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ALERT MEMORANDUM

The Corporate Sustainability **Due Diligence** Directive

The EU proposes a comprehensive corporate accountability regime to protect human rights and the environment across large companies and their supply chains

March 24, 2022

On February 23, 2022, the European Commission published its long-awaited proposal for a new **Directive on Corporate Sustainability Due Diligence** ("CSDD").

The proposal aims to address any negative impacts of global corporate value chains on the **environment** and **human rights**, by requiring companies that sell products within the EU to identify, monitor and address (*i.e.* prevent, put an end to, or mitigate) any such impacts.

Larger companies will be required to draft a **climate plan**, to ensure that their business strategy is compatible with limiting global warming to 1.5°C (in line with the target set under the "Paris Agreement"). Company **directors** will be responsible for setting up and overseeing companies' due diligence efforts, and will be required to take into account the human rights, climate change and environmental consequences of their business decisions.

A number of EU Member States have already introduced national rules on due diligence. The CSDD aims to harmonise such rules at the EU-level, and to create a level playing field between EU companies, on the one hand, and foreign companies that do significant business in the EU, on the other.

It is estimated that, once in force (likely not before 2025), the Directive will apply to about **13,000 EU companies** and **4,000 non-EU companies**.

This alert *memorandum* provides an overview of the scope and the main provisions of the CSDD proposal.

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I. Background

The EU's corporate sustainability due diligence initiative[1] falls under Action 10 (*Fostering sustainable corporate governance and attenuating short-termism in capital markets*) of the European Commission's 2018 "Action Plan for Financing Sustainable Growth. [2]

In January 2020, the British Institute of International and Comparative Law, Civic Consulting and the London School of Economics published their "Study on due diligence requirements through the supply chain", commissioned by the EU Commission.[3] The Study:

(i) Surveyed market practice and general perceptions regarding regulatory options, through desk research, country analyses, interviews and surveys;

(ii) Conducted a regulatory review looking at the way in which standards of corporate ESG due diligence are increasingly being introduced or proposed across EU Member States;

(iii) Formulated four policy options:
- *Option 1* : no change
- *Option 2* : new voluntary guidelines
- *Option 3* : new reporting requirements
- *Option 4* : mandatory due diligence as a legal standard of care;

(iv) And then carried out a preliminary assessment of the potential impacts (economic, on public authorities, on ESG factors) of each policy option.

As "*Option 4*" gathered increasing support (including from the corporate sector, caught in-between fragmented national level due diligence rules and regulatory uncertainty), between September 2020 and March 2021 the European Parliament passed two resolutions asking for the Commission to regulate corporate ESG due diligence and accountability at the EU-level.[4]

The Commission's proposal (initially scheduled for Q2 2021) was finally published on February 23rd of this year.

II. General framework

Overall, the purpose of the CSDD is to establish certain minimum requirements for companies to **identify, disclose, monitor and remediate** any negative impacts of their activities on the **environment** and **human rights**.

(a) <u>*Companies in scope*</u>

The Directive proposal sets a wide scope of application, targeting also companies established outside of the European Union.[5] The following companies will be concerned:

"**Very large companies**"

= <u>500+ employees</u> and <u>>150M Euro turnover</u> *

"**Large *high-impact* companies**" [6]

= <u>250+ employees</u> and <u>>40M Euro turnover</u> *

where 50% of such turnover is generated in the textiles, fashion, agriculture and farming, food and beverage, extraction of minerals, manufacture of metal products and other "high-impact" industries [7]

(*) Turnover figures refer:
- <u>*For EU companies*</u>, to worldwide net turnover
- <u>*For non-EU companies*</u>, to the net turnover generated within the EU

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[1] The CSDD proposal is accessible here.

[2] The 2018 Action Plan is accessible here.

[3] The 2020 Study is accessible here.

[4] The European Parliament Legal Committee's draft motions 2020/2137(INI) of December 17, 2020, and 2020/2129(INL) of March 10, 2021 are respectively accessible here and here. Motion 2020/2129(INL) included the Parliament's suggestions on the text of a Directive.

[5] This approach is in line with other recent sustainability-related reforms brought about in the EU. One notable example of this is the "Sustainable Finance Disclosure Regulation" (SFDR), that applies since March 2021 to all funds (including non-EU based) that are marketed to European professional investors. For our analysis of the SFDR, access our dedicated alert here.

[6] For "high-impact companies" (that do not also qualify as "very large"), CSDD obligations should kick in 2 years later.

[7] A complete list of the "high-impact" industries is provided under Article 2, Paragraph 1, letter (b) of the Directive proposal. Article 29 requires the Commission to advise the EU Council and Parliament on whether to expand such list within 7 years of the CSDD's entry into force.

(b) *Negative ESG impacts to be monitored*

Companies that fall in-scope of the CSDD will be required to monitor and address the **potential and actual negative impacts** of their operations on the ESG factors that are listed in the Annex to the CSDD. [8]

These include, most notably:

(A) *As regards* ***environmental*** *impacts*:

- Sound handling, collection, storage and disposal of waste
- Prohibition on the production and use of certain persistent organic pollutants, and substances depleting the ozone layer
- Prohibition to import certain hazardous chemicals and pesticides
- Prohibition to export hazardous waste

(B) *As regards* ***human rights***:

- Prohibition of torture and inhuman or degrading treatment
- Freedom of religion and thought
- Just, safe and healthy working conditions
- Prohibition of forced and child labour
- Right to freedom of association and workers' collective bargaining
- Adequate living wages
- Indigenous peoples' collective right to their land

(c) *Perimeter of companies' due diligence and accountability*

The perimeter of companies' ESG due diligence duties under the CSDD will extend to:

The activities of

- The company itself
- Its subsidiaries
- The **established** business relationships that are part of the relevant "**value chain**"

A company's **value chain** should cover all upstream and downstream activities that are related to the production of the goods or services that are offered on the European market. This will go from the development of the product, all the way to its disposal (*i.e.* the product's entire "life-cycle").

In practice:

- *Upstream* relationships will include entities that design, extract, manufacture, transport, store and supply raw material, products and product components, and any other entities that provide services to the company that are necessary to carry out the company's activities;
- *Downstream* relationships will include entities that use or receive products (or product components), including for purpose of their distribution to retailers, transport, storage, dismantling, recycling, composting or landfilling.

Established business relationships within such value chain will be any direct and indirect contractors, subcontractors and other entities with which the company has a commercial relationship, or that perform business operations related to the products or services offered by the company. This will include relationships of a financial nature (such as the recipients of loans or insurance).

To qualify as "**established**", a business relationship (whether direct or indirect) will have to be "*lasting, in view of its intensity or duration*". Negligible and ancillary parts of the value chain will not be seen as "established business relationships". Companies should reassess which entities qualify as their "established business relationships" on at least an annual basis.

(d) *Proportionality*

The CSDD will require companies to take "*appropriate measures*" to identity and remediate the ESG impacts of their value chain.

The CSDD generally applies a **proportionality principle**. For every company, the "*appropriate measures*" will therefore depend on the characteristics of the economic sector in which the company operates, the resources that are available to that company, and its effective influence on its established business

[8] Article 29 requires the Commission to advise the EU Council and Parliament on whether to expand the list of ESG impacts, within 7 years of the CSDD's entry into force.

relationships (when these are responsible for the negative impacts).

In practice, companies that are larger, more influential and more resourceful will be expected to do *more* to protect human rights and the environment.

By virtue of the same proportionality principle, measures should be commensurate to the severity and the likelihood of a negative impact. Companies will be expected to prioritise their action on such basis. Violations such as forced and child labour, for instance, should deserve more immediate action and be given a higher priority.

III. Key requirements under the CSDD

Under the proposed Directive, companies will essentially be required to:

(1) Have in place an **ESG due diligence policy** (reviewed annually by the company's board) to identify and monitor the negative impacts of their operations on the environment and human rights;

(2) Have in place an **ESG code of conduct** applicable to their employees, subsidiaries and established business relationships;

(3) Put in place a **complaints procedure**, enabling persons who are affected by the company's operations to flag negative impacts and receive appropriate follow-up;

(4) **Address negative impacts**; and

(5) Publicly disclose through an **annual statement** the outcome of their ESG due diligence and remediation activities.

(a) *Addressing negative impacts*

Companies will be expected to take the following actions to prevent, put an end to or at least mitigate the negative ESG impacts of their operations:

- Develop and implement adequate **preventative or corrective action plans**, with timelines for action and performance indicators;
- Seek **contractual assurances** (whether directly, from their business partners, or **cascading** so as to capture also indirect partners), to ensure the compliance of their established business relationship with the company's own code of conduct and action plans;
- Actively **verify compliance** with such contractual assurances (such as through third-party audits);
- **Support SMEs** with which the company has an established business relationship to comply with the code of conduct and action plans, where necessary;
- Make the necessary **investments**, such as with respect to their own production processes;
- **Compensate damages** to the persons and communities that are negatively affected by the company's operations; and even
- **Collaborate with each other** to increase their ability to bring adverse impacts to an end, where no other action is suitable or effective.[9]

Companies will be expected to refrain from entering into new or extending existing relations with partners that are responsible for negative impacts that cannot be brought to an end or adequately mitigated. They will also be expected to suspend such relationships temporarily, where possible, and – only as a last resort action – to terminate them where the negative impacts are severe and cannot otherwise be addressed.

The Commission is expected to issue guidelines to support to companies on how companies to fulfil their due diligence obligations.

(b) *Climate transition plans*

"Very large companies" that are in-scope of the CSDD will be required to also adopt a plan to ensure that their business model and strategy are compatible with the transition to a sustainable economy and the limiting of global warming to 1.5°C (in line with the Paris Agreement).

For companies for which case climate change is a material risk (or a material negative impact), the transition plan shall include **emission reduction objectives**.

[9] Cross-industry collaboration must be done "*in compliance with competition law*". On March 1, 2022, the Commission published however a draft set of "Horizontal Guidelines", which aim to provide greater clarity on how to assess sustainability agreements against competition concerns. The draft Guidelines are accessible here. For a brief commentary, access our opinion piece published on the Oxford Business Law Blog, here.

(c) *Company directors*

The CSDD proposal also creates new duties of care applicable to *(i)* the members of a company's administrative management and supervisory bodies, *(ii)* its CEO and Deputy CEO and *(iii)* any other individuals performing similar functions.

These directors and officers will be required to take into account the **consequences of their decisions** on human rights, climate change and the environment, in the short, medium and long term.

In addition, for "very large companies", where variable remuneration is linked to a director's contribution to the company's business strategy, long-term interests and sustainability, **remuneration policies** should be consistent with the company's climate transition plan (including any emission reduction objectives).

IV. Enforcement and sanctions

National competent authorities will have the power to investigate companies for non-compliance with the CSDD, either on their own initiative or based on substantiated concerns raised by stakeholders. Whistle-blowers will be protected under the EU's whistle-blower regime.

Competent national authorities will be empowered to also impose fines based on companies' turnover. In doing so, they will need to take into account the company's efforts to comply with any remedial action, and any investments, support and collaboration made by the company to address the relevant negative impacts.

Enforcement decisions and sanctions issued under the CSDD will be made public. They will also bar companies from being able to obtain state aid or other forms of public support. The Commission will set up a **European Network of Supervisory Authorities** to facilitate cooperation in supervision and enforcement across the EU.

V. Interactions with other sustainability-related EU rules

(a) *The Corporate Sustainability Reporting Directive (CSRD)*

As mentioned on this alert's cover, it is estimated that about 13,000 EU companies (of which about 3,400 "high-impact") and 4,000 non-EU companies (of which about 1,400 "high-impact") will fall within the scope of the CSDD. This totals approximately 17,000 companies.

Compare this with the estimated 50,000 (*only* EU-based) that are expected to fall within scope of the EU's Corporate Sustainability Reporting Directive (the "CSRD"), from 2024.[10] ESG due diligence obligations will therefore apply to a smaller number of corporates, compared to ESG reporting.

The two Directives are however highly interrelated, and will facilitate a number of synergies for those EU companies that are subject to both. For instance:

- Information collection processes set up to identify adverse impacts (under the CSDD) will be useful also for reporting purposes under the CSRD;
- Companies' CSDD due diligence findings and climate transition plans will be subject to reporting according to CSRD rules (including the forthcoming technical standards and templates).

(b) *The Sustainable Finance Disclosure Regulation (SFDR)*

For similar reasons, the CSDD will create synergies with the ESG reporting requirements of the Sustainable Finance Disclosure Regulation (the "SFDR"). [11]

Asset managers that are in-scope of the SFDR are in fact required to disclose (under certain conditions) the "principal adverse impacts" of their investment decisions on ESG factors, both at the level of the asset manager and with respect to each individual fund that they manage.

[10] For our analysis of the CSRD proposal issued last year (and now also under the scrutiny of the EU Parliament and Council), see our dedicated alert accessible here.

[11] For our analysis of the SFDR (applicable since March 2021 to EU asset managers as well as (in part) non-EU alternative investment fund managers that market their funds to EU professional investors), see our dedicated alert accessible here.

(c) *Sectoral due diligence regimes*

The CSDD will be the first ESG due diligence regime to apply potentially to all types of goods and services offered in the EU.

Other due diligence regimes already exist however (or are planned) in relation to specific industries and products. They include:

- The "Timber Regulation" (no. 995/2010), that requires distributors and importers of timber products to ensure that these are not derived from illegally harvested timber; [12]
- The "Conflict Minerals Regulation" (no. 2017/821), which lays down supply chain due diligence obligations for importers of tin, tantalum, tungsten and gold (3TG) originating from conflict-affected areas; [13]
- The Commission's December 2020 proposal for a new "Batteries Regulation", aimed at reducing the ESG impacts of batteries' entire life-cycle;[14]
- The November 2021 proposal for a new "Regulation on Deforestation-free products", that should apply to all importers of certain commodities linked to deforestation (such as soy, beef, palm oil, coffee, cocoa and wood) and their derived products (such as leather and chocolate); [15]
- The upcoming initiative announced by the Commission through its "Communication on Decent Work" (released on the same day as the CSDD proposal), that should prohibit the placement on the EU market of products that employ forced labour at any level of the supply chain.[16]

These regimes will continue to apply after the CSDD comes into force.

VI. Conclusion

The CSDD proposal is widely considered – with reason – to be one of the most ambitious corporate law reforms to be ever proposed, anywhere in the world.

Implications for companies – both EU and non-EU – will be far reaching. They will affect many aspects of their day-to-day business, from supply chain management to directors' duties, internal corporate governance, risk management and transparency.

Preparing for compliance will necessary begin from the mapping of potential material risks (*i.e.* ESG impacts) across one's "value chain", well in advance of the Directive's entry into force. Internal policies, codes of conducts, compliance mechanisms and lines of ESG reporting will need to be tested and adjusted to the company's business, and the nature of its business partners.

Not least, the CSDD is likely to bring new dispute risk. Climate change litigation (among others) against companies is sharply rising across the globe, and stakeholders are increasingly scrutinising companies' ESG disclosures for greenwashing claims. [17]

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[12] The "Timber Regulation" is accessible here.

[13] The "Conflict Minerals Regulation" is accessible here.

[14] The "Batteries Regulation" proposal is accessible here.

[15] The proposal for a "Regulation on Deforestation-free Products" is accessible here.

[16] The "Communication on Decent Work" is accessible here.

[17] For a recent review of climate change litigation phenomenon, see our interactive paper accessible here. Click here for a commentary of the first EU lawsuit (anchored in Italy) between competitors on greenwashing grounds. Cleary actively tracks on developments in this space: for updated running commentary, access our Sustainability thought leadership page.