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The future Due Diligence Directive and its possible effects outside the EU

1. Executive summary

Once enacted, the Corporate Sustainability Due Diligence Directive currently under legislative discussion (the "**future Directive**") will direct European Union ("**EU**") Member States to require companies to adopt measures to prevent, mitigate, eliminate and minimise adverse effects on the environment and human rights resulting from their activities along their value chain.

Following the adoption of the position of the Council of the European Union (the "**Council**") and the European Parliament (the "**Parliament**") on the text proposed by the European Commission (the "**Commission**" and the "**Proposal**", respectively), negotiations between the three institutions (the trilogues) have started. The final text is expected to be adopted before the European Parliament elections in June 2024. After its adoption, Member States will have a period of two years to transpose the provisions of the future Directive into national law.

The Proposal is one of the most significant initiatives of the *EU Green Deal*, which includes numerous legislative measures on sustainability at EU level and seeks to promote, among other objectives, sustainable business practices. According to the Proposal, the Directive will provide a minimum threshold for Member States, expressly establishing the principle of non-regression in the protection of human rights, the environment and the climate, as provided for by the national legislation of Member States.

Under the Proposal, EU-domiciled companies, as well as companies from third States with substantial business activities within the EU, will be required to implement due diligence measures in their business relationships—direct or indirect—across their value chain. Although the scope of the term "value chain," which the Council has expressed reservations about, is yet to be defined, it is generally understood to encompass any association a company has with contractors, subcontractors or other companies that receive funding from the company, or otherwise contribute to activities related to the company's products and services.

Companies that fail to comply with their due diligence obligations with respect to the environment and human rights may be subject to sanctions and may be exposed to civil liability arising from the resulting adverse effects, with a consequent increase in litigation.

Both EU-based companies and entities from third States interacting with EU companies, should ready themselves for the impending implementation of this regulatory framework. Harmonising the due diligence obligations and contractual clauses covering, among others, guarantees, contractual termination and dispute resolution will be crucial. This proactive approach will not only pre-empt potential exposure, but also address liability issues stemming from non-compliance.

Currently, the positions of the Council and the Parliament differ on key points, so it is difficult to know what level of obligations will be required from companies. In any case, it is certain that this Directive will create new obligations, which must be implemented by companies, once the Directive is transposed in each Member State, and taking into account the transitional periods that may be established.

2. Scope of the future Directive

Article 2 of the Proposal establishes the subjective scope of the Directive. Although there are differences between the positions of the Council and the Parliament regarding the scope established by the Commission in its Proposal, it appears that the Directive will apply to companies domiciled in EU Member States and, under certain circumstances, to companies domiciled in third States outside the EU:

i) For companies domiciled in EU Member States, the criterion used to determine the application of the obligations of the Proposed Directive is based, firstly, on the number of employees[1] and, secondly, on the revenue generated[2]. It appears that the thresholds will have to be met both at the level of individual companies and at group level[3].

ii) For companies domiciled in third States, the focus will be on the revenue generated by the company within the EU[4].

3. How will the Proposed Directive affect companies that are required to comply?

A. Due diligence obligations required of companies that fall under the subjective scope of the new regulatory framework

The Proposal imposes due diligence obligations on companies. Some countries have already adopted legal frameworks based on due diligence or a duty of care, such as France (*Loi relative au devoir de vigilance*) and Germany (*Act on Corporate Due Diligence Obligations in Supply Chains*). Equivalent legislation is in the pipeline in the Netherlands.

The key feature of the Proposal is that, for the first time, the EU will require Member States to impose strict obligations on companies to identify, prevent, report, supervise, mitigate and minimise risks relating to the environment and climate change, social and labour rights, and governance[5].

Companies subject to the scope of the future Directive will be required to prepare environmental and human rights risk analyses of their activities, establish a due diligence plan, and implement measures for risk prevention and the mitigation and remediation of actual adverse effects, with adequate control and supervision of compliance. Articles 5 to 11 of the Proposal include a list of concrete measures to be taken by companies in the framework of this duty of diligence[6].

In their positions, both the Council and the Parliament have mandated regulated companies to develop due diligence plans at group level, tasking parent companies with ensuring their subsidiaries' compliance.

1. Regarding this criterion, the Parliament's position has lowered the threshold proposed by the Commission from 500 to 250 employees.

2. Similarly, the Parliament has reduced the threshold proposed by the Commission from EUR 150 million in total to EUR 40 million in total in the last fiscal year for which annual financial statements have been prepared. For its part, the Council proposed that these conditions had to be met for two consecutive fiscal years for the Directive to apply.

3. The Commission's Proposal required these conditions to be met at the level of individual companies, and provided that at least 50% of revenue was generated in the so-called "high impact sectors" - defined as textiles, agriculture and mineral resource extraction. While the Council maintained this understanding in its position, the Parliament deleted it and required these requirements to be at group level, regardless of the sector of activity.

4. It appears that companies with a revenue of more than EUR 150 million will be covered by this regulation provided that at least EUR 40 million of that revenue was generated within the EU. The Commission's Proposal included the additional requirement that where the threshold of EUR 150 million generated in the EU is not exceeded, but the revenue was generated in one of the "high impact sectors", the Directive would also apply. The Parliament proposed that, instead of the "high impact sectors" criterion, companies that do not exceed these thresholds but are the parent companies of a group with more than 500 employees and a revenue of more than EUR 150 million, of which at least EUR 40 million is generated in the EU, should be subject to the Directive.

5. It should be noted that among the adverse effects that companies must prevent, the risk of global warming is expressly included in Article 15 of the Proposed Directive, meaning that companies must adopt a transition plan aligned with the emissions targets set by the EU to reach net zero emissions by 2050, and the emissions reduction targets for 2030.

6. Among other issues, companies are obliged to: (i) carry out an action plan, with clearly established milestones and deadlines, describing the risks identified and the measures that will be taken in the short, medium and long term by group companies to prevent them and mitigate possible adverse effects; (ii) determine the magnitude of the adverse effects and damage that the group's activities, or those of its business partners, may cause; (iii) establish consultation, reporting and complaint procedures; and (iv) implement continuous internal monitoring and control mechanisms.

Regulated companies must also anticipate any potential adverse effects caused by entities in their value chain, providing for contractual mechanisms to uphold the company's standards of conduct. Should these mechanisms prove inadequate in mitigating such risks, companies may temporarily suspend business relationships or terminate the contract with the respective business partner.

B. Consequences of non-compliance with due diligence obligations

Companies failing to fulfil the obligations imposed by the Proposal may face sanctions by the supervisory authorities designated by Member States. Further, under Article 22 of the Proposal, non-compliant companies will bear civil liability for any damage resulting from their non-compliance or that of their business partners in the value chain, provided such non-compliance should have been identified, prevented and mitigated. The latter scenario could occur, for example, if a company has not adopted measures to identify, prevent and mitigate labour rights violations committed by its business partners in third States.

The nature of the liability regime and its scope are yet to be determined, and this is expected to be one of the issues of major debate among the Institutions before the final text is adopted. While the text initially proposed by the Commission includes a system of strict liability, the positions of both the Council and the Parliament include the concept of fault-based or negligent civil liability. The possible exemption from civil liability of a company in cases where the fault is exclusively attributable to the supplier or business partner acting in the value chain, which was included by the Council in its position, will also be strongly debated.

4. How will the Proposed Directive affect third-party companies that have business relationships with entities to which the new regulation applies?

The Proposal will have implications for companies both inside and outside the EU, as the obligations imposed on companies to which the new regulatory framework applies within the EU will, in turn, require changes in their relationships with their partners located in third States with which they do business.

Faced with potential sanctions or incurring liability, both companies subject to the new regulatory regime and their value chain partners must adapt to these new rules. The Proposal sets out measures to prevent potential adverse effects, which have been fine-tuned in the Council's and the Parliament's positions. Those measures include:

i) Adopting contractual mechanisms in agreements concluded with third-party value chain partners, aimed at ensuring their adherence to due diligence obligations established at company or group level (Articles 7.2 and 8.3 of the Proposal). In its position, the Parliament stated that such clauses should be "reasonable, non-discriminatory and fair", accounting for the capacity of business partners. Recital 34 of the Proposal states that such mechanisms should be accompanied by measures taken by the company itself to ensure that its business partners are able to comply with its code of conduct. In this regard, the inability of a third party to comply with due diligence obligations should not lead to a disengagement by the company or to an immediate contractual termination.

ii) Conducting and promoting the necessary investments for companies to ensure that their business partners can comply with the Code of Conduct (Articles 7.4 and 8.5 of the Proposal). The Parliament's position on this section added that this type of contractual mechanism will not entail a transfer of the company's liability to exempt it from carrying out its due diligence obligations. Although contractual guarantees do not exonerate the company from liability, their incorporation into contracts with business partners will streamline the company's ability to pursue legal action if the latter has not adequately complied with the due diligence standards.

iii) The temporary suspension or termination of business relationships concerning activities that risk causing adverse effects (Articles 7.5 and 8.6 of the Proposal). The termination of existing contracts should be a last

resort. The Parliament's position states that, before taking unilateral termination measures, companies should assess whether the harm of termination outweighs the adverse effects that it seeks to prevent or mitigate. In this respect, the current text obliges Member States to ensure that contracts governed by their laws allow for the option to terminate.

The use of such contractual mechanisms is primarily aimed at enabling companies to take action in the event of non-compliance with the standards set forth by the company under the future Directive. Thus, if a company were to be sanctioned and/or held civilly liable for any breach of due diligence obligations for acts committed by third parties with whom it has a business relationship, it would have the option of seeking redress against its business partners for breach of contract. This is provided that the company can prove that it has adopted the due diligence measures it was obliged to adopt under the future Directive.

The following consequences can be expected:

i) Firstly, the indirect effects that the future Directive will have beyond the borders of the EU will mean that there will be a tendency to apply European sustainability due diligence standards to companies incorporated and operating outside the EU. To the extent that companies bound by the regime of the future Directive impose contractual obligations on their business partners to comply with their codes of conduct, this will lead to an indirect application of the provisions of the future Directive to companies located in third States, which will have to comply with the same standards.

ii) In addition, increased litigation between EU companies and their business partners can be expected. Sustainability litigation is becoming increasingly relevant in several Member States. Litigation arising from potential adverse effects caused by companies' failure to comply with their due diligence obligations will be joined by contractual liability litigation against business partners in the value chain. Given the typically transnational nature of these types of contracts, it is foreseeable that dispute resolution clauses will include the submission of such disputes to arbitration, with a consequent increase in arbitration proceedings arising from a breach of due diligence standards in the areas of sustainability and human rights.

5. Conclusion

The future Directive on due diligence will have significant implications for companies inside and outside the EU regarding the adoption of measures to prevent, mitigate, minimise and eliminate adverse effects in relation to the environment and human rights.

The Proposed Directive focuses on the liability of companies for breaches of these obligations in their value chains. This liability will foreseeably entail an increase in the identification, prevention, reporting, supervision, mitigation and elimination measures that companies adopt towards their business partners with whom they have contractual supply relationships. These measures may include appropriate contractual requirements for manufacturing and supplying companies to comply with the code of conduct and the diligence plan established by companies, as well as, as a last resort and if other mitigation and prevention mechanisms have not worked, contractual termination in the event of non-compliance by the supplier with these duties of conduct. This will also entail an increase in civil liability litigation, both contractual and non-contractual, to determine the existence of a breach and compensable damage resulting from a lack of due diligence on the part of companies or their business partners.

Companies falling under the scope of the future Directive should prepare for the entry into force of this regulatory framework and follow the approval process to implement the necessary changes in their relationships with partners in their value chain, including reviewing and adapting existing contracts and updating compliance protocols in anticipation of these changes.

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