Update on the Corporate Sustainability Due Diligence Directive

4 May 2023

Introduction

In February 2022, the European Commission adopted a proposal (the "Commission Draft") for a Directive on corporate sustainability due diligence (the Corporate Sustainability Due Diligence Directive; "CSDDD") with the goal to promote sustainable and responsible business practices. To that end, the CSDDD will introduce a framework for EU companies, and non-EU companies operating within the EU, to carry out due diligence along their supply chains and to identify, prevent or stop adverse impacts related to human rights and the environment (we published an update on the Commission Draft **here**). Adverse human rights and environmental impacts are broadly defined as breaches of international law, treaties, conventions and (prospectively) guidelines in these fields.

The push for extensive and widespread corporate due diligence is part of a broader attempt to move the EU economy to a sustainable economic model and commit the European Union to climate neutrality by 2050. It also reflects a growing awareness of the responsibilities of EU companies with supply chains in the developing world. The CSDDD will complement the Corporate Sustainability Reporting Directive (the "CSRD"), which came into force in January 2023 (we published an update on the new Directive **here**) and aims to harmonize existing EU Member State laws on supply chain due diligence, such as the French Corporate Duty of Vigilance Law (*Loi de Vigilance*) and the recently enacted German Supply Chain Due Diligence Act (*Lieferkettensorgfaltspflichtengesetz*) (we published an update on the German Act **here**).

After extensive debate and negotiation among Member States, in December 2022, the EU Council agreed a negotiating position (the so-called General Approach; "Council Draft") for deliberations with the European Parliament. The Council Draft contained a number of changes from the Commission Draft and was met with mixed reactions from stakeholders and the public.

On 25 April 2023, the European Parliament's Committee on Legal Affairs (JURI) agreed a number of final compromise amendments to the Commission Draft ("JURI Report"), which will be put to a vote in a Parliament plenary meeting in May/early June 2023. Once the Parliament adopts a formal position, the Parliament and the Council will enter into negotiations for the final text of the CSDDD.

We set out below a number of noteworthy positions from the Council Draft and from the JURI Report below. The Council Draft and the JURI Report contain significant differences on important points, with further intense negotiations expected. In particular, the treatment of financial services providers, including funds and their managers, and the due diligence they are required to conduct on their clients and the companies in which they invest has been subject to extensive debate and remains uncertain.

Key Takeaways

- The European Council and the European Parliament's Committee on Legal Affairs have adopted negotiating positions on the European Commission's proposed Corporate Sustainability Due Diligence Directive. The directive will introduce due diligence obligations for EU companies, and non-EU companies operating within the EU regarding actual and potential human rights adverse impacts and environmental adverse impacts with respect to their own operations and those of their subsidiaries and other entities in their value chain. The directive is expected to be formally adopted in 2024.

- The European Council's draft narrows the scope of the due diligence obligations from the Commission's full life-cycle "value chain" approach to a more limited "chain of activities" that excludes the use of a company's products by its consumers and leaves it up to the Member States to decide whether regulated financial undertakings (including fund managers) shall be included in the scope of the directive. In addition, the Council's proposal deletes the director's duties introduced by the Commission.

- The Parliament Legal Committee's draft reverts to the Commission's "value chain" approach and includes regulated financial entities (including funds and fund managers) but limits the scope of the directive with respect to regulated financial entities by providing that their due diligence obligations extend only to the activities of clients that directly receive financial services from the in-scope entity. The proposal introduces an obligation for institutional investors and fund/asset managers (and possibly the funds which they control) to take appropriate and proportionate measures to induce their investee companies to bring actual adverse impacts caused by them to an end.

Changes Proposed in the Council Draft

A summary of the changes is in **Annex 1**.

Scope

The Council Draft contains largely the same general thresholds for companies in scope regarding the number of employees (for EU companies) and net turnover as the Commission Draft (see below) but adds the requirement that these thresholds must be met in two consecutive financial years (in contrast to the Commission Draft, which specifies the thresholds by reference to the last financial year).

Turnover and Employee Thresholds under the Council Draft

- EU companies:
  - net worldwide turnover of more than EUR 150 million and more than 500 employees on average (Group 1 Companies); or
  - net worldwide turnover of EUR 40 million, provided that at least EUR 20 million of this net turnover was generated in a high-risk sector, and with more than 250 employees on average (Group 2 Companies).
- Non-EU companies:
  - net turnover of more than EUR 150 million in the European Union (Group 1 Companies); or
  - net turnover of more than EUR 40 million but less than EUR 150 million in the European Union, provided that at least EUR 20 million was generated in a high-risk sector (Group 2 Companies).

As in the Commission Draft, the Council Draft considers the manufacture and wholesale trade of textiles, leather and related products; agriculture and the manufacture of food products and beverages as well as the extraction of mineral resources and the manufacture of basic metal products as the so-called “high-risk sectors”.

Phase-in

Unlike the Commission Draft, the Council Draft sets out a staggered phase-in period for the application of the CSDDD:

- After the transposition deadline for the directive (two years after entry into force), the Council Draft provides for a one-year period before the rules apply to any company.

- Starting three years after entry into force, the CSDDD would apply to very large EU companies with over 1,000 employees and net worldwide turnover of more than EUR 300 million in the last financial year and very large non-EU companies with over EUR 300 million net turnover in the European Union in the last financial year.

- Starting four years after entry into force, the CSDDD would apply to all other EU and non-EU Group 1 Companies.

- Staring five years after entry into force, the CSDDD would apply to EU and non-EU Group 2 Companies.

Council Draft Narrows the Scope: Value Chain vs. Chain of Activities

In addition, the Council Draft narrows the substantive scope of the CSDDD. Whereas the Commission Draft applies due diligence obligations throughout a company's entire *value chain*, the Council Draft introduces the concept of a *chain of activities*. A company's chain of activities covers a company's upstream business partners (notably, its producers and suppliers of raw materials, products and services). However, unlike the Commission's definition, it narrows the scope with respect to a company's downstream business partners.

Specifically, the Commission Draft's definition of the value chain includes (a) the activities of a company's upstream business partners related to the company's production of goods or provision of services and (b) the activities of a company's downstream business partners related to the distribution, transportation, storage and disposal of the product (including disassembly, recycling or landfilling but explicitly excluding consumer disposal). Under the Council Draft, however, the Commission's comprehensive lifecycle value chain approach is limited. While distributors and entities responsible for disposal of products are included within an entity's chain of activities, the *user* of a company's products or services, for example, would not necessarily be included.

Business Relationships vs. Business Partners

The Council Draft also replaces the notion of "(established) business relationships", *i.e.*, business relationships with contractors, subcontractors or any other legal entities, whether direct or indirect, which are, or are expected to be, lasting, in view of their intensity or duration, and which do not represent a negligible or merely ancillary part of the value chain (introduced in the Commission Draft as a substitute for the term "supplier"). Instead, the Council Draft relies on the notions of "direct and indirect business partners", which are defined as legal entities (i) with whom the company has entered into a commercial agreement in connection with its business activities or to which it provides certain services related to its chain of activities (direct business partner) or (ii) that carry out business activities related to the company (indirect business partner).

Financial Services

Reflecting severe divisions of opinion amongst Member States, the Council Draft leaves it up to the Member States to decide whether to include regulated financial undertakings, such as credit institutions, insurance undertakings and fund managers (AIFMs and UCITS management companies) within the scope of the CSDDD with regard to their provision of financial services to their business partners. Funds, such as alternative investment funds (AIFs) and UCITS, are no longer included as regulated financial entities. If Member States apply the CSDDD to the provision of financial services, regulated financial undertakings will be required to identify adverse impacts in the operations of their business partners only *before* providing the financial service and not during the provision of the financial service (however, they are still required to carry out periodic assessments to monitor the effectiveness of the measures put in place to address any identified adverse effects). This provision has been criticized as leading to inconsistent application of the rules across Member States and complicating the intended EU-wide harmonization of due diligence requirements.

Risk Assessment and Remedial Action

The Council Draft strengthens the Commission's risk-based approach to the preventive and remedial actions to be taken by companies to address adverse impacts by requiring a prioritization of adverse impacts based on their severity and likelihood.

In addition, the Council Draft allows companies to elect not to terminate the relationship with a business partner if there is a reasonable expectation that it would result in an adverse impact that would be more severe than the potential adverse impact that could not be prevented or adequately mitigated. Business relationships may also be maintained if (i) the business partner provides a raw material, product or service that is essential to the company's production of goods or provision of services, (ii) there is no alternative source of supply and (iii) termination would cause significant harm to the company.

Directors' Duties and Renumeration

The Commission Draft introduces a director's duty of care, which obliges directors of in-scope companies to take into account the consequences of their decisions for sustainability matters, including, where appropriate, environmental, climate change and human rights impacts in the short, medium and long term. Directors will be responsible for setting up and overseeing the necessary due diligence processes and integrating due diligence into the corporate strategy while considering the input of stakeholders and civil society organizations. Member States will be required to qualify the failure to consider these sustainability matters as a breach of directors' duties under their national laws.

In addition, according to the Commission Draft, the variable remuneration of directors would under certain conditions need to be linked to the achievement of a company's sustainability targets. To ensure that their business model and strategy are in line with the Paris Agreement and consistent with the goal of limiting global warming to 1.5°C, EU and non-EU Group 1 Companies would be required to prepare a climate plan, which should specifically identify the extent to which the company's operations impact the climate. If risks have been identified or should have been identified, companies would be required to include emission-reduction targets in their plan. The Commission draft provides that the implementation of these commitments must be taken into account when determining variable remuneration.

In contrast, the Council Draft requires companies (rather than directors) to be responsible for implementing and monitoring their due diligence obligations and deletes the provision on directors' duties. The Council Draft also deletes the link between remuneration and sustainability targets, arguing that director remuneration is a corporate matter that is primarily the responsibility of the company and its relevant boards or shareholders.

Civil Liability

A particularly noteworthy aspect of the CSDDD is its introduction of a new basis of civil liability, which would allow natural or legal persons suffering damage as the result of a company's breach of its obligations under the CSDDD to prevent or end any adverse impacts to claim compensation. The interaction of this principle with existing Member State rules on civil liability is complex, but it is intended to override Member State rules, except to the extent existing rules provide for stricter liability.

In an attempt "to avoid undue interference with the tort law systems of the Member States", the Council Draft adopts the model of civil liability introduced by the Commission but rejects the concept of strict liability and instead introduces a fault requirement (intent or negligence). Under the Council Draft, a company shall be liable for damage caused to a natural or legal person if (i) the company intentionally or negligently failed to comply with its due diligence obligations laid down in the CSDDD and (ii) as a result of such a failure, damage is caused to the natural or legal person's legal interest protected under national law. In this context, it is to be expected that the conduct and fault of the corporate body will generally be attributed to the company. However, liability is ruled out when the damage was caused by a company's business partner.

The right to full compensation has been included in the Council Draft, although it is noted that this right should not lead to overcompensation, e.g., through punitive damages.

The Council Draft does not contain any specific provisions on the applicable burden of proof, so it can be assumed that the general rules of the Member States would apply. The plaintiff would most likely bear the burden of proof in most cases.

The exclusion of civil liability for companies that obtain contractual assurances from their indirect business partners, as proposed in the Commission Draft, was deleted in the Council Draft.

Due Diligence at Group Level

The Council Draft explicitly provides that parent companies may perform due diligence obligations on their subsidiaries' behalf, provided that both the parent company and the subsidiary fall within the scope of the CSDDD. However, if the requirements for civil liability are met, a subsidiary can be held liable for any damage caused by its parent company failing to comply with the due diligence obligations on behalf of the subsidiary.

Changes Proposed in the JURI Report

The JURI Report provides for lower employee and turnover thresholds and thus a broader scope of application while narrowing the specific obligations for in-scope companies.

A tabular summary of the changes can be found in **Annex 2**.

Scope

Turnover and Employee Thresholds under the JURI Report:

- EU companies:
  - net worldwide turnover of more than EUR 40 million and more than 250 employees on average; or
  - company is the ultimate parent company of a group that had more than 500 employees on average and a net worldwide turnover of more than EUR 150 million.
- Non-EU companies:
  - net worldwide turnover of more than EUR 150 million, provided that at least EUR 40 million was generated in the European Union, including turnover generated by third-party companies with whom the company and/or its subsidiaries have entered into a vertical agreement in the European Union in return for royalties; or
  - company is the ultimate parent company of a group that had more than 500 employees on average and a net worldwide turnover of more than EUR 150 million, provided that at least EUR 40 million was generated in the European Union, including turnover generated by third-party companies with whom the company and/or its subsidiaries have entered into a vertical agreement in the European Union in return for royalties.

Financial Services

The JURI Report reverts to the Commission's "value chain" approach and the notion of a "business relationship" (rather than the Council's "chain of activities" and "business partners") but limits the scope of the CSDDD with respect to regulated financial entities by clarifying that their value chain includes only the activities of clients that directly receive financial services from the financial entity, as well as companies belonging to their client's group whose activities are linked to the contract in question. Small and medium-sized undertakings, and households and individuals, are not are considered part of the value chain of financial undertakings.

Fund Managers and Institutional Investors in Scope Regarding Investment Activities

As in the Council Draft, the JURI Report notably removes UCITS and AIFs from the list of companies subject to the CSDDD. However, fund managers (AIFMs), UCITS management companies and MiFID investment firms as well as institutional investors (which comprises life insurers and institutions for occupational retirement provision) are in scope to a certain extent with respect to their investment activities (see below). It is worth noting in this context, however, that the JURI Report deviates from the Commission's and Council's definition of "'subsidiary" as a legal person through which the activity of a "controlled undertaking" (as defined in Directive 2004/109/EC (Accounting Directive)) is exercised. In contrast, the JURI Report cross-refers to Directive 2004/109/EC (Transparency Directive) to define "controlled undertaking", which has a broader scope and includes entities over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control.

Funds which are often 'controlled' by their fund managers (as defined in the Transparency Directive), could therefore be considered subsidiaries of a fund manager under the CSDDD. As a result, if an in-scope fund manager exercises a controlling influence over a fund and that fund owns a majority stake in a portfolio company, it could be argued that the fund manager also (indirectly) controls the portfolio company. The portfolio company might in this case be considered a subsidiary of the fund manager for the purposes of the CSDDD and the due diligence obligations of an in-scope fund manager could then potentially also extend to that portfolio company. This would obviously be of relevance to private equity funds that acquire controlling interests in their portfolio companies. It is unclear at this time whether this was actually the intent of the draft.

In addition to the above, the JURI Report introduces an important new obligation for institutional investors and fund/asset managers to take appropriate measures to induce "their" (the fund's) investee companies to bring actual adverse impacts caused by them to an end by engaging with companies and exercising voting rights to minimize the extent of those impacts. The obligation is subject to a "double proportionality" requirement:

- The action sought from the investee company must be proportionate to the significance and scale of the adverse impact and to the contribution of the investee company's conduct to the adverse impact.
- Likewise, the actions required from institutional investors and asset managers must be proportionate and commensurate and should take due account of the degree of control they have over the investee company.

Directors' Duties and Renumeration

The JURI Report does not provide for any changes to the Commission's proposal for directors' duties but does delete the link between the implementation of a company's sustainability goals and its directors' variable remuneration.

Civil Liability

The JURI Report is in line with the Commission Draft, which, as noted above, contains a strict liability principle of civil liability without reference to fault.

Outlook

Once the European Parliament adopts its mandate in the plenary, it will enter into interinstitutional negotiations with the Council on the final text of the CSDDD (so-called trilogues). Trilogue negotiations are anticipated to proceed through the rest of 2023 and the first quarter of 2024. The negotiation process is expected to be characterized by intense debate as a number of interest groups lobby for or against individual provisions while political parties struggle to reach unified positions. Nevertheless, an agreement between the parties is expected before April 2024 (final date for adopting legislation before the European Elections of May 2024).

After that, Member States will have two years to transpose the CSDDD into their laws.

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ANNEX 1: Overview of the Main Changes between the Commission Draft and the Council Draft

	Commission Draft	**Council Draft**
Scope – Thresholds	Scope Group 1 Companies: • EU companies with a net worldwide turnover of more than EUR 150 million and more than 500 employees on average (Group 1 Companies); and • non-EU companies with a net turnover of more than EUR 150 million in the European Union. Scope Group 2 Companies: • EU companies with a net worldwide turnover of more than EUR 40 million, provided that at least **50 percent of the net worldwide turnover** was generated in a high-risk sector; and • non-EU companies with a net worldwide turnover of more than EUR 40 million in the European Union, provided that at least **50 percent of the net worldwide turnover** was generated in a high-risk sector. Thresholds must be met in the last financial year.	Scope Group 1 Companies: • EU companies with a net worldwide turnover of more than EUR 150 million and more than 500 employees on average (Group 1 Companies); and • non-EU companies with a net turnover of more than EUR 150 million in the European Union. Scope Group 2 Companies: • EU companies with a net worldwide turnover of more than EUR 40 million, provided that at least **EUR 20 million** was generated in a high-risk sector; and • non-EU companies with a net worldwide turnover of more than EUR 40 million in the European Union, provided that at least **EUR 20 million** was generated in a high-risk sector. Thresholds must be met for two consecutive financial years.
Scope – Application Timeline	Two-year transposition deadline after CSDDD enters into force.	Staggered phase-in period: • Two-year transposition deadline after CSDDD enters into force. • One-year *vacatio legis* period after end of transposition phase. • Three years after entry into force: Only very large EU companies (> 1,000 employees / > EUR 300 million net worldwide turnover) and very large non-EU companies (> EUR 300 million net turnover in the European Union).

		• Four years after entry into force: Group 1 Companies. • Five years after entry into force: Group 2 Companies.
Scope – **Value Chain vs. Chain of Activities** **/** **Established Business Relationships vs. Direct and Indirect Business Partners**	**Value Chain and (Established) Business Relationships** • Full upstream and downstream value chain ("Full lifecycle approach") down to end customer. **(Established) Business Relationships** • Relationship with a contractor, subcontractor or any other legal entities.	**Chain of Activities and Business Partners** • Activities of a company's **upstream business partners** related to the production of a good or the provision of services by the company; and • Activities of a company's **downstream business partners** related to the distribution, transport, storage and disposal of the product, including the dismantling, recycling, composting or landfilling for or on behalf of the company but expressly excluding the disposal of the product by consumers and the distribution, transport, storage and disposal of products subject to certain export control restrictions. ➢ Users of a company's products or services, for example, would not necessarily be included within scope. **(Direct and Indirect) Business Partners** • Legal entities with which the company has entered into a commercial agreement in connection with its business activities or for which it provides certain services (direct business partner); and • Legal entities that carry out business activities related to the company (indirect business partner).
Scope – **Financial Services**	Regulated financial undertakings are in scope.	**Financial undertakings are excluded** from the scope. Member States may elect to bring regulated financial undertakings, such as credit institutions, insurance undertakings and fund managers (AIFMs and UCITS management companies) within the

		scope of the CSDDD, in which case the CSDDD due diligence obligations would apply with respect to the regulated financial undertakings' business partners for which financial services are provided. Funds, such as alternative investment funds (AIFs) and UCITS, are no longer expressly mentioned as financial entities. If Member States apply the CSDDD to the provision of financial services, regulated financial undertakings will be required to identify adverse impacts in the operations of their business partners only before providing the financial service.
Risk Assessment and Remedial Action	In case of actual adverse effects, business relationships must be suspended (or, in case of severe adverse impacts, even terminated) if the adverse impact cannot be brought to an end or minimized otherwise.	**Option not to terminate a relationship with a business partner** in case of a (potential) adverse impact caused by the business partner if: • there is a reasonable expectation that the termination would result in a more severe adverse impact; **or** • the business partner provides a raw material, product or service that is essential to the company's production of goods or provision of services; *and* • there is no alternative source of supply; *and* • termination would cause significant harm to the company.
Directors' Duties and Renumeration	**Directors' Duties**: Directors must consider the consequences of their decisions for sustainability matters in the short, medium and long term. Directors are responsible for setting up and overseeing the due diligence processes and integrating due diligence into the corporate strategy. Group 1 Companies must prepare a climate plan. **Variable**	**No specific directors' duties or liability.** **No link** between the achievement of a company's sustainability targets and variable remuneration of directors.

	remuneration of directors would under certain conditions be **linked** to the achievement of a company's sustainability targets.	
Civil Liability	**No requirement of fault**: A claim for damages only requires: • failure to comply with obligations; and • damage as a result of an adverse impact resulting from the failure to comply that should have been detected, mitigated and brought to an end. **Exclusion** of civil liability for companies that obtain contractual assurances from their indirect business partners.	**Requirement of fault**: A claim for damages requires • intentional or negligent failure to comply obligations; and • damage to the natural or legal person's legal interest protected under national law. Liability is ruled out when the damage was caused by a company's business partner. A right of natural or legal persons suffering damage to full compensation (the right to full compensation should not, however, lead to overcompensation, e.g., through punitive damages). **No exclusion** of civil liability for companies that obtain contractual assurances from their indirect business partners.
Due Diligence at Group Level	Each company must fulfil the due diligence obligations on their own.	Parent companies may perform due diligence obligations on their subsidiaries' behalf if both fall within the scope of the CSDDD. However, subsidiaries can be held liable for the damage incurred if their parent company insufficiently fulfilled the relevant obligation.

ANNEX 2: Overview of the Main Changes between the Commission Draft and the JURI Report

	Commission Draft	**JURI Report**
Scope – Thresholds	Scope Group 1 Companies: • EU companies with a net worldwide turnover of more than EUR 150 million and more than 500 employees on average (Group 1 Companies); and • non-EU companies with a net turnover of more than EUR 150 million in the European Union. Scope Group 2 Companies: • EU companies with a net worldwide turnover of more than EUR 40 million, provided that at least **50 percent of the net worldwide turnover** was generated in a high-risk sector; and • non-EU companies with a net worldwide turnover of more than EUR 40 million in the European Union, provided that at least **50 percent of the net worldwide turnover** was generated in a high-risk sector.	Scope Group 1 Companies: • EU companies with more than 250 employees on average and a net worldwide turnover of more than EUR 40 million; and • non-EU companies with a net worldwide turnover of more than EUR 150 million, provided that at least EUR 40 million was generated in the European Union (including turnover generated by third-party companies with whom the company and/or its subsidiaries have entered into a vertical agreement in the European Union in return for royalties). Scope Group 2 Companies: • EU companies that are the **ultimate parent company** of a group with more than 500 employees on average and a net worldwide turnover of more than EUR 150 million; and • non-EU companies that are the **ultimate parent company** of a group that had more than 500 employees on average and a net worldwide turnover of more than EUR 150 million, provided that at least EUR 40 million was generated in the European Union (including turnover generated by third-party companies with whom the company and/or its subsidiaries have entered into a vertical agreement in the European Union in return for royalties).
Scope – Financial Services	Regulated financial undertakings, such as funds and fund managers, are in scope. "Subsidiary" is defined as a legal person through which the activity of a "controlled undertaking" as defined in Directive	**UCITS and AIFs are removed** from the list of companies subject to the CSDDD. **Fund managers (AIFMs), UCITS management companies** and MiFID investment firms as well as institutional investors are **in**

	2004/109/EC (Accounting Directive) is exercised.	**scope**. **Value chain for financial entities**: only the activities of clients that directly receive financial services from the financial entity as well as companies belonging to their client's group whose activities are linked to the contract in question. The definition of "subsidiaries" cross-references Directive 2004/109/EC (Transparency Directive) to define "controlled undertaking", which has a broader scope and includes entities over which a natural person or legal entity has the power to exercise, or actually exercises, dominant influence or control. Institutional investors and fund/asset managers must take appropriate measures to induce their investee companies to bring actual adverse impacts caused by them to an end by engaging with companies and exercising voting rights to minimize the extent of actual impacts. • "Double proportionality" requirement: ➢ The action sought from the investee company must be proportionate to the significance and scale of the adverse impact and to the contribution of the investee company's conduct to the adverse impact. ➢ The actions required from institutional investors and asset managers must be proportionate and commensurate and shall take due account of the degree of control they have over the investee company.
Directors' Duties and Renumeration	**Directors' Duties**: Directors must consider the consequences of their decisions for sustainability matters in the short, medium and long term. Directors are responsible for setting up and	**No link** between the achievement of a company's sustainability targets and variable remuneration of directors.

	overseeing the due diligence processes and integrating due diligence into the corporate strategy. Group 1 Companies must prepare a climate plan. **Variable remuneration** of directors would under certain conditions be **linked** to the achievement of a company's sustainability targets.	

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