

Draft Directive on Corporate Sustainability Due Diligence

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Introduction

On 23 February 2022, the European Commission issued a long-awaited and much-anticipated draft Directive on Corporate Sustainability Due Diligence (the “Draft Directive”). The issuance of the Draft Directive is motivated in part by the European Commission’s stated responsibility to workers and others around the world who are connected to the European Union’s economy through global value chains.

If adopted, the Draft Directive will require certain in-scope companies to conduct corporate due diligence that identifies, prevents and mitigates adverse human rights and environmental impacts by the company and its subsidiaries themselves, and through established business relationships in their value chains. It also establishes directors’ duties in relation to the establishment and oversight of the due diligence requirements, and clarifies that a director’s duty to act in the best interests of the company extends to considering sustainability matters, including the short, medium and long-term consequences of their decisions on human rights, the environment and climate change.

The Draft Directive sets out an enforcement regime that includes both regulatory sanctions and civil liability for those companies that fail to meet the Draft Directive’s requirements.

Directives are not directly applicable into the national law of EU Member States. Member States are obliged to incorporate Directives into their national legislation. If passed by the EU Parliament and Council, EU Member States will have two years to pass legislation transposing the obligations under the Directive into their national laws.

Background

In April 2020, the European Commissioner for Justice, Didier Reynders, announced that the Commission would introduce rules for mandatory corporate environmental

and human rights due diligence (“MHREDD”), as part of its Sustainable Corporate Governance initiative. On 11 September 2020, the European Parliament’s Committee on Legal Affairs published recommendations and a legislative proposal for the MHREDD directive (we issued a description of the legislative proposal [here](#)). In December 2021, businesses and human rights experts and leaders addressed a joint statement to Commission President Ursula von der Leyen and the EU Commission, expressing concerns on the numerous delays to the proposed legislation, available [here](#). In February 2022, more than 100 companies, investors, business associations and initiatives released a statement urging the EU to swiftly adopt a legislative proposal on effective MHREDD, available [here](#).

The Draft Directive follows the adoption of laws mandating corporate environmental and human rights due diligence on by a number of EU Member States. France adopted its “Duty of Vigilance Act” (*Loi de Vigilance*) in 2017. Germany’s Supply Chain Act (*Lieferkettengesetz*) is slated to enter into force in 2023 (we published an update describing the law, available [here](#)). Norway and Switzerland have also recently adopted legislation focusing on human rights due diligence. The European Commission in its Explanatory Memorandum to the Draft Directive expressed concerns that these multiple legislative efforts would lead to fragmentation and parallel requirements that undermine legal certainty.

The EU’s legislative efforts are explicitly informed by international voluntary standards on supply chain due diligence. Such standards include the United Nations’ Guiding Principles on Business and Human Rights (“UNGPs”) and the OECD’s Guidelines for Multinational Enterprises (“OECD Guidelines”), both of which were published in 2011 and incorporate due diligence as a key means of preventing corporate adverse human rights impacts. In its Explanatory Memorandum to the Draft Directive, the European Commission explains that the efficacy of voluntary due diligence standards in countering adverse human rights and environmental impacts is undermined by a lack of legal clarity, market pressures and information deficiencies, amongst other factors. The Explanatory Memorandum expressly refers companies to the UNGPs for guidance as to the Draft Directive’s requirements.

Scope

The Draft Directive applies to the following categories of companies:

- **EU-based companies** with:
 - more than 500 employees and net turnover of more than €150 million worldwide (“Group 1 Companies”); or

- more than 250 employees and net turnover of more than €40 million worldwide that generate at least 50% of that turnover in certain “high-risk” sectors (“Group 2 Companies”). The definition of a “high-risk” sector is based on existing sectoral OECD due diligence guidance, and includes textiles, agriculture, forestry, fisheries, the manufacture of food products, extraction of mineral resources, manufacture of basic metal and non-metallic products and the trade of mineral resources.
- **Non-EU companies with:**
 - net turnover of more than €150 million generated in the EU (also considered Group 1 Companies); or
 - turnover of between €40 and €150 million generated in the EU, where at least 50% of net worldwide turnover is generated in the “high-risk” sectors noted above (also considered Group 2 Companies).

The Commission expects approximately (i) 9,400 companies to fall within Group 1, (ii) 3,400 companies to fall within Group 2 and (iii) 4,000 companies to fall within the non-EU Group 1 and Group 2 categories. This appears to be a significantly smaller scope than the earlier EU Parliament proposal had envisaged.

- **SMEs are excluded, but indirectly implicated:**

Small and medium sized enterprises (“SMEs”) are excluded from the scope of the Draft Directive. The Explanatory Memorandum explains that the financial and administrative burden of setting up and implementing a due diligence process would be disproportionately high for SMEs. Nonetheless, certain SMEs will be exposed indirectly to the Directive through “established business relationships” with in-scope companies which are expected to meet the Directive’s requirements with regard to those relationships.

- **The financial sector:**

The Draft Directive excludes the financial sector from the Group 2 “high-impact” sectors (despite the fact that the OECD has issued sector-specific criteria). This is to minimize the financial and administrative burden on such companies. In addition, an in-scope financial company’s established business relationships will not extend to SMEs receiving a loan, credit, financing, insurance or reinsurance. However, the Explanatory Memorandum clarifies that the financial sector will fall within the scope of the Directive. Group 1 companies that are regulated financial undertakings are still within the Draft Directive’s scope, even if they do not have a legal form with limited liability.

Obligations

Under the Draft Directive, companies that are “in-scope” must “conduct human rights and environmental due diligence ... by carrying out the following actions”:

- **Integrate due diligence into their corporate policies and put in place a due diligence policy**, to be updated annually. These policies should, among other things, include a description of the company’s approach to due diligence, a code of conduct (“CC”) to be followed by the company’s employees and subsidiaries, as well as a description of the company’s due diligence processes. Due diligence encompasses measures taken to verify compliance with the CC and to extend its application to the company’s subsidiaries and established business relationships.
- **Identify actual or potential adverse impacts**, which arise from a company’s own operations, those of its subsidiaries and from established business relationships in its value chains. To ensure proportionality, Group 2 Companies are required to identify actual and potential impacts that are *severe* (i.e., that satisfy a higher threshold) in their respective “high risk” sector.
- **Prevent potential adverse impacts**. Companies must take appropriate measures to prevent or adequately mitigate the potential adverse human rights and environmental impacts that they identify. Measures could involve:
 - Developing a prevention action plan in consultation with affected stakeholders.
 - Seeking contractual assurances from established business partners that they will comply with the company’s CC, and, as necessary, preventative action plan. This may give rise to “contractual cascading” as business partners within a value chain seek contractual assurances from each other. The Draft Directive also requires measures to ensure compliance with contractual assurances, such as third-party verification.
 - Providing resources and assistance to established business partners in order to help them comply with the CC and the prevention action plan.

Where potential adverse impacts cannot be prevented or adequately mitigated, companies may suspend or terminate business relationships that have given rise to the relevant impact.

- **Bring actual adverse impacts to an end**. Companies must then bring any adverse impacts that they identify to an end, or, if they are unable to do so, minimise these impacts. The actions required to comply with this obligation must be proportionate to the significance and scale of the adverse impact and to

the contribution of the company's conduct to the adverse impact. Companies may choose to put in place a corrective action plan and require contractual assurances of compliance with this plan. They may also need to provide targeted support to established business partners within their value chains to ensure compliance with the CC and the corrective action plan. Where relevant, bringing impacts to an end may include paying damages to persons affected by the impacts.

- **Establish and maintain a complaints procedure** for affected individuals, for civil society organizations active in the respective area and for trade unions and other organizations representing affected (or potentially affected) individuals.
- **Monitor the effectiveness of their due diligence policy and measures.** Periodic assessments of the efficacy of the measures adopted by the company to comply with its due diligence obligations should be conducted at least every 12 months or at any point when it is reasonable to believe that significant new risks of adverse impacts may arise. The assessments extend to the operations of the company itself, its subsidiaries and established business relationships.
- **Publicly communicate due diligence** by publishing an annual statement on the company's website.
- **Combat climate change.** Group 1 Companies must adopt a plan to ensure that their corporate strategies are compatible with the Paris Climate Agreement's goal of limiting global warming to no greater than 1.5°C.
- **Directors' duties.** Directors are responsible for putting in place and overseeing the due diligence requirements of the Draft Directive. The Draft Directive also states that a director's duty to act in the best interests of the company requires consideration of its climate, environmental and human rights impacts. Member States' laws, regulations and administrative provisions concerning directors' duties should include the Draft Directive's definition of best interests.

"Adverse Human Rights and Environmental Impacts"

Adverse impacts are defined broadly in the Draft Directive, by reference to a number of international standards:

- Adverse environmental impacts are defined as adverse impacts resulting from the violation of a series of environmental conventions, including the Vienna Convention for the protection of the Ozone Layer and its Montreal Protocol, CITES and the Convention for the Prevention of Biodiversity.
- Adverse human rights impacts are defined as adverse impacts on protected persons resulting from the violation of a series of human rights treaties and

conventions. The list of conventions is comprehensive and includes the Universal Declaration of Human Rights, the Convention on the Rights of the Child and the Convention Against Torture. It also includes instruments that are not treaties or conventions, including the UN Declaration on the Rights of Indigenous Peoples.

Established Business Relationships

The Draft Directive extends a company's due diligence obligations beyond its own operations and those of its subsidiaries to its value chain, through the novel concept of an "established business relationship" ("EBR"). For the purposes of the Draft Directive:

- "*Value chain*" means all activities related to the production of goods or the provision of services by a company, including related upstream and downstream activities through its EBRs.
- "*Business relationship*" means a relationship with a contractor, subcontractor or any other legal entities (i) with whom the company has a commercial agreement or to whom the company provides financing, insurance or reinsurance, or (ii) that performs business operations related to the products or services of the company for or on behalf of the company.
- "*EBR*" means 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 company's value chain. Whether a business relationship is 'established' should be reviewed periodically, and at least every 12 months.

Regulatory Enforcement

The Draft Directive requires each EU Member State to establish a supervisory authority whose role is to monitor compliance with the national legislation implementing the Directive. Investigations may be conducted at the initiative of the supervisory authority or based on the "substantiated concerns" of a natural or legal person. The supervisory authority can order companies to cease infringements, and Member States may also establish penalties for violations of the legislation—as long as they are "effective, proportionate and dissuasive"—including the imposition of pecuniary sanctions based on the company's annual turnover.

Civil Liability

The Draft Directive establishes that in-scope companies are liable for damages caused by their failure to prevent and mitigate potential adverse impacts or to cease or minimise actual adverse impacts. A company will have to prove that it adequately complied with its obligations to prevent, mitigate, cease and minimise the relevant impact to avoid liability. Where the impact in question is caused indirectly, through an “established business relationship”, it will also be a defence for the company to show that it had sought contractual assurances from its business partner regarding compliance with the CC and prevention/corrective action plan, unless it was unreasonable to expect that the action actually taken by that partner would be adequate.

Next Steps

The Draft Directive is subject to further legislative review from the European Parliament and the European Council. This may result in amendments to the text. Once ratified, EU Member States will have two years to pass legislation transposing the obligations under the Directive into their national laws.

Implications

According to the European Commission, the Draft Directive is intended to create a level playing field, further legal certainty and assist in the efficacy of human rights and environmental due diligence efforts, including through an enhanced flow of information. It forms part of the EU’s broader corporate sustainability efforts and complements recent legislative developments, including the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation, as well as the Corporate Sustainability Reporting Directive. Prior client updates on those Regulations can be found [here](#), [here](#) and [here](#) respectively.

While the publication of the Draft Directive, mandating EU-wide standards for mandatory human rights and environmental due diligence, is undoubtedly significant, it has also been subject to criticism. For example, the European Coalition for Corporate Justice has argued that excluding EU SMEs from the scope of the Draft Directive leaves fewer than 0.2% of all EU companies within scope (a fact acknowledged in the Explanatory Memorandum). The European Trade Union Confederation has suggested that sanctions against delinquent companies should be tighter, and perhaps include criminal sanctions. Other organisations, including Shift, have questioned the Draft Directive’s focus on EBRs to define the scope of a company’s due diligence obligations, rather than the risk and severity of adverse impacts, as envisaged in the UNGPs and other international instruments. It remains

to be seen whether the final text of the Directive will evolve to address these perceived shortcomings.

Once implemented, in-scope companies will be required to comply with due diligence obligations contained in the relevant national laws transposing the provisions of the Directive. Companies that are out-of-scope of the Draft Directive, but that conduct business with in-scope companies, should also be prepared for changes, as business relationships throughout global value chains are likely to be impacted by the Draft Directive. In particular, it is anticipated that there will be increased reliance on contractual provisions referring to in-scope companies' CCs and other due diligence obligations, as a means of building protections into value chains against liability under the Draft Directive's provisions.

Helpful preparatory actions for in-scope and other affected companies include:

- Ensure that risks related to adverse human rights and environmental impacts are built into compliance and due diligence policies and processes.
- Audit existing contracts with business partners to ensure adequate access to the information necessary to fulfil due diligence obligations under the Draft Directive, and protections against potential future due diligence liability.
- Utilize the [Debevoise Business Integrity Screen](#) tool, which is designed to provide in-house counsel, sustainability leaders and compliance departments with a guidance tool as they develop and maintain a systemic approach to integrity risk, and consult our [ESG Resource Center](#) for useful insight and knowhow.
- Ensure familiarity and consistency with external statements related to sustainability issues and that any future disclosures are accurate.

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Please do not hesitate to contact us with any questions on how these developments may impact your business. We have significant experience in the broad range of issues that arise as ESG concerns and requirements become increasingly important, and would be happy to assist as you navigate these challenging developments.

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