A&L Goodbody

CORPORATE AND M&A

Proposed directive on corporate sustainability due diligence

Earlier this year, the European Commission published its long-awaited Proposal for a directive on corporate sustainability due diligence (the **Proposed Directive**) to address the human rights and environmental impacts of global value chains.

The proposal, which has been in the pipeline since 2020, has been criticised by a number of high-profile organisations, including Amnesty International and the European Coalition for Corporate Justice, for failing to go far enough. For example, the number of companies captured is substantially reduced compared to the recommended proposal, originally adopted by the European Parliament in 2021.

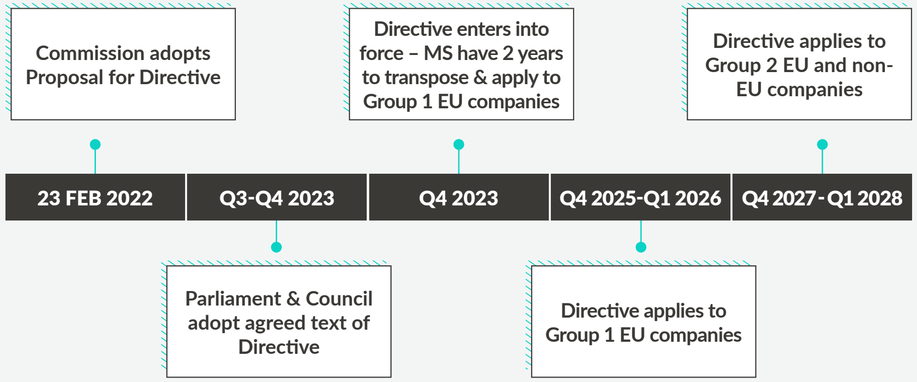
9 MIN READ

Now, over 220 of these civil society groups have issued a statement calling for the Proposed Directive to be strengthened. Among the points of objection raised by these groups are the following:

- The rules should apply across the entire value chain and not be limited to "established business relationships".
- SMEs must be brought within scope of the Proposed Directive. The original proposal, adopted by the European Parliament in 2021, applied to publicly listed SMEs and SMEs operating in high risk sectors.
- The provisions on civil liability and access to justice need to be strengthened and the burden of proof in court proceedings placed on the company to prove whether it acted appropriately or not.
- Climate due diligence measures, which are currently absent from the Proposed Directive, must be included.
- The current measures of compliance – codes of conduct, contractual clauses, third party audits and industry initiatives – are insufficient and companies should be explicitly required to address the risks and adverse impacts of their purchasing practices.
- The Proposed Directive should further clarify the directors' duty of care and the responsibility to provide oversight of the due diligence process, including transition plans and sustainability targets.

While the stage seems set for the Proposed Directive to undergo protracted debate in the European Parliament and Council of the EU in the coming months, the proposal as currently drafted has significant implications for in-scope companies. In this publication, we will take you through the key aspects of the proposal and their potential impacts. Given the novelty, breadth and significance of what is proposed, in-scope companies need to begin a review and audit of their value chains in order to ensure their preparedness.

Anticipated timeline



These dates are projections based on the typical duration of the EU ordinary legislative procedure for a directive (18 months) and are therefore subject to change. The Parliament elections, scheduled for spring 2024, suggest an obvious target date for reaching agreement.

The date of applicability to companies on a national level is also dependent on Member States, such as Ireland, implementing the Directive into national law within the transposition deadline (two years for Group 1 EU companies and four years for Group 2 EU companies and non-EU companies).

The Proposed Directive at a glance

1. **Due diligence obligations** - "identify, prevent, mitigate and account for external harm resulting from adverse human rights and environmental impacts in the company's own operations, its subsidiaries and in the value chain"
2. **Climate change obligations** – certain large EU and non-EU companies must adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and the limiting of global warming
3. **Directors' duties** - set up and oversee the implementation of the due diligence processes and integrate due diligence into the corporate strategy. In addition, when fulfilling their duty to act in the interests of the company, directors must take into account the human rights, climate change and environmental consequences of their decisions.

Which companies will have to comply?

The Proposed Directive applies directly to both EU and non-EU entities as follows:

Large EU-incorporated companies

Group 1: companies of substantial size and economic power (500+ employees and €150m+ in net turnover worldwide).

- Group 1 companies will be subject to the Proposed Directive from its initial application (based on the current expected timeline, from Q4, 2025 or Q1, 2026).
- Our analysis suggests that there are a significant number of Group 1 companies in Ireland, across a number of sectors, which will be impacted by the Proposed Directive.

Group 2: Other midcap companies with at least 50% net turnover generated in certain "high-impact sectors" (including manufacturing of textiles, extraction industries and agriculture)[1] and with 250+ employees and €40m + in net turnover worldwide.

- The selection of high-impact sectors for the purposes of the Proposed Directive is based on existing sectoral OECD due diligence guidance and the Commission reserves the power to add to or amend this list.
- By way of exemption as regards the financial sector, the Proposed Directive provides that, even if it is covered by sector-specific OECD guidance, it should not form part of the high-impact sectors covered. However, at the same time, the broader coverage of actual and potential adverse impacts in the financial sector should be ensured by also including very large companies in the scope that are regulated financial undertakings, even if they do not have a legal form with limited liability.
- Group 2 companies will be subject to the Proposed Directive two years from its application to Group 1 EU companies (based on the current expected timeline, from Q4, 2027 or Q1, 2028).

Non–EU companies

- Third-country incorporated companies with turnover generated in the EU in line with group 1 or group 2 thresholds, even if they do not have a physical presence in the EU.
- Non-EU companies will be subject to the Proposed Directive two years after its application to Group 1 EU companies (based on the current expected timeline, from Q3, 2027 or Q1, 2028).

Company

The definition of 'company' in the Proposed Directive is widely drawn. From an Irish perspective, it includes public and private companies limited by shares or guarantee, as well as partnerships, limited partnerships and unlimited companies. It also includes specified regulated financial undertakings, regardless of their legal form, including credit institutions, financial institutions, investment firms, alternative investment funds and their managers, UCITS and insurance undertakings.

Small and medium enterprises (SMEs) excluded[2]

While the Proposed Directive specifically excludes SMEs from its scope, such entities may be "exposed to some of the costs and burden through business relationships with companies in scope as large companies are expected to pass on demands to their suppliers".[3] There is a concept of "**established business relationships**" in the Proposed Directive (see further on this below) which may well bring SMEs within indirect scope of the Proposed Directive. The Proposed Directive therefore stipulates that support and financial aid (including from Member States) should be provided for affected SMEs.

[1] *Recital 22: "The following sectors should be regarded as high-impact for the purposes of this Directive: 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 from (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)."*

[2] *Article 3 of the Proposed Directive: "'SME' means a micro, small or a medium-sized enterprise, irrespective of its legal form, that is not part of a large group, as those terms are defined in Article 3(1), (2), (3) and (7) of Directive 2013/34/EU [the Accounting Directive]."*

[3] *See the Proposed Directive's Explanatory Memorandum: Legal basis, subsidiarity and proportionality.*

What must companies do?

Companies must carry out due diligence on their own operations, their subsidiaries, and their established direct and indirect business relationships throughout their value chains with a view to preventing or mitigating adverse impacts on human rights and the environment.

Established business relationships

Crucially, both upstream and downstream business relationships are captured and in-scope companies will have to look beyond tier 1 suppliers to "established business relationships" throughout the value chain, which contribute to the production of their goods or provision of services. This includes contractors, subcontractors and other entities in the supply chain. This will add further complexity to supply chain risk assessments and ongoing risk management.

The concept of an "established business relationship" is defined as "a business relationship, whether direct or indirect, which is, or which is expected to be lasting, in view of its intensity or duration and which does not represent a negligible or merely ancillary part of the value chain".

Adverse impacts

Adverse human rights and environmental impacts are defined with reference to a list of international conventions contained in an annex to the Proposed Directive. These cover a range of issues including forced labour, child labour, inadequate workplace health and safety, exploitation of workers, greenhouse gas emissions, pollution, biodiversity loss and ecosystem degradation.

Due diligence obligations

In order to comply with their due diligence obligations, companies will have to:

- integrate due diligence into corporate policies and have a dedicated value chain due diligence policy in place
- identify actual or potential adverse human rights and environmental impacts arising from their operations or those of their subsidiaries, and from their established business relationships
- take "appropriate measures" to prevent and mitigate potential adverse impacts
- bring to an end actual impacts (or minimise these where it's not possible to bring them to an end)
- establish and maintain a complaints procedure for certain prescribed persons and organisations
- monitor the effectiveness of the due diligence policy and measures (carry out qualitative and quantitative assessments at least every 12 months)
- publicly communicate on due diligence (companies not subject to the Non-Financial Reporting Directive will be required to publish an annual statement on their websites)

Non-EU companies will have to designate a legal or natural person, established or domiciled in a Member State where they operate, as their "authorised representative". This requirement is analogous to that in other EU legislation; such as non-EU entities complying with the General Data Protection Regulation (**GDPR**).

Where regulated financial undertakings provide credit, loans or other financial services, identification of actual and potential adverse human rights and environmental impacts need only be carried out before providing that service.

ALG comment

- In anticipation of the application of the Proposed Directive, we think companies will need to audit or review their value chains, to identify both their established business relationships and any exposure in relation to potential adverse impacts in their supply chains.
- Companies will need to assess their processes and internal controls so they can address the adverse impacts in their own operations.
- Companies will require access to reliable information on their suppliers in order to comply, something which may prove more difficult when dealing with non-EU-based suppliers. Developing a method by which to collect and standardise this information will be important and will need to be built into the process for on-boarding suppliers.
- Due diligence verification by independent third parties may also need to be considered in order to strengthen stakeholders' confidence in the process (for example, the proposed Corporate Sustainability Reporting Directive mandates external verification).
- Greater clarity on the concept of an "established business relationship" and what it means in practice will also be needed and it is hoped that guidance will be provided by the Commission and other sectoral bodies in due course.

Appropriate measures

The Proposed Directive requires companies to take appropriate measures to identify, prevent, mitigate and end adverse impacts. The appropriateness of a measure will be judged according to whether it is:

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

A company's influence over a business relationship includes:

- its ability to persuade the business relationship to take action to bring to an end or prevent adverse impacts (for example through ownership or factual control, market power, pre-qualification requirements, linking business incentives to human rights and environmental performance, etc.)
- the degree of influence or leverage that the company could reasonably exercise (for example through cooperation with the business partner or engagement with another company in the chain)

Bringing adverse impacts to an end

The Proposed Directive requires a company to bring actual adverse impacts to an end, or to minimise the extent of the impact where it cannot be brought to an end. In circumstances where the impact cannot be brought to an end, companies are required to consider a number of remedial actions, including:

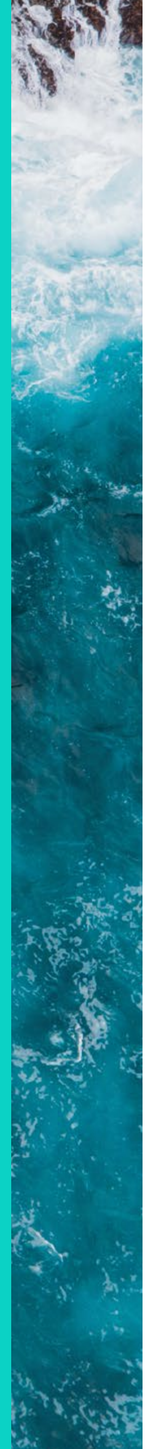
- payment of damages to affected persons and compensation to affected communities
- develop and implement a corrective action plan where the impact cannot be brought to an end immediately
- seek contractual assurances from an established business partner, including by seeking corresponding contractual assurances from its partners, to the extent that they are part of the value chain (contractual cascading)
- make necessary investments, such as into management or production and infrastructures

The Proposed Directive indicates that companies should prioritise engagement with business relationships in the value chain and termination of the relationship should be a last resort action. However, a company should:

- refrain from extending or entering into new commercial relations with a business partner where the impact has arisen
- to the extent legally possible, suspend commercial relations with the partner while pursuing measures to prevent, mitigate, minimise or bring to an end the impact

The Proposed Directive stipulates that a company should ultimately terminate a business relationship if the potential or actual impact is considered severe. In order to allow companies to fulfil that obligation, it is expected that Member States will provide for the availability of an option to terminate the business relationship in contracts governed by their laws.

There is some alleviation for financial institutions here: they are not required to terminate a financial services contract where doing so may reasonably be expected to cause "substantial prejudice" to the counterparty.



ALG comment

- At present, it is unclear how businesses will comply, in practice, with the requirements for 'appropriate measures' and bringing adverse impacts to an end.
- In some situations, suspending or ending a commercial relationship may lead to further human rights impacts which need to be assessed and managed (as noted in the UN Guiding Principles). Engagement is usually preferable, with termination as a last resort.
- Termination rights in commercial contracts will likely also need to evolve to give relevant companies the ability to exit a relationship where it has not been possible to mitigate adverse impacts.

Climate change

Group 1 EU companies and non-EU companies with the turnover of group 1 will also have to adopt a plan to ensure that the business model and strategy of the company 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.

The company's plan must identify the extent to which "climate change is a risk for, or an impact of, the company's operations". If climate change is or should have been identified as a principal risk or impact, the company must include emission reduction objectives in its plan.

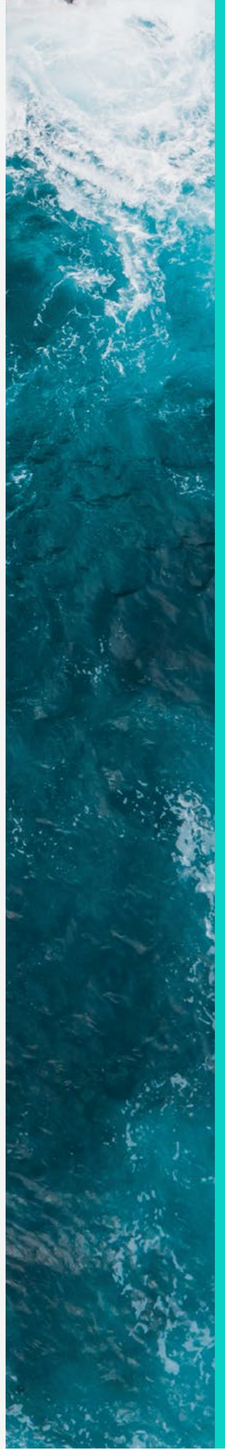
Obligations related to climate change plans must also be taken into account when setting variable remuneration, but only if that variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability. Furthermore, the directors' duty of care (for EU companies) will need to account for the consequences of their decisions on climate change, including in the short, medium and long term.

Directors' duties

The Proposed Directive introduces a duty of care for directors of EU-established companies, which may necessitate changes to directors' duties at national level (currently codified in the Companies Act 2014 in Ireland). Member States must ensure that directors take into account the human rights, climate change and environmental consequences of their decisions when fulfilling their duty to act in the best interests of the company.

Directors will also be responsible for:

- setting up and overseeing the implementation of the due diligence processes (adapting corporate strategy and formulating a due diligence policy)
- integrating due diligence into the corporate strategy



ALG comment

- Boards play a crucial role in corporate sustainability. The board's composition and directors' experience, competencies and continued professional development on sustainability matters will be instrumental to meeting the requirements of the Proposed Directive.
- Companies may need to consider appointing suitable personnel to the board with expertise in sustainability matters.
- Tools and standards to help companies assess their sustainability decisions are not yet fully developed and assessing a director's performance of their duties in this space may prove challenging in practice.
- It is as yet unclear if the codified directors' duties in the Companies Act 2014 will need to be amended as a result of the Proposed Directive to specifically account for these obligations.
- However, it is interesting to note that in the UK, where section 172 of the Companies Act 2006 codifies a broader approach to directors' duties (the so called 'enlightened shareholder' value standard), ESG-related litigation relying on section 172 has recently emerged.

Interaction with other sustainability legislation

The Proposed Directive builds on the UN's Guiding Principles on Business and Human Rights and OECD Guidelines for Multinational Enterprises on Responsible Business Conduct Matters, and is in line with internationally recognised human rights and labour standards.

It should not to be confused with the Proposal for a Directive on Corporate Sustainability Reporting (**CSRD**), published last year, which will replace the Non-Financial Reporting Directive. Whereas the CSRD is aimed at disclosure and accountability rules, the Proposed Directive will supplement this by requiring companies to consider their sustainability responsibilities at a more foundational level.

The Proposed Directive will also underpin the EU Sustainable Finance Disclosure Regulation (**SFDR**) which requires financial market participants to publish a statement on their due diligence policies with respect to principal adverse impacts of their investment decisions on sustainability on a comply-or-explain basis. It will also complement the EU Taxonomy Regulation, a transparency tool that facilitates decisions on investment and helps tackle greenwashing by providing a categorisation of environmentally sustainable investments in economic activities.

Publication of the Proposed Directive coincided with the publication by the Commission of a Communication on Decent Work Worldwide. This sets out the Commission's commitment to eliminate child and forced labour. It also includes plans for a new legislative instrument (form as yet unknown) to ban products made by forced labour from entering the EU market.

Enforcement

The rules will be enforced at Member State level through the establishment of a national supervisory authority.

Administrative supervision: The national supervisory authority will supervise companies and impose "effective, proportionate and dissuasive" sanctions, including fines and compliance orders. When pecuniary sanctions are imposed, they shall be based on the company's turnover.

At European level, the Commission will set up a European Network of Supervisory Authorities, which will bring together representatives of the national bodies to ensure a coordinated approach.

Civil liability: Member States must also ensure that victims get compensation for damages resulting from the failure to comply with the obligations of the new proposals.

Directors: The rules on directors' duties are to be enforced through existing Member States' laws on directors' duties. The Proposed Directive does not include an additional enforcement regime for directors who do not comply with their obligations.

ALG comment

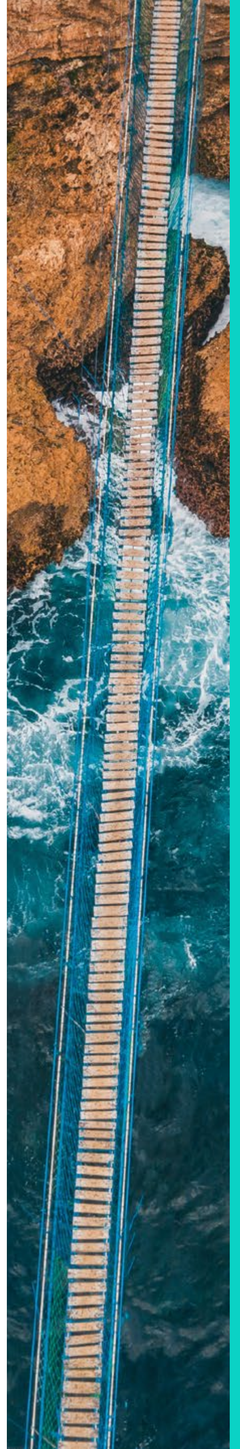
- A new civil liability regime could set the stage for an increase in human rights and environmental related litigation.

When will the proposed directive enter into force?

The road to publication of the Commission's proposal has already involved much debate and dissension and this is likely to continue. The Proposed Directive is unlikely to enter into force before the end of 2023 (at the earliest).

Member States will then have two years from the date of entry into force in which to introduce national implementing legislation, which will then apply to Group 1 companies. Group 2 EU companies (midcaps in high impact sectors) and third country companies will have four years from the date of entry into force (i.e. an additional two years) before the Proposed Directive applies to them.

It is anticipated that the European Commission will issue guidance and a set of voluntary model clauses to support companies in complying with their obligations under the Proposed Directive.



ALG practical recommendations

While the Proposed Directive is likely to change during the legislative process, waiting until it comes into force to begin the process of compliance is too late and risks exposing a company to administrative penalties, civil liability and reputational damage. With an understanding of the potential changes, and some early planning, in-scope companies can engineer a smoother transition to the new regime.

The text of the Proposed Directive, as it currently stands, gives a good indication of the scope and likely expectations of the human rights and environmental due diligence programme. To get ahead, companies doing business in the EU should:

- Assess whether they are likely to fall within the scope of the Proposed Directive and if so, whether this will be as a Group 1 company, a Group 2 company, or indirectly as a result of being a part of the value chain of such companies.
- Conduct high-level reviews of existing policies, systems and processes set up to identify and address adverse human rights and environmental impacts (looking at both the company's own operations and value chain, and how its products and services are used).
- Review existing value chain contracts and consider what mechanisms may be used or needed to enable compliance with the Proposed Directive, such as enhanced audit, suspension and termination clauses.
- Keep the Proposed Directive in mind when negotiating new business contracts or renegotiating existing ones. It may be sensible to draft or renegotiate agreements in compliance with the Proposed Directive, especially if the agreement is envisaged to still be in place when the Directive applies.
- Consider the efficacy of current due diligence verification procedures and annual reporting requirements on value chains.
- Build in a right to carry out independent audits on businesses in the company's value chain.
- Where deficiencies are identified, take preliminary steps to address these gaps in accordance with international standards, while remaining flexible enough to accommodate the eventual requirements of the Proposed Directive.
- Give the Proposed Directive due consideration and time. The onerousness of the task will depend on factors such as the size and global reach of the company and also on the level of analysis of human rights and environmental impacts that has been conducted to-date. Even companies with sophisticated systems in place will likely have to undertake significant expansion to comply with the new legislation. A report commissioned by the French Ministry of Economy on the French law of vigilance noted that it took about three years for companies to map out human rights risks in their supply chain.

A&L Goodbody

We are actively engaged in this area and will be publishing further updates and best practice in the months to come. Check out our ESG and Sustainability Hub to stay informed.

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OECD Guidelines for Multinational Enterprises on Responsible Business Conduct Matters	READ MORE