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European Commission (Finally) Proposes Mandatory Human Rights and Environmental Due Diligence Directive – A Deep Dive Q&A on the Commission Proposal

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Last week, the European Commission released its long-awaited proposed Directive on Corporate Sustainability Due Diligence, the core of which would require mandatory human rights and environmental due diligence. The Directive was widely anticipated, since it originally was supposed to be released in mid-2021.

The Directive would require EU Member States to adopt legislation requiring due diligence in respect of adverse human rights and environmental impacts involving subject companies, their subsidiary operations and their value chains. Among other things, subject companies would be required to integrate due diligence into policies, take steps to identify and address actual and potential adverse impacts and publicly report on due diligence. In addition, larger companies would be required to take specified steps to combat climate change. For violations, the Directive contemplates both administrative sanctions and liability to third parties for damages.

The Directive would apply to a significant number of EU-organized subsidiaries of U.S.-based multinationals. By European Commission estimates, it also would apply to 4,000 third-country organized companies, a large number of which are based in the United States.

In this Alert, we provide a detailed overview of the proposed Directive, including initial reactions to the Directive and our views on near-term compliance steps.

Purpose and Scope

What Does the Directive Do?

The Directive would require EU Member States to transpose into national law a corporate due diligence duty to identify, prevent, bring to an end, mitigate and account for adverse human rights and environmental impacts. The duty would apply to a company's own operations, its subsidiaries and their value chains. These concepts and requirements are further discussed in this Alert.

What Is the Goal of the Directive?

The Directive aims to ensure that companies active in the EU internal market contribute to sustainable development and the sustainability transition of economies and societies through the identification, prevention and mitigation, cessation and minimization of potential and actual adverse human rights and environmental impacts connected with companies' own operations, subsidiaries and value chains.

What Are Adverse Human Rights Impacts?

The Directive would seek to protect human rights broadly. This would be in contrast to many other corporate human rights laws, which often are focused on specific issues, such as forced or child labor.

Under the Directive, an adverse human rights impact would be an adverse impact on a protected person resulting from the violation of one of the following rights or prohibitions, in accordance with listed international human rights instruments:

- Right to dispose of a land's natural resources and not to be deprived of means of subsistence;
- Right to life and security;

- Prohibition of torture or cruel, inhuman or degrading treatment;
- Right to liberty and security;
- Prohibition of arbitrary or unlawful interference with a person's privacy, family, home or correspondence and attacks on their reputation;
- Prohibition of interference with the freedom of thought, conscience and religion;
- Right to enjoy just and favorable conditions of work, including a fair wage, a decent living, safe and healthy working conditions and reasonable limitations on working hours;
- Prohibition on restricting workers' access to adequate housing if the workforce is housed in accommodations provided by the company, and restricting workers' access to adequate food, clothing, water and sanitation in the workplace;
- The right of a child to (1) have his or her best interests given primary consideration in all decisions and actions that affect children, (2) develop to his or her full potential, (3) the highest attainable standard of health, (4) social security and an adequate standard of living, (5) education and (6) protection from all forms of sexual exploitation and sexual abuse and from being abducted, sold or moved illegally to a different place in or outside of their country for the purpose of exploitation;
- Prohibition of the employment of a child under the age at which compulsory schooling is completed and, in any case, generally not less than 15 years;
- Prohibition of the worst forms of child labor for children, including (1) all forms of slavery or practices similar to slavery, such as the sale and trafficking of children, debt bondage and serfdom, as well as forced or compulsory labor, including the forced or compulsory recruitment of children for use in armed conflicts, (2) the use, procurement or offering of a child for prostitution, for the production of pornography or for pornographic performances, (3) the use, procurement or offering of a child for illicit activities, in particular for the production of or trafficking in drugs, and (4) work which by its nature or the circumstances in which it is carried out is likely to harm the health, safety or morals of children;
- Prohibition of forced labor, including work or service that is exacted under the menace of a penalty and for which the person has not offered himself or herself voluntarily, for example, as a result of debt bondage or trafficking in human beings;
- Prohibition of all forms of slavery, practices akin to slavery, serfdom or other forms of domination or oppression in the workplace, such as extreme economic or sexual exploitation and humiliation;
- Prohibition of human trafficking;
- Right to freedom of association, assembly, organization and collective bargaining, including that (1) workers be free to form or join trade unions, (2) the formation, joining and membership of a trade union not be used as a reason for unjustified discrimination or retaliation, (3) workers' organizations be free to operate in accordance with their constitutions and rules without interference from authorities and (4) there be a right to strike and to collective bargaining;

- Prohibition of unequal treatment in employment, in particular the payment of unequal remuneration for work of equal value;
- Prohibition of withholding an adequate living wage;
- Prohibition of causing any measurable environmental degradation, such as harmful soil change, water or air pollution, harmful emissions or excessive water consumption or other impacts on natural resources, that would (1) impair the natural bases for the preservation and production of food, (2) deny a person access to safe and clean drinking water, (3) make it difficult for a person to access sanitary facilities or destroy them, (4) harm the health, safety, normal use of property or land or normal conduct of economic activity of a person or (5) affect ecological integrity, such as deforestation;
- Prohibition of unlawfully evicting or taking land, forests and waters when acquiring, developing or otherwise using land, forests and waters, including by deforestation, the use of which secures the livelihood of a person; or
- Indigenous peoples' right to the lands, territories and resources they have traditionally owned, occupied or otherwise used or acquired.

The foregoing list of human rights would not be exhaustive. To ensure comprehensive coverage of human rights, a violation of a prohibition or right not listed above that directly impairs a legal interest protected in an international human rights instrument listed in the Annex to the Directive also would be covered, provided the company could have reasonably established the risk of impairment and appropriate measures to be taken to comply with its due diligence obligations, taking into account all relevant circumstances of its operations, such as the sector and operational context. Twenty-two foundational human rights instruments are listed on the Annex.

What Are Adverse Environmental Impacts?

Adverse environmental impacts would cover a narrower range of harms than the human rights component of the Directive. An adverse environmental impact would be an adverse impact on the environment resulting from the violation of a prohibition or obligation pursuant to one of twelve specified environmental conventions, which, among other things, pertain to:

- Biological diversity and endangered species;
- Manufacture, use and treatment of mercury;
- Production and use of persistent organic pollutants;
- Handling, collection, storage and disposal of waste;
- Importation of hazardous chemicals;
- Production and consumption of specific substances that deplete the ozone layer; and
- Exporting and importing hazardous waste.

How Does the Directive Relate to the EU Non-Financial Reporting Directive?

The Directive is intended to complement the current NFRD and its proposed amendments by adding a substantive requirement to perform due diligence to identify, prevent, mitigate and account for external harm resulting from adverse

human rights and environmental impacts in a company's own operations, its subsidiaries and their value chains. As discussed later in this Alert under "Are There Exceptions to Reporting," companies required to report under the NFRD would not have a separate reporting requirement pursuant to the Directive.

What Is the Relationship Between the Directive and Other Existing Requirements?

By its terms, the Directive would not constitute grounds for reducing the level of human rights, environmental or climate protection under EU Member State laws in effect when the Directive is adopted.

By its terms, the Directive also would not modify obligations relating to human rights, protection of the environment or climate change under other EU legislation. If the Directive conflicts with a provision of another EU law providing for more extensive or specific obligations, the more restrictive requirement would apply.

Does the Directive Ban Imports of Products Produced with Forced Labor?

The Directive does not ban importing into the European Union products produced with forced labor. This is expected to be addressed in separate EU legislation. However, forced labor would be an adverse human rights impact covered by the due diligence requirements of the Directive.

What Is Civil Society's Reaction to the Directive?

Although acknowledging the significance of the Directive, as expected with any proposal involving corporate social responsibility legislation, many civil society organizations have been critical. Early criticisms of the Directive include, among others, (1) the coverage is too narrow due to the exclusion of small and medium-sized enterprises (SMEs); (2) the scope of due diligence is too limited; (3) victims have insufficient access to remedy; (4) director obligations are insufficient; (5) greater engagement with stakeholders should be required; (6) there should be a centralized reporting mechanism; and (7) the time frame for reviewing the effectiveness of the Directive is too long.

Covered Companies

Which Companies Are Covered?

The Directive's obligations as transposed into national law generally would apply to both companies formed in an EU Member State and companies formed outside the European Union. Whether a particular company would be covered would depend on turnover, number of employees and/or sector.

All companies above a certain size generally would be covered. These are informally referred to by the Commission as group 1 companies. Smaller companies – informally referred to as group 2 companies – would be covered if they meet a size threshold and are in specified high-impact sectors covered by existing sectoral OECD guidance.

For EU companies, the size threshold would take into account both turnover and number of employees. For non-EU companies, size would be measured only by turnover.

The compliance thresholds are described with more specificity below:

EU Member State company. A company formed in an EU Member State would be required to fulfill one of the following sets of conditions:

- ***Group 1***: More than 500 employees on average and net worldwide turnover of more than €150 million for the last fiscal year for which annual financial statements were prepared; or

- ***Group 2***: If not a group 1 company, more than 250 employees on average and net worldwide turnover of more than €40 million for the last fiscal year for which annual financial statements were prepared, so long as at least 50% of the net turnover was generated in one or more of the following sectors:

- The manufacture of textiles, leather and related products (including footwear), and the 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;

- The extraction of mineral resources, regardless of 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 and basic and intermediate mineral products (including metals and metal ores, construction materials, fuels, chemicals and other intermediate products).

Non-EU company. Companies formed under the laws of a third country would be required to fulfill one of the following conditions:

- ***Group 1***: Generated net turnover of more than €150 million in the European Union in the fiscal year preceding the last fiscal year; or

- ***Group 2***: Generated net turnover of more than €40 million, but not more than €150 million, in the European Union in the fiscal year preceding the last fiscal year, provided at least 50% of its net worldwide turnover was generated in one or more of the high-impact sectors listed above.

An employee test would not apply to non-EU companies. In addition, for non-EU companies the turnover threshold would be based in whole (group 1) or in part (group 2) on EU turnover, rather than worldwide turnover.

Does Company Form Matter?

"Company" would be defined broadly, encompassing most types of legal entities. It also would specifically include, regardless of form, a long list of types of regulated financial undertakings, including among others alternative investment fund managers, UCITS management companies, insurance and reinsurance undertakings and crypto-asset service providers. However, because financial services are not treated as a high-impact sector, regulated financial undertakings only would be subject to the requirements of the Directive if they are group 1 companies.

How Is the Number of Employees Calculated?

Part-time employees would be calculated on a full-time equivalent basis.

Temporary agency workers would be included in the employee count in the same manner as if they were workers employed directly for the same period of time by the company.

How Is Net Turnover Calculated?

Net turnover generally would be the amount derived from the sale of products and the provision of services after deducting sales rebates and value added tax and other taxes directly linked to turnover.

If a company applies international accounting standards or was formed outside the European Union, net revenue instead would be defined by or within the meaning of the financial reporting framework used in connection with the preparation of the company's financial statements.

Are the Compliance Requirements Different for Group 2 Companies?

Group 2 companies would have a lesser due diligence obligation. They only would be required to focus on severe adverse impacts relevant for their sector.

In addition, due diligence would not be required until two years after the end of the transposition period for the Directive. This is intended to enable group 2 companies to establish the necessary processes and procedures and benefit from industry cooperation, technological developments and standards that are likely to be prompted by the earlier implementation date for group 1 companies.

Furthermore, actions to address climate change contemplated by the Directive would not apply to group 2 companies.

How Many Companies Will Be Covered?

The Commission estimates the Directive will cover approximately 13,000 EU companies and 4,000 third-country companies. It estimates that 9,400 EU companies will be part of group 1, with the remainder in group 2. The Commission estimates that 2,600 non-EU companies will be in group 1 and 1,400 will be in group 2.

Status and Effective Date

Is the Directive Currently Legally Binding?

The Directive has been adopted by the Commission. However, it does not yet have legal effect.

The next step is for the Commission's proposal to be presented to the European Parliament and the Council for their approval.

Will the Directive Create Obligations for Companies?

The Directive would create obligations for EU Member States, which in turn would be required to adopt national legislation in accordance with the Directive. That transposed national legislation would be binding on companies.

For brevity, in this Alert we generally refer to obligations under the Directive as being applicable to companies, rather than referring specifically to transposed national legislation.

When Is Compliance Required?

Once adopted, Member States would have two years to transpose the Directive into national law.

Group 1 companies would be required to comply beginning two years after the Directive enters into force.

Group 2 companies would have an additional two years before they would be required to comply.

This means that, at the earliest, group 1 companies would have compliance obligations starting in 2024 and group 2 companies would have compliance obligations starting in 2026. However, the prevailing view is that adoption will not occur before next year, which would push compliance to 2025 and 2027, respectively, under the current proposal.

Is the Directive a Done Deal?

Under the EU's tri-partite system, the final Directive must be agreed to by the Commission, Parliament and Council. It is highly likely the final Directive will differ from the Commission proposal in at least some respects, potentially significantly.

How Does the Directive Relate to the Prior Proposal by the European Parliament?

On March 10, 2021, the European Parliament adopted a resolution approving the text of a draft directive on mandatory human rights due diligence. The Directive adopted by the Parliament is not binding on the Commission, but was intended

by the Parliament to inform the Commission's proposal. In some respects, the Parliament's proposal contained more stringent requirements. Aspects of that proposal are expected to factor into ongoing negotiations.

Getting Started

What Is Due Diligence?

At a high level, due diligence would consist of the following actions:

- Integrating due diligence into policies;
- Identifying actual or potential adverse impacts;
- Preventing and mitigating potential adverse impacts;
- Bringing actual adverse impacts to an end and minimizing their extent;
- Establishing and maintaining a complaints procedure;
- Monitoring the effectiveness of the due diligence policy and measures taken; and
- Publicly communicating on due diligence.

Due diligence generally is aligned with the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises. This is in contrast to the narrower meaning typically given to due diligence in the transactional context.

What Impacts Does Due Diligence Cover?

Due diligence would apply to the adverse human rights and environmental impacts addressed by the Directive. These are discussed in more detail earlier in this Alert under "What Are Adverse Human Rights Impacts?" and "What Are Adverse Environmental Impacts?"

What Is an Established Business Relationship?

A ***"business relationship"*** would be a relationship with a contractor, subcontractor or any other legal entity (1) with whom the company has a commercial agreement or to whom the company provides financing, insurance or reinsurance or (2) that performs business operations related to the products or services of the company for or on behalf of the company.

A business relationship would be an ***"established business relationship"*** if it is expected to be lasting, in view of its intensity or duration and does not represent a negligible or merely ancillary part of the value chain. An established business relationship could be direct or indirect.

Limiting due diligence to established business relationships is intended to allow companies to properly identify the adverse impacts in their value chain and make it possible for them to exercise appropriate leverage.

The nature of business relationships should be reassessed periodically, and at least every 12 months.

What Is a Value Chain?

A company's ***"value chain"*** would include both upstream and downstream activities. "Value chain" would be defined in the Directive to include activities related to the production of goods or the provision of services by a company, including the development of the product or service and the use and disposal of the product, as well as the related activities of

upstream and downstream established business relationships. This construct is intended to cover upstream established direct and indirect business relationships that design, extract, manufacture, transport, store and supply raw materials, products or parts of products, or that provide services to the company that are necessary to carry out the company's activities. Covered downstream relationships are intended to include established direct and indirect business relationships that use or receive products, parts of products or services from the company up to the end of life of the product, including the distribution of the product to retailers, the transport and storage of the product, dismantling of the product and its recycling, composting or landfilling.

For a regulated financial undertaking, its value chain with respect to the provision of a loan, credit or other financial service only would include the activities of the receiving client and of the client's other group companies whose activities are linked to the applicable contract. However, the value chain of a regulated financial undertaking would not include an SME receiving a loan, credit, financing, insurance or reinsurance.

Are Due Diligence Obligations Different for EU and non-EU Companies?

Due diligence obligations would be the same for EU and non-EU companies, to the extent these companies are in the same group (i.e., group 1 or group 2) and engaged in the same line of business.

Is Due Diligence Different for Group 1 and Group 2 Companies?

Group 2 companies only would be required to identify actual and potential severe adverse impacts relevant to their in-scope sector.

How Does the Directive Relate to "Soft Law" Instruments?

As earlier noted, the due diligence requirements of the Directive generally are consistent with the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises. The requirements of the Directive, therefore, will be familiar to companies with compliance programs aligned with the UN Guiding Principles and the MNE Guidelines.

How Is Due Diligence Integrated into Company Policies?

Companies would be required to integrate due diligence into their corporate policies and have in place a due diligence policy.

The due diligence policy would be required to contain the following elements:

- A description of the company's approach to due diligence, including in the long term;
- A code of conduct describing rules and principles to be followed by the company's employees and subsidiaries;
- A description of the processes put in place to implement due diligence, including the measures taken to verify compliance with the code of conduct and to extend its application to established business relationships.

The due diligence policy would be required to be updated annually.

What Are Appropriate Due Diligence Measures?

Companies would be required to take "appropriate measures" to:

- Identify actual or potential adverse human rights and environmental impacts arising from their own operations, their subsidiaries and the established direct or indirect business relationships in their value chain;

- Prevent potential adverse impacts identified, or adequately mitigate those impacts where prevention is not possible or requires gradual implementation; and

- End actual adverse human rights and environmental impacts they had or should have identified.

In addition, contractual assurances implemented as part of preventing or ending adverse impacts (discussed later in this Alert under "What Measures Are Required to Prevent Potential Adverse Impacts?" and "What Needs to Be Done to Address an Actual Adverse Impact?") should be accompanied by appropriate measures to verify compliance.

A measure would be appropriate if it 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. Whether a measure is appropriate also would take 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, and the need to ensure prioritization of action. This approach is consistent with the UN Guiding Principles and the MNE Guidelines.

A company could be held liable if it failed to comply with its obligation to take appropriate measures to prevent potential adverse impacts or bring an actual adverse impact to an end if, as a result of the failure, an adverse impact occurred and led to damage. Liability is discussed in more detail later in this Alert under "Enforcement."

Do Companies Need to Assess the Effectiveness of Due Diligence?

Companies would be required to carry out periodic assessments to monitor the effectiveness of the identification, prevention, mitigation, cessation and minimization of human rights and environmental adverse impacts. The assessment would be required to take into account the company's own operations and measures, those of its subsidiaries and those of established business relationships related to the company's value chains.

The assessment would be required to be based, where appropriate, on qualitative and quantitative indicators. The assessment would be required to be carried out at least every 12 months. In addition, the assessment would be required to be carried out if there are reasonable grounds to believe that significant new risks of the occurrence of the adverse impacts may arise.

The due diligence policy would be required to be updated to take into account the outcome of the assessment.

Can Due Diligence Leverage Third-party Initiatives?

Companies would be able to rely on appropriate industry schemes and multi-stakeholder initiatives to support implementation of their due diligence obligations.

What Should Companies Be Doing Now?

At a minimum, companies should assess whether they are likely to come within the scope of the Directive and, if so, they should continue to monitor the status of the Directive. Potentially affected companies also should consider conducting a high-level preliminary gap assessment, to provide a directional sense of the amount of work that would be required to comply with the Directive's requirements. Since the ultimate terms and timing of the final Directive will determine companies' compliance obligations and when those begin, we believe it is premature for companies to begin implementing compliance measures specifically in response to the Directive.

Of course, many companies have in place or are developing or enhancing policies, procedures and programs to address adverse human rights and environmental impacts, whether to meet current or pending legal requirements, meet customer, consumer or other stakeholder requirements or demands or align with the company's human rights and environmental sustainability goals and values. These initiatives should continue. New or enhanced policies, procedures and programs should be designed to be flexible enough to accommodate the requirements of the Directive.

Identifying and Addressing Adverse Impacts

What Measures Need to Be Taken to Identify Adverse Impacts?

Companies would be required to take appropriate measures to identify actual and potential adverse human rights and environmental impacts arising from their own operations or those of their subsidiaries and, where related to their value chains, from their established business relationships. What would qualify as "appropriate measures" is discussed earlier in this Alert under "What are Appropriate Due Diligence Measures?"

To the extent relevant, companies would be required to carry out consultations with potentially affected groups, including workers and other relevant stakeholders, to gather information on actual or potential adverse impacts. Adverse impacts also may be identified through the company's complaints mechanism. The complaints mechanism is discussed later in this Alert under "The Complaints Mechanism."

Group 2 companies only would be required to identify actual and potential severe adverse impacts relevant to their sector.

Regulated financial undertakings that provide credit, loan or other financial services only would be required to take action to identify actual and potential adverse human rights impacts and adverse environmental impacts before providing the service.

What Is a Severe Adverse Impact?

A ***"severe adverse impact"*** would be an adverse human rights or environmental impact that (1) is especially significant by its nature, (2) affects a large number of persons or a large area of the environment, (3) is irreversible or (4) is particularly difficult to remedy as a result of the measures necessary to restore the situation prevailing prior to the impact.

Group 2 companies only would be required to focus on severe adverse impacts relevant to their sector.

In addition, complainants would be entitled to meet with company representatives at an appropriate level to discuss potential or actual severe adverse impacts that are the subject matter of the complaint. The complaints mechanism is discussed later in this Alert under "The Complaints Mechanism."

What Measures Are Required to Prevent Potential Adverse Impacts?

Companies would be required to take appropriate measures to prevent or, if prevention is not possible or immediately possible, adequately mitigate potential adverse human rights and environmental impacts that have been, or should have been, identified through the measures required to identify these impacts. The concept of "appropriate measures" is further discussed earlier in this Alert under "What are Appropriate Due Diligence Measures?"

More specifically, companies would be required to take the following actions, where relevant:

- Where necessary due to the nature or complexity of the measures required for prevention, develop and implement a prevention action plan, with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement.

  The prevention action plan would be required to be developed in consultation with affected stakeholders.

- Seek contractual assurances from the business partner with whom the company has a direct business relationship that the partner will ensure compliance with the company's code of conduct and, as necessary, prevention action plan, including by seeking corresponding contractual assurances from its partners to the extent their activities are part of the company's value chain (referred to in the Directive as "contractual cascading").

  The Commission would be required to adopt guidance concerning voluntary model contract clauses to support compliance with this requirement.

If contractual assurances are obtained, measures to verify compliance would be required to be taken, as described later in this Alert under ”When Does Compliance Need to be Verified?”

- Make necessary investments, such as into management or production processes and infrastructures, to comply with the requirement to prevent or mitigate potential human rights and environmental impacts.
- Provide targeted and proportionate support for an SME with which the company has an established business relationship, where compliance with the code of conduct or prevention action plan would jeopardize the viability of the SME.
- Collaborate with other entities, including where relevant to increase the company’s ability to bring the adverse impact to an end, in particular, where no other action is suitable or effective.

  Collaboration would be required to occur in compliance with EU law, including competition law.

If these measures cannot prevent or adequately mitigate potential adverse impacts, the company would expressly be permitted to seek to conclude a contract with a partner with whom it has an indirect relationship, with a view to achieving compliance with the company’s code of conduct or prevention action plan.

What if a Potential Adverse Impact Cannot Be Prevented or Adequately Mitigated?

If a potential adverse impact could not be prevented or adequately mitigated by the measures described above (see “What Measures are Required to Prevent Potential Adverse Impacts?”), the company would be required to refrain from entering into new or extending existing relations with the partner in connection to or in the value chain of which the impact has arisen.

In addition, where the law governing the relationship entitles the company to do so, it would be required to take the following actions:

- Temporarily suspend commercial relations with the partner in question, while pursuing prevention and minimization efforts, if there is a reasonable expectation that these efforts will succeed in the short term.
- Terminate the business relationship with espect to the activities concerned if the potential adverse impact is severe.

  Regulated financial undertakings that provide credit, loan or other financial services would not be required to terminate the credit, loan or other financial service contract if this would reasonably be expected to cause substantial prejudice to the counterparty.

Under the Directive, Member States would be required to provide for the availability of an option to terminate the business relationship in contracts governed by their laws.

What Needs to Be Done to Address an Actual Adverse Impact?

Companies would be required to take appropriate measures to bring to an end actual adverse impacts that have been, or should have been, identified pursuant to the due diligence measures required to be taken. If the adverse impact cannot be brought to an end, the company would be required to minimize the extent of the impact. The concept of “appropriate measures” is further discussed earlier in this Alert under “What Are Appropriate Due Diligence Measures?”.

Companies specifically would be required to take the following actions, where relevant:

- Neutralize the adverse impact or minimize its extent, including by the payment of damages to the affected persons and financial compensation to the affected communities.

This action would be required to be proportionate to the significance and scale of the adverse impact and the contribution of the company's conduct to the adverse impact.

- Where necessary due to the fact that the adverse impact cannot immediately be brought to an end, develop and implement a corrective action plan with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement.

  Where relevant, the corrective action plan would be required to be developed in consultation with stakeholders.

- Seek contractual assurances from a direct partner with whom the company has an established business relationship that the partner will ensure compliance with the company's code of conduct and, as necessary, corrective action plan, including by seeking corresponding contractual assurances from its partners to the extent they are part of the value chain (i.e., contractual cascading).

  The Commission would be required to adopt guidance concerning voluntary model contract clauses to support compliance with this requirement.

- Make necessary investments, such as into management or production processes and infrastructures, to comply with the foregoing three items.

- Provide targeted and proportionate support for an SME with which the company has an established business relationship, where compliance with the code of conduct or the corrective action plan would jeopardize the viability of the SME.

- Collaborate with other entities, including, where relevant, to increase the company's ability to bring the adverse impact to an end, in particular where no other action would be suitable or effective.

  Collaboration would be required to occur in compliance with EU law, including competition law.

If the actual adverse impact cannot be brought to an end or adequately mitigated by the foregoing measures, the company expressly would be permitted to seek to conclude a contract with an indirect partner, with a view to achieving compliance with the company's code of conduct or corrective action plan.

When Does Compliance Need to Be Verified?

Contractual assurances from a business partner or indirect partner in connection with addressing adverse impacts (see "What Measures Are Required to Prevent Potential Adverse Impacts?" and "What Needs to Be Done to Address an Actual Adverse Impact?") would be required to be accompanied by appropriate measures to verify compliance. The company would be permitted to refer to suitable industry initiatives or independent third-party verification.

If a contractual assurance is obtained from or a contract is entered into with an SME, the terms used would be required to be fair, reasonable and non-discriminatory. The company would be required to bear the cost of the independent third-party verification when verifying SME compliance.

An ***"industry initiative"*** would be defined as a combination of voluntary value chain due diligence procedures, tools and mechanisms, including independent third-party verifications, developed and overseen by governments, industry associations or groupings of interested organizations.

Third-party verification could be provided by an auditor who is independent from the company, free from conflicts of interest, has experience and competence in environmental and human rights matters and is accountable for the quality and reliability of the audit.

What if an Actual Adverse Impact Cannot Be Ended or Minimized?

If an actual adverse impact cannot be brought to an end or minimized by the measures described above (see "What Needs to be Done to Address an Actual Adverse Impact?"), the company would be required to refrain from entering into new relations or extending existing relations with the partner in connection to or in the value chain of which the impact has arisen.

In addition, if permitted by the law governing the relationship, the company would be required to take one of the following actions:

- Temporarily suspend commercial relationships with the partner in question, while pursuing efforts to end or minimize the extent of the adverse impact; or
- Terminate the business relationship with respect to the activities concerned, if the adverse impact is considered severe.

Member States would be required to provide in local law for the ability to terminate the business relationship if the contract is governed by local Member State law.

A regulated financial undertaking that provides credit, loan or other financial services would not be required to terminate the credit, loan or other financial service contract if this would reasonably be expected to cause substantial prejudice to the counterparty.

Reporting

Is Reporting Required?

Most subject companies would be required to annually report on the matters covered by the Directive.

What Is Required to Be Included in the Report?

The Commission would be required to adopt delegated acts regarding reporting content and criteria. These would be required to specify information on the description of due diligence, potential and actual adverse impacts and related action taken.

How Does Reporting Occur?

Statements would be published on the company's website.

When Are Reports Due?

Statements would be required to be published by April 30 each year, for the prior calendar year.

Is There a Language Requirement for the Statement?

The Statement would be required to be in a language customary in the sphere of international business.

Are There Exceptions to Reporting?

Companies would not have to report under the Directive if they are required to report under the Non-Financial Reporting Directive (or the Corporate Sustainability Reporting Directive, which will supersede the NFRD).

Under the NFRD, subject companies are required to include in their management report a non-financial statement containing information relating to, at a minimum, environmental, social and employee matters, respect for human rights and anti-corruption and bribery matters, to the extent that information is necessary for an understanding of the undertaking's or group's development, performance, position and impact of its activity.

Directors' Duties

What Are the Responsibilities of Directors?

When fulfilling their duty to act in the best interest of the company, directors would be required to take into account the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term. Member States would be required to ensure that laws, regulations and administrative provisions providing for a breach of directors' duties apply to these duties.

Directors also would specifically be responsible for establishing and overseeing due diligence. In particular, directors would be responsible for the due diligence policy, with due consideration for relevant input from stakeholders and civil society organizations. The due diligence policy is discussed earlier in this Alert under "How Is Due Diligence Integrated into Company Policies?" Directors would be required to report to the board of directors regarding the establishment and oversight of due diligence.

Directors also would be required to take steps to adapt the corporate strategy to take into account actual and potential adverse human rights and environmental impacts identified and any measures taken to prevent or remedy adverse impacts or pursuant to the complaints mechanism.

Who Is a Director?

A "director" would include the following:

- Any member of the administrative, management or supervisory body of a company;
- If not a member of the administrative, management or supervisory body, the chief executive officer and, if the function exists, the deputy chief executive officer; and
- Other persons who perform functions similar to the foregoing.

To Which Companies Do These Responsibilities Apply?

The foregoing duties would apply to directors of EU companies subject to the Directive. The duties would not be applicable to directors of non-EU companies.

The Complaints Mechanism

How Can Concerns Be Submitted?

Companies would be required to have a complaints mechanism available for submission of legitimate concerns regarding actual or potential adverse human rights and environmental impacts in their own operations, at their subsidiaries or in their value chains.

In addition, persons would be able to submit substantiated concerns to a supervisory authority if the person has reason to believe, on the basis of objective circumstances, that a company is failing to comply with national legislation adopted pursuant to the Directive.

Who Can Submit Concerns?

The company complaint mechanism would be required to enable the following to submit concerns:

- Persons affected or who have reasonable grounds to believe they might be affected by an adverse impact;
- Trade unions and other workers' representatives representing individuals working in the value chain; and

- Civil society organizations active in the areas related to the value chain.

How Do Complaints Need to Be Handled?

Companies would be required to establish a procedure for addressing complaints, including complaints the company considers to be unfounded. The company would be required to inform the relevant workers and trade unions of the complaints procedures.

Complainants would be entitled to request appropriate follow-up on the complaint from the company.

In addition, they would be entitled to meet with the company's representatives at an appropriate level to discuss potential or actual severe adverse impacts that are the subject matter of the complaint.

Climate Change

What Actions Are Companies Required to Take to Address Climate Change?

Group 1 companies would be required to adopt a plan to ensure their business model and strategy are compatible with the transition to a sustainable economy and with limiting global warming to 1.5°C in line with the Paris Agreement.

What Does the Climate Change Plan Require?

The climate change plan would be required to identify, on the basis of information reasonably available to the company, the extent to which climate change is a risk for, or an impact of, a company's operations.

If climate change is or should have been identified as a principal risk for, or a principal impact of, a company's operations, the company would be required to include emission reduction objectives in its plan.

What Other Actions Are Required to Address Climate Change?

Group 1 companies would be required to take into account the fulfillment of the climate change-related obligations discussed above when setting a director's variable compensation, if variable compensation is linked to the director's contribution to the company's business strategy, long-term interests and sustainability.

Enforcement

Who Is the Enforcement Body?

Each Member State would be required to designate one or more supervisory authorities to supervise compliance with the due diligence and climate change-related obligations adopted under national law pursuant to the Directive.

In addition, the Commission would be required to establish a European Network of Supervisory Authorities composed of representatives of the supervisory authorities. The Network would facilitate the cooperation of the supervisory authorities and the coordination and alignment of regulatory, investigative, sanctioning and supervisory practices of the supervisory authorities and, as appropriate, sharing of information. However, the Network would not be an enforcement body.

What Are the Powers of the Supervisory Authorities?

The Member State supervisory authorities would be required to be given adequate powers and resources to carry out their tasks, including the power to request information and carry out investigations.

Supervisory authorities generally would be required to have at least the power to (1) order a company to end infringing conduct and abstain from future infringements and, where appropriate, order remedial action proportionate to the infringement necessary to bring it to an end, (2) impose pecuniary sanctions and (3) adopt interim measures to avoid the risk of severe and irreparable harm.

What Are the Sanctions for Violations?

The Directive does not specify particular sanctions. Instead, it provides a framework for determining sanctions. Under the Directive, Member States would be required to establish rules on sanctions in the event of a violation of national provisions adopted pursuant to the Directive.

Sanctions would be required to be effective, proportionate and dissuasive. In deciding whether to impose sanctions and, if so, in determining their nature and appropriate level, due consideration would be required to be given to the company's efforts to comply with any remedial action required by a supervisory authority, any investments made and any targeted support provided to address potential or actual adverse impacts, as well as collaboration with other entities to address adverse impacts in the company's value chain.

If pecuniary sanctions are imposed, they would be required to be based on the company's turnover.

If a supervisory authority identifies a failure by a company to comply with national requirements adopted pursuant to the Directive, the company would be required to be given an appropriate period of time to take remedial action, if possible. However, remedial action would not preclude a supervisory authority from imposing administrative sanctions or civil liability if there are damages.

Can a Claim for Damages Be Brought?

Victims would be required to be able to bring a civil liability claim in appropriate Member State courts.

Member States would be required to ensure that companies could be held liable for damages if:

- they failed to comply with their obligations to prevent potential adverse impacts and bring actual adverse impacts to an end; and
- As a result of the failure, an adverse impact that should have been identified, prevented, mitigated, brought to an end or minimized occurred and led to damage.

However, if a company sought required contractual assurances as part of preventing or ending adverse impacts and the assurances were accompanied by appropriate measures to verify compliance, the company would not be liable for damages caused by an adverse impact arising as a result of the activities of an indirect partner with whom it had an established business relationship, unless it was unreasonable under the circumstances to expect the action actually taken, including as to verifying compliance, would be adequate to prevent, mitigate, bring to an end or minimize the adverse impact.

Is There Strict Liability for Adverse Impacts?

The Directive is not intended to impose strict liability for adverse human rights or environmental impacts. The Directive notes that it should not require companies to guarantee, in all circumstances, that adverse impacts will never occur or that they will be stopped.

Other Actions in Furtherance of the Directive

Will the Commission Publish Guidance?

The Commission would be required to adopt guidance pertaining to voluntary model contract clauses. These clauses could be used if the company sought required contractual assurances as part of preventing or ending adverse impacts.

The Commission would be expressly empowered to issue guidelines to provide support to companies or Member State authorities on how companies should fulfill their due diligence obligations. Among other things, guidelines could be

issued for specific sectors or specific adverse impacts. However, the Commission would not be required to issue guidelines.

To the extent guidelines are issued, the Commission would be required to consult with EU Member States and stakeholders, the European Union Agency for Fundamental Rights, the European Environment Agency and, to the extent appropriate, with international bodies having expertise in due diligence.

The Commission, in collaboration with Member States, also would be expressly empowered to issue guidance for assessing the fitness of industry schemes and multi-stakeholder initiatives.

What Other Actions Might the European Union Take in Support of the Directive?

Among other things, the Directive notes the Commission may put in place other supporting measures building on existing EU actions and tools to support due diligence implementation within the European Union and in third countries. These may include facilitating joint stakeholder initiatives to help companies fulfill their obligations and supporting SMEs impacted by the Directive.

The Directive also may be complemented by EU development cooperation instruments to support third country governments and upstream economic operators in third countries in addressing adverse human rights and environmental impacts of their operations and upstream business relationships.

Will the Directive Be Strengthened in the Future?

No later than the 7th anniversary of the effective date of the Directive, the Commission would be required to submit a report to the European Parliament and Council on the implementation of the Directive. The report would be required to evaluate the effectiveness of the Directive in reaching its objectives and whether:

- The employee and net turnover thresholds need to be lowered;
- The list of covered sectors needs to be changed, including to align to OECD guidance;
- The Annex specifying relevant human rights and environmental prohibitions and related agreements and conventions needs to be modified, including in light of international developments; and
- The due diligence requirements and related provisions should be extended to adverse climate impacts.

About our Practice

Ropes & Gray has a leading ESG, CSR, business and human rights and supply chain compliance practice. We offer clients a comprehensive approach in these subject areas through a global team with members in the United States, Europe and Asia. In addition, senior members of the practice have advised on these matters for more than 30 years, enabling us to provide a long-term perspective that few firms can match.

For further information on the practice, click here.