CLIFFORD CHANCE

EUROPEAN COMMISSION PROPOSES MANDATORY HUMAN RIGHTS AND ENVIRONMENTAL DUE DILIGENCE

CLIFFORD CHANCE

EUROPEAN COMMISSION PROPOSES MANDATORY HUMAN RIGHTS AND ENVIRONMENTAL DUE DILIGENCE

On 23 February 2022, the European Commission published its long-awaited text for a proposed Directive on corporate sustainability due diligence which, if adopted, would require large companies to carry out due diligence to identify and address adverse human rights and environmental impacts of their operations, subsidiaries and value chains, and to produce climate plans. It remains to be seen how the proposal develops in the months ahead as the EU law-making process gets underway.

INTRODUCTION

The recent unveiling of the Commission's proposed corporate sustainability due diligence ("**CSDD**") Directive ("**proposed Directive**") ends many months of speculation as to the nature and scope of new obligations on large companies operating in the EU and beyond.

As described in more detail in this briefing, the proposed Directive would require Member States to place new obligations on companies and their directors as follows:

- In-scope companies must carry out due diligence on actual and potential adverse human rights and environmental impacts ("**HREDD**") arising from their own operations, those of their subsidiaries and, where related to their value chains, from their established business relationships. The obligations will include actions to address actual and potential adverse impacts that are, or should have been, identified by the due diligence process.[1]
- Very large companies must adopt a plan ("**Climate Plan**") to ensure that their business model and strategy 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, as well as identifying the extent to which climate change is a risk for, or an impact of, the company's operations. Some companies will be required to include emissions reduction objectives in their Plan.[2]
- When fulfilling their duty to act in the best interests of their companies, the directors of very large EU companies must take into account the consequences of their decisions for sustainability matters. They will also be responsible for putting in place and overseeing HREDD, and for taking steps to adapt corporate strategy to take account of impacts identified and measures required under the proposed Directive.[3]

"The proposal will be further reaching than we've seen in the past and it will reach into supply chains that are located outside the European Union."

Didier Reynders, European Commissioner for Justice

1 See page 11 below.
2 See page 20 below.
3 See page 20 below.

The proposed Directive also provides for civil liability in the event of violations of the due diligence obligations imposed on in-scope companies, as well as supervision, enforcement and complaints.

In this briefing we discuss: (i) the context to the proposed Directive, (ii) who will have to comply with the proposed Directive, (iii) the nature of the proposed HREDD obligations, and how far they align with international standards on responsible business conduct, (iv) the Climate Plan, (v) directors' duties regarding sustainability, (vi) supervision, complaints, civil liability and enforcement, and (vii) alignment with national HREDD laws.

In particular, the briefing aims to identify aspects of the proposed Directive that, in its current form, might fall short of providing legal clarity – if not certainty – for business, and might fail to achieve the Commission's objective of harmonisation of standards across the EU that would offer coherence, consistency and a level playing field for businesses. Within the briefing, we address a number of questions (see text and links below).

Key questions

Context to the Proposed Directive

Scope

- Which companies will have compliance obligations under the proposed Directive?
- Will only large, In-scope Companies be affected by the proposed Directive?
- What is a High-Impact Sector and why are High-Impact Sector Companies in scope when other companies of similar size and scale of business are not?
- When will In-scope Companies have to comply?
- Is the financial sector in scope?
- Are all In-scope Companies subject to the same due diligence obligations?
- What are the implications of the proposed Directive for Non-EU businesses?

Human Rights and Environmental Due Diligence across Value Chains

- What do In-scope Companies have to do?
- What adverse impacts does due diligence apply to?
- Are adverse climate change impacts in scope of the due diligence obligations?
- What are the "value chain" and "established business relationships" for the purposes of HREDD under the proposed Directive?
- What are "appropriate measures" under the proposed Directive?
- Is the approach to HREDD proposed under the Directive the same as the due diligence approaches outlined in the UNGP and OECD Guidelines?
- The challenges of extending value chain due diligence into the environmental domain.
- What further guidance may In-scope Companies draw on?
- Who is responsible for setting up and overseeing due diligence policies and processes?

Climate Plan
- Is climate change covered by the proposed Directive?
- What does the Climate Plan entail?
- Will the goals of the Climate Plan fit with other EU legislative requirements?

Directors' duties regarding sustainability
- Would there be new directors' duties?

Supervision, complaints, enforcement
- Who supervises the implementation of the obligations in the Directive?
- Can complaints be lodged with a supervisory authority if a company fails to comply with the proposed Directive?
- What other powers will supervisory authorities have?
- What type of sanction or penalty can be imposed?
- What reach will supervisory authorities have over non-EU companies?
- What liability arises if the company fails to take "appropriate measures" as required under the proposed Directive?

Alignment with existing EU legislation and with national legislation of EU Member states
- Are there differing standards under other EU laws?
- How does the proposed Directive compare with the French law?
- How does the proposed Directive compare with the German law?

Next Steps
- When will the Directive come into effect and be applicable?

CONTEXT TO THE PROPOSED DIRECTIVE

We focus on three of the core drivers for the Commission's proposed Directive.

First, promotion of various EU policy objectives and fundamental values: in particular, the Commission recognises that the behaviour of companies across all sectors of the economy is vital to the success of the EU's sustainability objectives. This includes the EU's commitments to a just transition, and the protection and improvement of the quality of the environment, including as set out in the European Green Deal.[4] The Commission also refers to the role of the private sector in addressing climate change in line with the Paris Agreement and Glasgow Climate Pact, and in supporting the objectives of the European Climate Law and the Commission's 2030 Climate Target Plan.[5] The proposed Directive forms part of a package of legislative initiatives designed to meet these various policy objectives and to harness the support of business in doing so.

4 Proposed Directive, Recitals (1) – (3) and (9).
5 Proposed Directive, Recitals (8) and (9).

The Commission also asserts that it is in the interest of companies to protect human rights and the environment, given the rising concern of consumers and investors in these areas. The Commission refers to and draws upon existing international standards on responsible business concerning the protection of human rights and the environment, consistent with the EU's commitments to actively promote the implementation of such standards. Of key relevance are the UN Guiding Principles on Business and Human Rights (the "**UNGP**") which recognise the corporate responsibility to respect human rights including by the conduct of human rights due diligence. The concept of due diligence as set out in the UNGP is also reflected in the OECD Guidelines for Multinational Enterprises ("**OECD Guidelines**") which extend the application of due diligence to environmental and governance topics.[6] The OECD Due Diligence Guidance on Responsible Business Conduct ("**OECD RBC Guidance**") and other similar sector-specific guidance published by the OECD set out practical steps in these areas.

Second, in pursuing mandatory HREDD measures, the Commission is responding to calls from a variety of quarters for effective regulation of business in these areas.

- Support for a meaningful and rigorous regime has come not only from NGOs, but also from companies and investors which have lobbied for HREDD obligations.[7] Recently, over 100 companies wrote to the Commission to set out their views, including that the due diligence expectations set out in the UNGP and in the OECD Guidelines should form the core requirements on business in mandatory HREDD obligations.[8]
- Alongside broad stakeholder pressure for regulation, the European Parliament and the Council of the EU have also pressed the Commission to propose comprehensive corporate due diligence obligations along global supply chains, as part of a sustainable corporate governance framework.[9]

Third, a growing number of Member States have introduced or have plans to legislate for HREDD obligations at a national level. The potential proliferation of differing requirements on businesses within the European market has motivated the Commission to take action on legislating for mandatory HREDD across the EU. In this respect, the Commission believes that the shift to a sustainable economy and sustainable development "cannot be sufficiently achieved by the Member States acting individually or in an unco-ordinated manner" which could lead to "fragmentation of the internal market."[10]

The Commission's 'Sustainable Corporate Governance' initiative, which began the process culminating in the proposed Directive, was launched in Spring 2020 and aimed to "improve the EU regulatory framework on company law and corporate governance".[11] A public consultation was undertaken on the scope and nature of

6 Proposed Directive, Recitals (5), (6) and (12).
7 Statement: Support for meaningful and safe stakeholder engagement as a central aspect of the EU framework on mandatory human rights and environmental due diligence, 10 November 2021, available **here**.
8 Making EU Legislation on mandatory human rights and environmental due diligence effective, 8 February 2022, available **here**.
9 Proposed Directive, Recital (13).
10 Proposed Directive, Recital (71).
11 See ''About this Initiative", available **here**.

proposed HREDD requirements as well as broader corporate governance reform. Debate over the content of the Commission's proposals delayed publication of the proposed Directive. During that period, it was also suggested that commitments to ban products associated with forced labour from the EU market might be included in the proposal.[12]

The proposed Directive focuses on HREDD and corporate action on climate change, with more limited refinements to directors' duties and remuneration that avoid the need for substantive reform of national corporate law. The proposed Directive does not include the product ban to address forced labour. The inclusion of such a ban had been touted as a potential late inclusion; this will now be addressed within a separate 'decent work' legislative initiative.[13]

SCOPE

Which companies will have compliance obligations under the proposed Directive?

The proposed Directive applies to defined categories of EU and non-EU companies[14], ("**In-scope Companies**") as follows:

- Companies formed under the laws of an EU Member State ("**EU Companies**") with more than 500 employees on average[15] and a worldwide net turnover of more than €150 million (in the previous financial year) ("**Very Large EU Companies**").
- EU Companies with more than 250 – but less than 500 – employees on average and a worldwide net turnover of more than €40 million (in the previous financial year), if at least 50% of this net turnover was generated in one or more "high-impact" sector(s) (discussed below) ("**Large High-Impact Sector EU Companies**").

The proposed Directive would also apply to companies formed under the laws of a non-EU country ("**Non-EU Companies**") if they have:

- a net turnover of more than €150 million generated in the EU (in the previous financial year) ("**Very Large Non-EU Companies**"); or
- a net turnover between €40 million and €150 million generated in the EU (in the previous financial year), if at least 50% of net worldwide turnover was generated in one or more high-impact sector(s) ("**Large High-Impact Sector Non-EU Companies**").

The Commission estimates that, in its current form, the Directive would apply to around 13,000 (1% of all) EU Companies and about 4,000 Non-EU Companies. The

12 2021 State of the Union **Address** by President von der Leyen, 15 September 2021.
13 On 23 February 2022, the European Commission published a Communication entitled: **Decent Work Worldwide**, which confirmed the Commission's intention to publish a new legislative initiative, which will effectively prohibit the placing on the EU market of products made using forced labour, including forced child labour. The initiative will cover both domestic and imported products and combine a ban with a risk-based enforcement framework.
14 The term "company" is defined in Article 3(a).
15 The number of part-time employees would be calculated on a full-time equivalent basis. Temporary agency workers are included as if they were workers employed directly for the same period of time by the company.

Commission considers the turnover threshold criteria applied to define In-scope Non- EU Companies creates a sufficient connection between the relevant Non-EU Companies and the territory of the EU, with the effects on the internal market justifying the application of EU law to those Non-EU Companies consistent with international law.[16]

Will only large, In-scope Companies be affected by the proposed Directive?

The Commission has clarified that companies with fewer than 250 employees and less than €40 million worldwide turnover ("**SMEs**") have been "completely excluded" from the scope of the proposed Directive, on the basis that most of these companies do not have pre-existing due diligence mechanisms in place, which would be burdensome to set up and implement.[17]

Although the limited number of In-scope Companies is an obvious headline issue, there will nevertheless be real-world implications for many SMEs in Europe and beyond, even though they may not themselves be subject to the compliance obligations within the proposed Directive. The same will be true for many EU and non-EU companies with net turnovers of between €40 and €150 million not falling within a category of Large High-Impact Sector Companies. This is because the due diligence requirements on In-scope Companies (described on page 9 below) that contemplate contractual and other consequences throughout value chains will necessarily affect companies that are not in scope, being those that are either subsidiaries or within the value chains of In-scope Companies.

The proposed Directive includes provisions designed to ensure support for SMEs that will be affected by the demands that In-scope Companies are expected to place on their respective value chains in compliance with their due diligence obligations. Some of this support is to be extended to SMEs by In-scope Companies themselves. When acting to address actual and potential adverse impacts that have or should have been identified by their HREDD, In-scope Companies will need to be alert to the potential implications – financial and otherwise – for SMEs with which they deal (see Article 7(2)(d), and In-scope Companies will be required to bear certain costs (Article 8(5(d)). In-Scope Companies whose business partner is an SME are also encouraged to support them in fulfilling the due diligence requirements, in case such requirements would jeopardize the viability of the SME (preamble 47); however, whether this is a specific requirement (page 14 of the Proposed Directive suggests this is a requirement whereas preamble 47 only speaks of encouragement), and what such requirement would actually mean in practice, remain unclear.

What is a High-Impact Sector and why are High-Impact Sector Companies in scope when other companies of similar size and scale of business are not?

Three sectors are considered "high impact" and relevant to determining whether a company is in scope (subject to the other turnover or employee thresholds):

16 Proposed Directive, Recital (24).
17 Proposed Directive, Explanatory Memorandum, page 1.

- Manufacture of textiles, leather and related products (including footwear) and wholesale trade of textiles, clothing and 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.
- 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).

The application of the proposed Directive to large companies operating in these sectors has been justified on the basis that existing sectoral OECD due diligence guidance is already available. However, the proposed Directive leaves open the opportunity for further sectors to be added to the list in due course.

When will In-scope Companies have to comply?

After the proposed Directive enters into force, Member States will have two years to adopt and publish regulations and administrative provisions necessary to comply with the Directive.

As of that date, the provisions of the proposed Directive that relate to Very Large EU and Very Large Non-EU Companies are to be applied.

Large High-Impact Sector Companies (together "**Very Large Companies**") would have an additional 2 years from the end of the 2-year transposition period of the Directive (i.e. four years after its entry into force) before the due diligence obligations would apply. The Commission considers that this longer period allows such companies to establish the necessary processes and procedures and to benefit from industry cooperation, technological developments, standards, etc. that are likely to be prompted by the earlier implementation date for Very Large Companies.

Is the financial sector in-scope?

Yes, if relevant threshold criteria are met. The proposed Directive defines the companies to which it applies to include “regulated financial undertakings”, as defined in EU legislation listed in the proposed Directive (Article 3(a)(iv)). Regulated financial undertakings that are Very Large EU Companies or Very Large Non-EU Companies will be in scope. In principle, any banks and other financial services providers that qualify as Large High-Impact Sector Companies would also be in scope. But the Commission has specifically decided that the financial services sector does not, of itself, constitute a high-impact sector.[18]

18 Proposed Directive, Recital (22).

Are all In-scope Companies subject to the same due diligence obligations?

Broadly speaking, yes, but there are some limitations on the obligations applicable to Large High-Impact Sector Companies and to regulated financial undertakings. These differences are discussed under What do In-scope Companies have to do?

What are the implications of the proposed Directive for Non-EU businesses?

In-scope Non-EU Companies are subject to the same due diligence obligations as In-scope EU Companies. If a Non-EU Company is in scope, it is not clear whether such a business would have to conduct due diligence on its global operations but the requirement to conduct due diligence with respect to subsidiaries and value chains suggests that this is the likely effect. Although it is the thresholds of net turnover generated within the EU that bring Non-EU Companies within scope, there is no suggestion that the due diligence requirements on such Non-EU Companies are limited in any way.

As noted above, Recital (24) explains the basis for the application of EU law to those Non-EU Companies and states that this is consistent with international law. However, there remain potential uncertainties with regards to enforcement, such as identifying a relevant jurisdiction for potential civil liability claims (where they are not caught by the Rome I Regulation[19]) and issues with supervising compliance (supervisory requirements are discussed below on page 21).

HUMAN RIGHTS AND ENVIRONMENTAL DUE DILIGENCE ACROSS VALUE CHAINS

The proposed Directive lays down rules on obligations for companies regarding actual and potential human rights and environmental adverse impacts of their own operations, the operations of their subsidiaries and the value chain operations carried out by entities with which the company has an established business relationship.

What do In-scope Companies have to do?

Under Article 4 of the proposed Directive, Member States must ensure that companies carry out HREDD comprising six steps. The six-step due diligence process is fleshed out in the detailed requirements of Articles 5 – 10 of the proposed Directive. Main features of the proposed Directive include requirements on Member Steps to ensure that In-scope Companies:

1. **Integrate due diligence into all of their policies.** In-scope Companies must have in place a due diligence policy, which must be updated annually (Article 5). The due diligence policy must contain a description of the company's approach to due diligence; a code of conduct to be followed by the company's employees and subsidiaries; and a description of the processes put in place to implement due diligence. Aside from the bespoke due diligence policy, due diligence must be integrated "into all … corporate policies".

19 The Rome regulation on the law applicable to contractual obligations ((EC) No 593/2008) (Rome I Regulation) determines the law governing contracts concluded from 17 December 2009 and applies in all EU member states except Denmark (and applied to the UK as EU law until the end of the transition period).

2. **Identify actual and potential adverse impacts.** In-scope Companies must take "appropriate measures" to identify actual or 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 concepts of "appropriate measures", "value chains" and "established business relationship" are key to interpreting the scope of the Article 6 requirements and applying them in practice. These terms appear also in Articles 7 and 8. They are each defined in Article 3 of the proposed Directive and discussed further at page 15 below.

   Identifying potential and actual adverse impacts will "where appropriate" be based on quantitative and qualitative information. Companies will be entitled to make use of "appropriate resources", including independent reports and information gathered through complaints procedures. The Article also provides that companies shall, "where relevant", carry out consultations with potentially affected stakeholder groups. Pursuant to Article 4(2), Member States are to ensure that, for the purposes of due diligence, companies may share resources and information within their respective groups of companies and with other legal entities, to the extent consistent with applicable competition law. There are some differences in the requirements on different categories of In-scope Companies when it comes to identifying their actual and potential adverse impacts. Thus, Large High-Impact Sector Companies (both EU and Non-EU) are only required to identify actual and potential "severe" adverse impacts relevant to their high-risk sector(s), on the basis that this ensures a proportionate burden on companies in this category. This implies that all other In-scope Companies will be expected to identify all actual and potential adverse impacts relevant to their operations, subsidiaries and, where related to their value chains, established business relationships regardless of severity. It is unclear how this distinction might affect the due diligence obligations of Very Large Companies, one or more subsidiaries or established business partners of which is a Large High-Impact Sector Company. "Severe adverse impact" is defined as "an adverse environmental impact or an adverse human rights impact that is especially significant by its nature, or affects a large number of persons or a large area of the environment, or which is irreversible, or is particularly difficult to remedy as a result of the measures necessary to restore the situation prevailing prior to the impact."

   In so far as regulated financial institutions are concerned, Article 6(3) clarifies that, in connection with the provision of credit, loan or other financial services, they are only required to identify actual and potential adverse impacts before the relevant service is provided. This implies that there is no requirement to conduct ongoing due diligence during the course of a relevant relationship or transaction, at least to the extent of identifying adverse impacts. No similar limitation applies to other In-scope Companies.

3. **Take appropriate measures to address potential or actual adverse impacts that have been or should have been identified** by the process outlined in Article 6. The actions companies are required to take to address adverse impacts that have been or should have been identified depends on whether they are potential impacts (Article 7 – requirement to prevent and, where not possible, mitigate) or actual impacts (Article 8 – requirement to end or, where not possible, minimise the extent of the impact). In each case, the proposed Directive identifies sequential actions to be taken "where relevant", with initial options to be attempted and subsequent actions adopted where required if prior ones have not been effective in addressing the relevant actual or potential impacts. These may ultimately involve suspension or – as a "last resort"[20]– termination of business relationships. The content of Articles 7 and 8 of the proposed Directive will be of particular concern for those that might qualify as In-scope Companies, because these are the provisions in relation to which civil liability for damages may arise (see Article 22 and page 23 below).
   The actions to be taken in response to potential and actual adverse impacts that are or should have been identified are as follows:
   a. **In relation to potential impacts**, the requirement is to take "appropriate measures" to prevent, or where prevention is not (immediately) possible, adequately mitigate adverse impacts. To do this, companies should, firstly (i) where "necessary" due to the nature or complexity of the measures required for prevention, develop and implement a prevention action plan, in consultation with affected stakeholders, and the plan should include reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement; (ii) seek contractual assurances from a direct business partner that it will ensure compliance with the company's code of conduct and, as necessary, a prevention action plan. In such cases, corresponding contractual assurances should be sought by the direct business partner from its partners that are part of the company's value chain ("contractual cascading"). When such contractual assurances are obtained, they are to be accompanied by "appropriate measures" to verify compliance; (iii) make necessary investments into due diligence governance processes in order to take appropriate measures to prevent or adequately mitigate potential adverse impacts; (iv) if compliance with the company's code of conduct or prevention action plan by an SME with which the company has an established business relationship would jeopardise the viability of the SME, provide targeted and proportionate support to that SME; and (v) collaborate with other entities where appropriate to increase the company's ability to bring an adverse impact to an end.

20 Proposed Directive, Recital (36).

If these measures do not prevent or adequately mitigate the potential adverse impact, then the company may seek to conclude a contract with an indirect business partner, with a view to achieving compliance with the company's code of conduct or prevention action plan. Where the above measures do not prevent or adequately mitigate the potential adverse impact, then the company is required not to enter into a new (or extend an existing) relationship with the relevant business partner in connection with or in the value chain of which the impact has arisen. Where the governing law of the contract between the In-scope Company and that business partner permits, then the In-scope Company should temporarily suspend commercial relations with that partner while continuing to pursue prevention and mitigation efforts, if there is a reasonable expectation that these will succeed in the short-term or, if the potential adverse impact is severe, terminate the business relationship. In order to allow companies to fulfil that obligation, Member States are required to ensure the availability of an option to terminate the business relationship in contracts governed by their laws.

Regulated financial institutions are not required to terminate credit, loan or other financial service contracts where this could be reasonably expected to cause substantial prejudice to the entity to whom the service is provided.

b. **In relation to actual impacts**, companies are required to bring them to an end or, if this is not possible, minimise the extent of the impacts. The actions In-scope Companies are to take to achieve these objectives are of the same type, "where relevant", as required in relation to potential impacts (Article 7 – see a above), but with some variations. For actual impacts under Article 8, there is an additional initial requirement that companies should take action to neutralise the adverse impact or minimise its extent, including by the payment of damages to affected persons and financial compensation to affected communities. Such action shall be proportionate to the significance and scale of the adverse impact and to the contribution of the company's conduct to the adverse impact. Further, in relation to prevention action plans, these are considered "necessary" in relation to actual impacts where the adverse impact cannot be brought to an end immediately. Where the actual adverse impact cannot be brought to an end or adequately mitigated by the above measures, then the company may seek to conclude a contract with an indirect business partner, mirroring the possibilities and requirements of Article 7 (including with respect to SMEs).

   When these options do not bring the adverse impact to an end or its extent cannot be minimised by them, the company should then refrain from new or extended relations with the partner and, as appropriate, either temporarily suspend or terminate the business relationship. Regulated financial institutions are exempt from any requirement to terminate relationships in the same circumstances as provided in Article 7.

4. **Establish and maintain a complaints procedure.** The procedure must provide the possibility for persons actually or potentially affected by an adverse impact, trade unions and workers' representatives representing individuals working in the value chain concerned, and relevant civil society organisations to submit complaints that raise "legitimate concerns" regarding actual or potential human rights or environmental impacts. Such complaints may relate to alleged impacts of the In-scope Company's own operations, the operations of its subsidiaries and of its value chains (Article 9). Various elements of the complaints procedure will be mandatory: for example, in the case of complaints about potential or actual severe adverse impacts, complainants will be entitled to meet company representatives. Also, within the context of the company's compliant procedure, if a complaint is determined to be well-founded, it will be deemed to be "identified" within the meaning of Article 6 (with the consequence of requiring action in accordance with Article 7 or 8).

5. **Monitor the effectiveness of due diligence policies and measures** by way of periodic assessments (at least annually) of the operations and measures of the company, its subsidiaries and those of their established business relationships. The assessments should evaluate the effectiveness of steps taken to prevent, mitigate and bring to an end adverse human rights and environmental impacts, and the company should update the company's due diligence policy accordingly (Article 10). Assessments are to be based, "where appropriate", on qualitative and quantitative indicators.

6. **Publicly communicate** (i.e. report) on the company's due diligence policy and associated measures. This will be through an annual statement to be made available on the company's website unless the In-scope Company is already required to report on non-financial issues in accordance with the EU Non-financial Reporting Directive (see Articles 19a and 29a of Directive 2014/95/EU amending Directive 2013/34/EU) ("**NFRD**") (Article 11). The Commission's recent proposal for a Corporate Sustainability Reporting Directive ("**CSRD**"), revising the NFRD, would, if implemented, cover the public reporting stage of the due diligence duty, for companies that are also covered by the CSRD.

What adverse impacts does due diligence apply to?

Adverse Human Rights Impacts: In-scope Companies must carry out due diligence in respect of the potential or actual "adverse human rights impacts" on "protected persons" resulting from a violation of one of the rights or prohibitions listed in Part I.1 of the Annex to the proposed Directive, as enshrined in a list of international conventions listed in Part I.2 of the Annex. Twenty violations of rights or prohibitions are listed, at first blush suggesting that due diligence is limited to a closed list of human rights (superficially differing from the approach under the UNGP and the OECD Guidelines where all internationally recognised human rights are within scope of the due diligence that businesses are expected to carry out, as a minimum).

The violations listed in Part I.1 of the Annex to the proposed Directive are widely cast and include violations of fundamental rights such as the right to life, liberty and security, to be protected from torture, as well as the rights of vulnerable persons such as children and indigenous people and violations arising from issues and situations such as employment, land acquisition and environmental degradation. These are violations of rights and prohibitions included in 14 international law instruments listed in Part I.2 of the Annex to the Directive concerning human rights and fundamental freedoms, including the International Bill of Rights and the eight ILO Core Conventions, which, together encompass the main internationally recognised human rights.

In addition, other violations of human rights *may* also be relevant to due diligence *if* the violation directly impairs a legal interest protected in the human rights agreements listed in the Annex, and *if* the company could have reasonably established the risk of such impairment and any appropriate measures to be taken to comply with its due diligence obligations, taking account of the relevant circumstances including their sector and operational context. It is questionable whether this catch all provision supports legal certainty for In-scope Companies in understanding the requirements on them and which adverse human rights impacts they need to consider, although the purpose of this provision appears to be to make the coverage "comprehensive"[21] and is likely more consistent with due diligence that encourages companies to take steps to identify all potential and actual adverse human rights impacts with which they may be involved.

Adverse Environmental Impacts: Due diligence must also cover "adverse environmental impacts" resulting from the violation of the prohibitions and obligations contained in seven international environmental conventions and related protocols listed in Part II of the Annex. In broad terms, the relevant prohibitions and obligations relate to the following:

- using biological resources causing adverse impacts on biological diversity, in particular in relation to Genetically Modified Organisms (GMOs) and accessing genetic resources;
- trading in endangered species;
- manufacturing, use and treatment regarding mercury and mercury-added products;
- manufacture and use of Persistent Organic Pollutants (POPs) and dealing with related waste;
- production and consumption of ozone-depleting substances; and
- import and export of hazardous wastes and some other household-related and plastic wastes, and import of pesticides.

Are adverse climate change impacts in scope of the due diligence obligations?

Not expressly, and only to the extent that the relevant climate impact is within the scope of the identified adverse human rights impacts and adverse environmental impacts covered by the proposed Directive and listed in the Annex. Climate change is only specifically referenced in Article 15 of the proposed Directive, in the context of the requirements on certain In-scope Companies to produce Climate Plans addressing climate change risks.

21 Proposed Directive, Recital (25).

What are the "value chain" and "established business relationships" for the purposes of HREDD under the proposed Directive?

The obligation for companies to carry out due diligence relates not only to adverse impacts from their own operations, and from their subsidiaries, but also from their value chains. "Value chain" is broadly defined to mean activities related to the production of goods or the provision of services by an In-Scope 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 established business relationships of the company, both upstream and downstream.

Beyond In-scope Companies' own operations and those of subsidiaries, the proposed Directive limits the scope of value chain due diligence to entities with which the company has an "established business relationship" – meaning any direct or indirect business relationship which is or 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. There is clearly a possibility for interpretational debate over what comprises a 'lasting' business relationship – and therefore potential for the use of resources and court time in litigating over what an "established business relationship" means (or other related issues of terminology), rather than in whether a business is liable for adverse impacts. The Recital to the proposed Directive clarifies that "if the direct business relationship of a company is established, then all linked indirect business relationships should also be considered as established regarding that company"[22] but this is not carried over into the terms of the proposed Directive itself.

Where a regulated financial undertaking is providing loans or credit and other financial services, only the undertaking's client and those of its subsidiaries linked to the product form part of the undertaking's value chain. There is an express exclusion for SMEs, households and natural persons – these are not included in the value chain of the regulated financial undertaking for the purposes of the HREDD obligations under the proposed Directive.

What are "appropriate measures" under the proposed Directive?

"Appropriate measure" is defined to mean "a measure that is capable of achieving the objectives of due diligence, commensurate with the degree of severity and the likelihood of the adverse impact, and reasonably available to the company, taking into account the circumstances of the specific case, including characteristics of the economic sector and of the specific business relationship and the company's influence thereof, and the need to ensure prioritisation of action."

This multi-pronged definition incorporates elements of reasonableness, and its objective assessment by reference to the particular circumstances and the element of prioritisation. The inclusion of this limitation as part of the defined due diligence obligation in Articles 6 to 8 is consistent with the Commission's clarification that the proposed Directive does not expect companies "to guarantee, in all circumstances, that adverse impacts will never occur or be stopped" and that the main obligations in the proposed Directive are "**obligations of means**".[23]

22 Proposed Directive, Recital (20).
23 Proposed Directive, Recital (15).

Since the requirement to take "appropriate measures" is incorporated within Articles 7 and 8, whether an In-scope Company has adopted "appropriate measures" in a particular case may be relevant to potential liability in a civil claim. Since particular facts and circumstances will be relevant to whether a measure is "appropriate" in a particular context, there is scope for argument in claims that may be brought. The Recital (29) provides further information regarding the relevance and justification to ensure prioritisation of action – such detail could usefully be fleshed out in the Directive itself.

The 'tools' that will be part of "appropriate measures" and that are listed in Articles 7 and 8 are familiar elements within existing supply chain risk management (including codes/contract clauses/correction action plans/auditing, amongst others) – but will require careful adaptation to ensure potential and actual adverse impacts are addressed effectively.

Is the approach to HREDD proposed under the Directive the same as the due diligence approaches outlined in the UNGP and OECD Guidelines?
The HREDD mechanism in the Directive is intended to cover the six steps that are set out in the OECD RBC Guidance, reflecting also the approach in the OECD Guidelines and UNGP.

Efforts by the Commission to draw and build upon these existing international frameworks is consistent with the approach in other recent EU legislation such as the EU Taxonomy which specifies that economic activities can only qualify as environmentally sustainable where they are carried out in alignment with the OECD Guidelines and the UNGP. They are also referenced in the CSRD.[24]

Since the articulation of due diligence as an aspect of responsible business conduct in these international standards, a number of companies have incorporated due diligence processes informed by these standards into their business and operations. One of the key features of such due diligence is the focus on adverse impacts on people and the planet, as opposed to risks to the business itself.

Although some features of the due diligence requirements of the proposed Directive appear broadly consistent with these existing frameworks, there are areas in which the proposed Directive does not fully reflect their apparent spirit and intent. This could inhibit addressing human rights and environmental impacts in a meaningful way and/or give rise to potentially perverse outcomes.

As to human rights, for example, both the UNGP and the proposed Directive incorporate concepts of value chain due diligence which, in turn, incorporates stakeholder engagement and the possible use of contractual mechanisms (which is one form of 'leverage') to effect change in the behaviour of business partners in relation to human rights impacts with which they are involved.

However, HREDD under the proposed Directive does not appear entirely aligned with international frameworks in some significant respects. For example:

24 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189

- The requirement on In-scope Companies to identify impacts in the value chain for "established business relationships" only is *narrower* than the equivalent expectation in the UNGP and the OECD Guidelines, which [both] state that businesses should carry out due diligence on actual and potential impacts arising from all their business relationships, throughout value chains. This approach carries a risk that some – even severe – potential or actual adverse impacts of one-off transactions or non-"lasting" relationships could be overlooked.
- By defining the due diligence requirements by reference to established business relationships, the Commission has placed the focus on contexts in which In-scope Companies might have the greatest leverage, rather than those in which the relevant company might have the greatest responsibility (by reference to its involvement in an impact).
- The limitations of Large High-Impact Sector Company due diligence to severe impacts and of regulated financial undertaking due diligence to pre-contractual contexts and only certain client categories do not originate in the existing frameworks and result in carve-outs that are dealt with by the UNGP and OECD Guidelines by recognising that due diligence will be commensurate with a business' context and resources.
- Under the UNGP and OECD Guidelines, once actual and potential adverse impacts have been identified, the action expected of a business to address such impacts is assessed by reference to the involvement of the business in those impacts: is the relationship to the adverse impact one of cause, contribution or direct linkage to a business's operations, products or services by a business relationship? Involvement with the impact also determines the responsibility, if any, of the business to provide for, cooperate in or otherwise enable access to [a]remedy. The proposed Directive is prescriptive in relation to required action, whenever an actual or potential impact is identified by due diligence and is not stated to be contingent on any analysis of responsibility for the impact on the part of the In-scope Company (except in the context of 'neutralising' or minimising the extent of an impact as set out in Article 8(a) of the proposed Directive), and in the civil liability provision in Article 22. By limiting the due diligence obligation (and therefore potential liability) by reference to ''established business relationships" in the value chain context, some adverse impacts will not attract any accountability by companies at all. The focus of due diligence on situations where leverage may be applied risks conflating the existence of leverage with responsibility – with potential consequences inconsistent with the UNGP and OECD Guidelines which emphasise that due diligence does not shift responsibility with respect to adverse impacts.
- There is a risk in practice that compliance-driven approaches to the measures prescribed by Articles 6, 7 and 8 of the proposed Directive could detract from some of the benefits of flexibility and significant discretion afforded to businesses in addressing adverse human rights impacts with which they are directly linked under the UNGP and OECD Guidelines. For example, the "last resort" measure of contract termination in the proposed Directive, while consistent with options for companies under the UNGP and OECD Guidelines when leverage cannot be increased or made effective, does not specifically require a consideration of the potential adverse impacts of that course of action. Moreover, while the Commission's stated objective in being somewhat prescriptive about the measures In-scope Companies are

expected to take to address potential and actual adverse impacts is "[t]o provide companies with legal clarity and certainty", one result could be compliance-driven rigidity in contexts where greater flexibility might be warranted, coupled with interpretational uncertainties relating to some of the relevant measures.

- Conversely, the complaints procedures envisaged by the proposed Directive are arguably *more extensive* than similar mechanisms described in the UNGP – since they require procedures to allow "legitimate concerns" to be raised with In-scope Companies about actual and potential adverse impacts by businesses' subsidiaries and value chains as well as their own operations. Having said that, complaints procedures meeting the requirements of the proposed Directive may well fall significantly short of the "effectiveness criteria" for company-led grievance mechanisms contemplated by the UNGP and OECD Guidelines.

As for environmental issues, the OECD Guidelines set expectations for environmental due diligence which includes compliance with existing laws. However, as the proposed Directive notes, existing EU environmental law does not typically apply to value chains or to value chains outside the EU where the environmental harm of EU production may occur. Some practical implications of this are discussed below.

The challenges of extending value chain due diligence into the environmental domain

Businesses that have embraced the UNGP/OECD Guidelines approaches are likely to be well-positioned to comply with the HREDD obligations in the proposed Directive and should be encouraged to continue to operate in alignment with those frameworks, even if this includes action over and above compliance with the proposed Directive. In this regard, institutions such as the Office of the High Commissioner for Human Rights, the OECD and the ILO have emphasised that mandatory measures such as those included in the proposed Directive would be part of a "smart mix of measures", implying that they should not be seen as superseding instruments such as the UNGP and OECD Guidelines.[25]

The Commission has sought to mitigate the practical difficulties presented by extensive value chain due diligence, principally by limiting the scope of the diligence in the value chain to established business relationships (as discussed above). Nonetheless, the investment required to set up and operate due diligence processes and extensive complaints and yearly monitoring processes across operations, subsidiaries and the value chain is likely to be significant.

In relation to environmental impacts specifically, the fact that the downstream value chain would be covered by the due diligence duty is likely to be important, given the issue of dealing with waste.

A key challenge will be for In-scope companies who produce waste to understand the level of due diligence they must undertake to comply in relation to the handling and export of waste transferred to third parties. The Commission will be particularly keen to target waste exports that have led to high-profile pollution incidents outside the EU, and more generally exporting the EU's waste problems to developing countries.

"The potential scope of environmental due diligence required on biodiversity and downstream waste issues are likely to prove challenging for corporates."

Michael Coxall, Knowledge Director, Clifford Chance

25 Letter from the ILO, OECD and OHCHR to President von der Leyen of the EU Commission dated 7 March 2022: https://mneguidelines.oecd.org/ilo-ohchr-oecd-response-to-eu-commission-proposal.pdf.

One potentially problematic area is how the due diligence duties would apply to prohibitions and obligations arising out of the Convention on Biological Diversity ("**CBD**") (Annex, Part II, Paragraph 1). The obligations contained in the associated Cartagena Protocol (on the development, use and release etc. of GMOs), and of the Nagoya Protocol (on access to genetic resources and benefit sharing) are reasonably precise and well-known. However, the inclusion of the broader Article 10(b) of the CBD, which requires measures to avoid or minimise impact from the use of biological resources on biological diversity, is much more wide-ranging and potentially uncertain. It could, for instance, cover the use of any naturally grown crops or produce that could have an impact on biodiversity. Carrying out due diligence on such a wide-ranging basis across value chains would be challenging. The proposed Directive notes that changes to the CBD coming out of the post-2020 Convention on Biological Diversity (which is still under discussion as part of the ongoing international COP15 talks) will need to be integrated. Given the high-level nature of most of the commitments being discussed at COP15, it will be interesting to see how far these can be sensibly brought within a corporate due diligence framework.

Another potentially difficult area is the inclusion of widely drawn environmental degradation impacts or activities (including harmful soil change, water or air pollution, harmful emissions or excessive water consumption or other impacts on natural resources) within the due diligence duty. These are only included if they cause specific harms (such as impairing food production, or denying a person access to safe drinking water, or harming health or the normal use of property) in contravention of relevant human rights agreements (Annex I, Part I, Paragraph 18). Companies may well find it challenging to implement a proactive due diligence strategy geared towards identifying common types of activity (such as pollution) that might have specific impacts, particularly where impacts might have several causal sources, and where breach of human rights agreements could well depend on *ex post facto* assessment of the level of harm caused. Would this, for example, cover greenhouse gas emissions because of their long-term impact on the health and safety of people through climate change; or levels of soil contamination which are permitted under local law, which have no internationally agreed limit but are found to have caused harm to children who have ingested the soil?

What further guidance may In-scope Companies draw on?

More specific guidance will be key to assisting companies with understanding how to comply with the proposed Directive's obligations in practice to achieve effective implementation. In this regard, the Commission anticipates providing model contract clauses and guidance on due diligence to support companies in complying with their due diligence obligations (the timing for which is currently unclear, but presumably after the proposed Directive's effective date), and also expects Member States to provide information to support companies, including providing financial support to SMEs in value chains of In-scope companies (Articles 12 - 14).[26]

Who is responsible for setting up and overseeing due diligence policies and processes?

The proposed Directive assigns responsibility in Article 25 to "directors" (a term which is defined for purposes of the proposed Directive to include CEOs and members of

26 See also Proposed Directive, Recital (26).

administrative, management or supervisory bodies of a company) to set up and oversee due diligence policies, processes and actions in accordance with Articles 4 and 5. Directors will be required to give due consideration to relevant input from stakeholders and civil society organisations, and will be required to report to the board. Directors are also required to take steps to adapt corporate strategy to take into account actual and potential human rights and environmental impacts identified, and the measures taken in relation to those pursuant to the requirements of the proposed Directive.

CLIMATE PLAN

Is climate change covered by the proposed Directive?

It is clear from the recitals to the proposed Directive that climate change is prominent in the minds of the Commission as far as environmental protection is concerned, and in particular the need to keep global temperature increases to below 1.5°C (the "**1.5°C Target**"). The EU has targeted climate change action at a number of different levels in recent years: from overarching climate change mitigation targets on Member States, through a sectoral approach legislating on emission reductions from different sectors (including industry, the power and buildings sectors, land use and forestry), to encouraging disclosure on climate matters through non-financial reporting rules and, most recently, under its Sustainable Finance Action Plan. The European Climate Law has now fixed the 1.5°C Target in EU law and it is crucial that the EU redoubles efforts to reduce emissions in all sectors to achieve that.

It has been recognised that various human rights are engaged by the impacts of climate change: for example, the right to life and the right to respect for private and family life. Please see, for example, our briefing on the *Urgenda* litigation **here**.

Nevertheless, subject to the points made above on environmental degradation and human rights impacts, none of the HREDD provisions in the proposed Directive directly impose any obligation on companies to identify emissions or other impacts associated with climate change (for example, the environment conventions listed in Annex 2 only cover ozone-depleting substances).

Instead, the Commission deals with climate change issues by imposing a requirement for Very Large Companies to put in place a Climate Plan.

What does the Climate Plan entail?

Very Large Companies must adopt a plan to ensure that their business model and strategy are aligned to the 1.5°C Target and to the transition to a sustainable economy, identifying climate change risks for the company and impacts of the company on climate change (Article 15). Where these risks are identified as "principal risk[s]", the company will need to include emission reduction objectives in its plan.

Though there are no directors' duties associated with this requirement, the fulfilment of this obligation should be taken into account when setting the remuneration of directors (broadly defined in the proposed Directive), where variable remuneration links a director's contribution to business strategy, long-term interests and sustainability.
This may well have limited application.

No further detail is given as to how to determine whether a business is 1.5°C Target-aligned. Indeed, the setting of science-based targets is not a precise method and is still a developing practice. Similarly, "compatibil[ity] with the transition to a sustainable economy" is a broad concept which may not lend itself well to a legal obligation on companies. Despite the focus on a just transition in the recital, Article 15 itself does not link the Climate Plan to any specific social issues or related human rights risks.

Will the goals of the Climate Plan fit with other EU legislative requirements?

The idea of company Climate Plans that are Paris-aligned and compatible with the transition to a sustainable economy is not new. The draft CSRD contains a proposed obligation on qualifying businesses to disclose details of their plans. Since the proposed Directive imposes an obligation on some companies to put such a plan in place, the two obligations ought to be designed to operate in a complementary and coherent way, although the CSRD takes a group-wide approach to compliance with disclosure duties, while the Climate Plan requirements are placed on individual Very Large Companies. This would mean that Very Large Companies would not necessarily have to produce a group-wide plan under the Proposed Directive, nor would any subsidiaries which were not themselves Very Large Companies have to adopt one. The potential for gaps and siloed approaches to climate change is evident.

DIRECTORS' DUTIES REGARDING SUSTAINABILITY

Would there be new duties for directors?

The proposed Directive is not intended to introduce new directors' duties or require national corporate structures to change as a result of its terms. However, the proposed Directive seeks to require Member States to clarify the directors' general duty of care in light of the proposed obligations. Therefore, the proposed Directive stipulates that directors should consider the consequences of their decisions for sustainability matters, in particular human rights, climate change and environmental consequences, in the short and medium as well as long-term when fulfilling their existing duty to act in the best interests of the company.

In practice, however, new duties for directors may need to be introduced in Member States. There may be situations under national law where directors currently do not need to take account of sustainability matters, and therefore, it seems possible that laws in those Member States may need to change in order to comply with EU law.

SUPERVISION, COMPLAINTS, ENFORCEMENT AND CIVIL LIABILITY

Who supervises the implementation of the obligations in the Directive?

Member States would be required to designate an authority (or authorities) to supervise compliance with the obligations in the proposed Directive (as transposed into national law). Article 17 sets out the principles to be applied to determine which Member State's supervisory authority will have competence with respect to In-scope EU and Non-EU companies respectively.

Representatives of these supervisory authorities would form part of a wider European Network of Supervisory Authorities established to facilitate cooperation between national supervisory authorities, and co-ordination and alignment of their practices under the proposed Directive, including by sharing information and providing assistance to one another in the context of investigations of alleged non-compliance with the proposed Directive.

Can complaints be lodged with a supervisory authority if a company fails to comply with the proposed Directive?

Under Article 19 of the proposed Directive, if a natural or legal person has reason to believe that a company is failing to comply with national provisions, they should be able to submit a "substantiated concern" to a supervisory authority. The supervisory authority with competence over the complaint is required to assess the complaint and inform the complainant of the outcome, together with its reasoning for that outcome. A complainant having a "legitimate interest" in the matter will have the ability to seek either judicial or other appropriate independent and impartial review of decisions of supervisory authorities (or alleged failures by the authority to act).

This mechanism is expressly open to NGOs so is likely to be a key route by which NGOs and affected parties will seek to bring pressure to bear on companies subject to this Directive.

What other powers will supervisory authorities have?

Supervisory authorities are to have the power to request information and to carry out investigations related to compliance with the proposed Directive, whether on its own motion or as a result of a complaint of "substantiated concerns".

What type of sanction or penalty can be imposed?

The supervisory authority should have appropriate powers, including to request information and undertake investigations (including inspections), to assess compliance with the proposed Directive. Where a supervisory authority identifies a failure to comply with Member State provisions giving effect to the proposed Directive, the relevant In-scope Company will be given an appropriate time to take remedial action, assuming such action is possible.

Supervisory authorities will have power to order companies to stop infringements of national legislation implementing the Directive, to order remedial action proportionate to the infringement and necessary to bring it to an end (where appropriate), to impose pecuniary sanctions, and to adopt interim measures to avoid severe and irreparable harm. Where sanctions are imposed, they should be based on a company's turnover. Member States will also ensure that companies applying for public support certify that no sanctions have been imposed on them for a failure to comply with the obligations of this Directive.

Any person, including an In-scope Company, that is subject to a legally binding decision by a supervisory authority that concerns them, should have the right to an effective judicial remedy against that decision.

What reach will supervisory authorities have over non-EU companies?

Non-EU companies caught by the due diligence obligations will be required to designate an authorised representative that is established or domiciled in one of the

Member States in which they operate, and to notify details of the authorised representative to the relevant supervisory authority (Article 16). The authorised representative will serve as a point of contact for the supervisory authority to ensure effective oversight and enforcement of the proposed Directive.

Member States are to ensure that the supervisory authority where the authorised representative is established or domiciled and, if different, the supervisory authority of the Member State in which an In-scope Non-EU Company generates most of its net turnover in the EU in a relevant financial year (see Article 17(3)), is notified that the relevant Non-EU Company is an In-scope Non-EU Company.

What liability arises if the company fails to take "appropriate measures" as required under the proposed Directive?

The proposed Directive contemplates possible civil liability for damages of In-scope Companies when their failure to comply with obligations imposed by Articles 7 and 8 of the proposed Directive leads to an adverse human rights or environmental impact. In this regard, the proposed Directive creates a new basis for corporate liability if companies fail to prevent, mitigate, bring to an end or minimise the extent of adverse impacts and damage suffered that is attributable to a failure to take "appropriate measures" as specified in Articles 7 or 8.

Although it will be for Member States to define the elements of a cause of action under national law, including the party that should bear the burden of proof on particular issues, liability seems likely to turn on the following elements being demonstrated: (i) an adverse human rights or environmental impact, as defined in Article 3(b) or (c) of the proposed Directive; (ii) a failure by a company to take "appropriate measures" in accordance with Article 7 or 8 – which will likely involve examining measures taken (or not taken) by the company, and a court assessment of whether or not they were "appropriate measures" in the circumstances; (ii) the adverse impact occurred as a result of that failure; and (iii) damage was suffered by the claimant as a result of the adverse impact.

The proposed Directive provides that there should be a defence from liability where an adverse impact results from the activities of an indirect partner with which it has an established business relationship, unless it was unreasonable (in the circumstances of the case) for the In-scope Company to expect that the action it had taken under Articles 7 and 8, including as regards verifying compliance, would be adequate to prevent, mitigate, end or minimise the extent of the adverse impact.[27] Thus if, in such cases, a company has sought relevant contractual assurances from a direct business partner such as by contractual cascading backed up by verification of compliance (mentioned on page 11 above), it will be a defence if, in the circumstances, it was reasonable for the company to expect that the action it took would be adequate to prevent, mitigate, bring to an end or minimise the extent of the adverse impact.

In assessing the existence and extent of liability, due account is to be taken of relevant efforts by the company to comply with remedial action required of it by a supervisory authority in relation to the damage in question, as well as other steps contemplated by

"The objective of the Directive to level the playing field is right. However, given the legal form of a directive, which needs to be transposed into national laws, many broad terms leave significant scope for interpretation and, if one adds the possibility of civil law claims being decided by different national courts, there is a serious risk of a further fragmentation of the legal requirements on companies operating across the EU."

Thomas Voland, Partner, Clifford Chance

27 Article 22(2), Proposed Directive, Explanatory Memorandum, page 16.

Articles 7 and 8 that have been taken by the company – including in collaboration with other entities – to address adverse impacts in its value chain.

The civil liability provision in Article 22 also makes clear that civil liability of an In-scope Company does not affect any civil liability of another party, such as a subsidiary or any direct or indirect business partners in the value chain.

Recital 15 is worth noting: "…This Directive should not require companies to guarantee, in all circumstances, that adverse impacts will never occur or that they will be stopped. For example, with respect to business relationships where the adverse impact results from State intervention, the company might not be in a position to arrive at such results. Therefore, the main obligations in this Directive should be '**obligations of means**'."

The thresholds for establishing liability against a company under these provisions are relatively high. However, the provision for civil liability for failures to meet obligations imposed by the proposed Directive is likely to lead to a significant uptick in claims. Even if claims are not successful, the litigation risks for In-scope Companies associated with human rights and environmental harms that occur in operations and value chains will be increased.

Article 22(5) establishes that Member States shall ensure that the liability provided for in provisions of national law transposing Article 22 (civil liability) is of overriding mandatory application in cases where the law applicable to claims to that effect is not the law of a Member State. On questions of jurisdiction, the proposed Directive is silent; however, the law applicable to contractual obligations – including jurisdiction – is presumably dependent on the Rome I Regulation which, as noted above, determines the law governing the relevant contract/s.

ALIGNMENT WITH EXISTING EU LEGISLATION AND WITH NATIONAL LEGISLATION OF EU MEMBER STATES

Are there differing standards under other EU laws?

Existing and forthcoming EU laws may impose differing standards on In-scope Companies than those stipulated by the proposed Directive. Where this is the case, the provisions of the Directive that provide for more extensive or specific obligations will prevail to the extent of any conflict and will apply to those specific obligations.[28]

For example, the proposed Directive notes that the Commission's proposal for a Regulation on deforestation-free supply chain requirements ("**Deforestation Proposal**") will, in some areas, be more prescriptive compared with the general due diligence duties under the proposed Directive. The proposal on deforestation-free supply chains has a very specific objective, namely, to reduce the impact of EU consumption and production on deforestation and forest degradation. To achieve this goal, the proposal on deforestation-free supply chains introduces a prohibition of placing on the EU market certain commodities (e.g., soya or beef) and derived products (e.g. leather or chocolate) which applies to all EU and non-EU companies placing the relevant products on the EU market, irrespective of their legal form and size (unlike the scope of the proposed Directive; see page 6 above). Therefore, the European Commission concludes that the proposed Directive will complement the

28 Proposed Directive, Recital (69).

proposal on deforestation-free supply chains by introducing value chain due diligence related to activities that are not covered by the proposal on deforestation-free supply chains. As another example, In-scope Companies must still adhere to the strict requirements on importing specific minerals from responsible and conflict-free sources only under the so-called Conflict Minerals Regulation and put in place more specific mechanisms for conducting due diligence, e.g., an independent third-party audit of supply chain due diligence. In relation to the Commission's proposed Batteries Regulation, the Commission notes that the proposed Directive's value chain due diligence will complement the proposed batteries regulation, since due diligence obligation covering raw materials is outside the scope of the Batteries Regulation.

The proposed Directive also offers guidance as to how it will operate with the NFRD and the proposed CSRD. The proposed CSRD would amend the existing reporting requirements of the NFRD, by extending the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises), requiring the audit of reported information, introducing more detailed reporting requirements, introducing a requirement to report according to mandatory EU sustainability reporting standards and by introducing digital tagging in its reporting to ensure accessibility.

The proposed CSRD also mandates the disclosure of the climate plan of an undertaking (as discussed above). The proposed Directive notes that proper information collection for reporting purposes under the proposed CSRD requires setting up processes, which is closely related to the identification of adverse impacts in accordance with the due diligence duty set up by this Directive. These interrelated processes should, it is noted, lead to synergies between the two proposed regulations.

Due diligence of the adverse environmental impacts of a business's operations is already required to a degree as part of environmental protection regimes under a number of EU laws; for example, in complying with established environmental protection standards for operators of large industrial plants, such as the Seveso Directives or the best available techniques ('BAT') standards which require companies to closely monitor the safety aspects and environmental impacts of plants and to implement relevant safety/environmental protection.

With regards to domestic legislation, some Member States – notably France and Germany – have passed laws imposing mandatory HREDD obligations on some companies. The French requirements came into effect in March 2017; the German law has passed and will apply from 2023-24. Other Member States, including Austria, Belgium, Finland and the Netherlands (alongside its Child Labour Due Diligence Act passed in 2019, which has yet to enter into force) have proposed initiatives for mandatory HREDD obligations which overlap in scope with aspects of the proposed Directive. See our briefing here for further information on these various legislative initiatives.

How does the proposed Directive compare with the French law?

In March 2017, France adopted a 'duty of vigilance' for companies (the "**Vigilance Law**"). For an overview of the French Vigilance Law, please refer to our briefing available **here**. In a nutshell, this law requires large companies to identify, assess and prevent the risks in human rights and environmental fields due to their activities and within their supply chain and make the information public.

So far, five claims have been introduced before French courts against corporations by NGOs on the basis of the Vigilance Law (see our previous blog posts: *First legal actions under the 2017 French Vigilance Law; Legal action based on the French Vigilance law triggered by a wind farm project in Mexico; France designates ordinary judges to rule on disputes over the Vigilance Law*).

The Commission's proposed Directive takes a narrow approach to HREDD, which is fairly close to the approach taken in the French Vigilance Law. In particular, both the content of the due diligence obligations and the related publicity requirements are found in both tools:

- As regards the content of the due diligence obligations, both pieces of legislation adopt a similar approach marked by the following steps:
  - identification of the risks of adverse impacts,
  - prevention and mitigation measures,
  - a whistleblowing line mechanism,
  - monitoring of the measures and of their effectiveness.
- As regards disclosure, both require companies to publish the content of their duty of vigilance or due diligence: the so-called 'vigilance plan' for the Vigilance Law, and a statement describing the due diligence, including adverse impacts and actions taken, for the proposed Directive.

It is also interesting to note that the Vigilance Law also incorporates the concept of the "established business relationship" ("*une relation commerciale établie*"), requiring the vigilance plan to cover the business, its subsidiaries, and those suppliers and subcontractors with which the company has an established business relationship.

The liability regime in the Directive aligns with that in the Vigilance Law in providing that victims seeking compensation will be required to demonstrate (i) a breach of the due diligence provisions and (ii) the damage that performance of these obligations would have avoided.

However, in contemplating a network of supervisory authorities and by supporting the HREDD obligations with clarifications regarding the scope of directors' duties in relation to sustainability, the proposed Directive is likely to achieve greater effectiveness than the French law.

Once the proposed Directive is adopted, it will be interesting to see how the French legislator will consolidate the two laws and take the opportunity, when transposing the proposed Directive, to strengthen the Vigilance Law to make it more effective.

How does the proposed Directive compare with the German law?
In 2021, the German parliament adopted the Act on Corporate Due Diligence Obligations in Supply Chains (*Lieferkettensorgfaltspflichtengesetz*) ("**German Supply**

Chain Act"), entering into force on 1 January 2023 and imposing extensive due diligence obligations on companies irrespective of their legal form and including subsidiaries of foreign companies, that are registered in Germany and employ at least 3,000 employees in Germany (from 2024: 1,000). For an overview of the German Supply Chain Act, please refer to our blog post available **here**.

Overall, the due diligence obligations imposed by the proposed Directive are more extensive than the German Supply Chain Act:

- Whilst the proposed Directive's scope of application depends on a company's number of employees, net worldwide turnover and/or activity in a high-impact sector, the German Supply Chain Act relies on a company's number of employees as well as the question of whether a company has an "anchor point" in Germany, i.e. whether a company's headquarters is registered in Germany, for its scope of application. Also, in contrast with the proposed Directive, subsidiaries only need to be considered if the parent company is exercising decisive influence on the subsidiary or the subsidiary is a supplier of the company.
- Additionally, the German Supply Chain Act focuses on the narrower concept of supply chains instead of value chains. The term "supply chain" is defined as all products and services of a company including all steps in Germany and abroad that are necessary to produce products and provide services, starting from the extraction of raw materials to delivery to the end customer. The German Supply Chain Act does not differentiate between different sectors and includes the actions of a company in its "own business area" as well as the actions of the company's direct and indirect suppliers. However, companies must only include their indirect suppliers in the due diligence process under the German Supply Chain Act if the companies have actual indications (so-called "substantiated knowledge") to suggest that a violation of human rights or environment-related rights by the indirect supplier has occurred. As a result, the number of suppliers to be monitored is significantly more limited compared with the proposed Directive.
- The international human rights and environmental treaties and conventions cited within the proposed Directive go beyond the protected international treaties and conventions under the German Supply Chain Act. Further, the German Act does not address climate change.
- Unlike the proposed Directive, the German Supply Chain Act explicitly rules out a specific civil liability arising from non-compliance with the German Supply Chain Act, even though civil liability under general German statutory law (e.g., the law of tort), remains possible. However, if a person claims a violation of a legally protected right, they may authorise a domestic trade union or an NGO to bring proceedings to enforce their rights in their own capacity. In this respect, the German Supply Chain

Act goes beyond the provisions of the proposed Directive, which does not provide for such a form of representative action.

- Further, and in contrast with the proposed Directive, the German Supply Chain Act does not clarify or refer to directors' duties of care which arise only from ordinary (civil) law. Whether or not the rules on director's duties in the proposed Directive may result in any additional duty of care for directors' under German national law remains unclear. As noted above, it seems possible that laws in Member States may need to change in order to comply with EU law on directors' duties (such as the taking into account of sustainability matters).

NEXT STEPS

To become part of the EU law, the text of the proposed Directive must now be adopted by the co-legislators: the European Parliament and Council of the EU. This will be in accordance with the ordinary legislative procedure, whereby the two institutions can amend the Commission's proposal but must jointly agree the final wording.

It is difficult to predict how long the process will take, but anything between 18 months and two years would seem a reasonable assumption; the European Parliament elections of spring 2024 provide an obvious target date for reaching agreement. Once agreed, the text is then translated into the official languages of the EU and published in the Official Journal.

"It is now up to the European Parliament and Council of the EU to determine the exact content of the new rules and how they will operate.
I expect we will see a robust debate over many months."

Gail Orton Head of EU Public Policy, Clifford Chance

When will the Directive come into effect and be applicable?

The Directive would come into effect shortly after its publication in the Official Journal, likely sometime in late 2023 or early 2024 at the earliest. Member States will then have two years to transpose it into national legislation (Article 30). The rules would apply to In-scope Companies within the timetable referenced at page 8 above.

Estimated timing of legislative process, implementation and application

23 Feb 2022	Q1/2022-Q3/2023	Q4/2023	Q4/2023 or Q1/2024	20 days later
European Commission proposal for a Directive	European Parliament reviews and amends draft Directive Council of the EU reviews and amends draft Directive	European Parliament and Council adopt common agreed text of Directive	Final text of directive published in Official Journal of the EU	Directive enters into force

Q1/2026

Deadline for Member States to transpose Directive into national law

(two years after the Directive enters into force)

Rules start to apply Very Large EU Companies and Very Large non-EU Companies

(two years after the Directive enters into force)

Q1/2028

Rules start to apply to Large High Impact Sector Companies

(four years after the Directive enters into force)

CONTACTS

Rae Lindsay
Partner
London
T: +44 207006 8622
E: rae.lindsay@cliffordchance.com

Dr. Thomas Voland
Partner
Düsseldorf
T: +49 211 4355 5642
E: thomas.voland@cliffordchance.com

Charles-Henri Boeringer
Partner
Paris
T: +33 1 4405 2464
E: charles-henri.boeringer@cliffordchance.com

Roger Leese
Partner
London
T: +44 207006 8710
E: roger.leese@cliffordchance.com

Mathias Elspaß
Partner
Düsseldorf
T: +49 211 4355 5260
E: mathias.elspass@cliffordchance.com

Nigel Howorth
Practice Area Leader
London
T: +44 207006 4076
E: nigel.howorth@cliffordchance.com

Michael Coxall
Knowledge Director
London
T: +44 207006 4315
E: michael.coxall@cliffordchance.com

Gail Orton
Head of EU Public Policy
Paris
T: +33 1 4405 2429
E: gail.orton@cliffordchance.com

Anna Kirkpatrick
Senior Associate
London
T: +44 207006 2069
E: anna.kirkpatrick@cliffordchance.com

Eoghan MacDonagh
Senior Associate
Paris
T: +33 1 4405 8268
E: eoghan.macdonagh@cliffordchance.com

Laura Isabell Dietz
Associate
Düsseldorf
T: +49 211 4355 5017
E: lauraIsabell.dietz@cliffordchance.com

Dr Frederic Mainka
Associate
Düsseldorf
T: +49 211 4355 5355
E: frederic.mainka@cliffordchance.com

Alice Dunoyer de Segonzac
Avocat
Paris
T: +33 1 4405 5262
E: alice.dunoyerdesegonzac@cliffordchance.com

Karima Chaib
Avocat
Paris
T: +33 1 4405 5219
E: karima.chaib@cliffordchance.com

C L I F F O R D
C H A N C E

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

2203-000452