enforce sanctions for non-compliance with the obligations set out in the Draft Directive (Article 20-). Such sanctions shall be "effective, proportionate and dissuasive" and may include financial penalties based on a company's turnover.

New Civil Liability Regime

Key Takeaway

A new civil liability regime could set the stage for an increase in human rights and environmental related litigation.

The Draft Directive introduces a new civil liability regime (Article 22). In particular, in scope companies will be liable for damages whether a failure to comply with the mandated due diligence obligation (particularly to identify, prevent, mitigate and end adverse human rights and environmental impacts) leads to damage. This new regime could set the stage for an increase in human rights and environmental related litigation (e.g. brought by civil society organisations). Furthermore, this regime may create have implications for existing national due diligence laws that do not currently provide for such a regime (e.g. the German Supply Chain law).

Model Clauses and Guidance

Key Takeaway

It is anticipated that the European Commission will issue guidance and a set of voluntary model clauses to support companies in complying with their obligations under the Draft Directive.

The Draft Directive states that the European Commission will adopt guidance about voluntary model contract clauses and may also issue guidelines to support companies in achieving compliance with the obligations set out in the Draft Directive. Our Previous Blog on ABA model

clauses provides insights into the types of voluntary model clauses that are already available in a supply chain context.

Timing and Implementation

The Draft Directive will now be presented to the European Parliament and the Council for approval. Once adopted, Member States will have two years to transpose the Directive into national law and communicate the relevant texts to the Commission.

How can your organisation prepare for the requirements set out in the Draft Directive?

The outline of the due diligence obligations in the Draft Directive gives a good indication of the scope and likely expectations of the design and implementation of a human rights and environmental due diligence programme. Companies should map, align and leverage their existing policies and procedures to the requirements in the Draft Directive (particularly those set out in Articles 5-11) to identify gaps and areas for enhancement and improvement ahead of the adoption of the Draft Directive. For many large companies, designing and implementing appropriate systems and controls and embedding them into "business as usual" could be, in many cases, a multi-year multi-stakeholder exercise, and so it is imperative for companies to prepare for these new obligations in haste.

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More generally, businesses can position themselves for the Draft Directive and other mandatory HREDD laws emerging at a national level by:

1. Integrating human rights into group policies and strategic planning processes;
2. Disclosing how human rights considerations are integrated into strategies, policies and procedures;
3. Carrying out a human rights impact assessment and taking proportionate counter-measures, as well as communicating internally and externally on what measures have been taken;
4. Reviewing and reinforcing complaints mechanisms and speak-up programmes;
5. Ensuring the business is well equipped to deal with 'crises';
6. Reviewing the extent to which their board is equipped to address supply chain risks; and
7. Reviewing the role, resources and expertise of the legal and compliance functions, who should play a key part in addressing these new challenges.