RocaJunyent Informs

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Analysis of the proposal for a European Directive on Corporate Sustainability Due Diligence

On 9 June we published an information alert on our blog following the European Parliament's approval of the amendments to the proposed Corporate Due Diligence Directive, the "CSDD" (also known as "CS3D" or "CSDDD") on sustainability made by the European Commission in February 2022, which led to the start of "tripartite" negotiations.

With the start of the trilogue phase, it is hoped that the remaining uncertainties will be addressed and that the final text can effectively contribute to the protection of human rights, with a focus on child labour and exploitation of workers, and the environment, pollution and biodiversity loss.

Some of the most relevant points of the proposal are discussed below:

I. Scope of application

The proposal targets both EU companies and non-EU companies operating in the EU, which would help to level the playing field. However, the three bodies exclude small and medium-sized enterprises and refuse to explicitly consider the financial sector as a high-impact sector, contrary to OECD guidance. That is, it would only apply to very large companies reaching high thresholds of employees and turnover.

This narrow scope of application is not in line with UN and OECD standards, which apply proportionally to all companies, and does not take into account the principle of subsidiarity, i.e. it does not recognise that all companies can harm human rights and the environment.

Even in the clearly insufficient list of sectors recognised by the Commission as high impact, only large companies would have due diligence obligations under this proposal, which has opened up a great deal of debate.

The Council proposes to exclude the financial sector from the scope of the Directive, a position which has been endorsed by the Member States. However, it proposes the inclusion of a review clause, which implies that the financial sector could be affected in the future. Furthermore, it proposes additional adjustments related to access to justice for victims of adverse effects caused by companies, the obligation to put in place a climate transition plan and link it to executive remuneration, etc.

II. Material scope

The proposal includes an incomplete list of human rights violations along with a general clause referring to UN and ILO instruments. Most worrying, however, is the scant definition of environmental impacts, which is reduced to a remarkably insufficient list of violations of environmental standards. Nor is there any reference to general principles of environmental law such as prevention, precaution, rectification at source and "polluter pays" principles that companies should respect.

III. Definition of the "value chain" concept

The Commission envisaged the establishment of due diligence obligations throughout the value chain, but only for so-called "established business relationships". Thus, business relationships that are not (or are not expected to be) long-lasting, in view of their intensity or duration, would fall outside the scope of application. This approach could encourage companies to resort to precarious recruitment and informal relationships to circumvent the Directive.

It is not clear what is the minimum duration of a business relationship to be considered "established". It is essential that the scope of the value chain clearly encompasses the less stable layers of work, including semi-formal and informal work systems, as well as informal subcontracting and home-based work.

The Parliament and the Council, however, have adopted a different perspective from that of the Commission, proposing the expansion of due diligence obligations beyond established business relationships. However, by delineating the activities requiring due diligence along the value chain, both bodies seek to avoid an unlimited expansion of due diligence obligations. Both institutions maintain the responsibility of companies with respect to their own activities, those of their subsidiaries and throughout their value chain. However, they restrict the activities included in the value chain, which cover the production, design, sourcing and manufacture of a product or service, as well as its distribution, transport, storage and waste management. Although some of these operations are linked to the downstream stages of the value chain, this limitation persists in the positions of both institutions.

IV. Civil Liability

The CSDD provides for civil liability for breach of due diligence, although it does not delimit the scope and conditions for such liability.

By establishing due diligence obligations in dealing with subsidiaries and business partners and liability for non-compliance with these obligations, the CSDD functionally extends civil liability to the company's operations within the group and along the value chain. The effectiveness of this approach depends on the extent of due diligence. The European Commission, Council and Parliament have adopted different approaches reflecting different sensitivities to the problems of companies in overseeing their subsidiaries and value chains.

The main issue in due diligence liability centres on the scope of corporate groups. A parent company could avoid liability for environmental or human rights violations by operating through controlled companies that do not qualify as subsidiaries under the CSDD. Alternatively, a non-EU parent company could operate in the EU through subsidiaries that do not fall within the definition of the Directive. The European Commission's proposal allowed for both strategies by defining corporate groups conservatively based on the Transparency Directive, using the vague notion of "dominant influence" to establish control of subsidiaries. In addition, no turnover thresholds were established to determine inclusion in the scope of application. The European Parliament introduced two innovations: indirectly controlled subsidiaries are included in the group of the ultimate parent company, and a company is considered in scope if it is the ultimate parent of a group with a worldwide turnover of more than EUR 150 million (of which EUR 40 million in the EU). This turnover is not only consolidated, but also includes turnover generated by third parties with which any member of the group has a vertical royalty agreement.

A second key aspect of the proposal's scope is business partners triggering due diligence obligations and potentially value chain liability. Including indirect partners could be problematic because a company may be liable for human rights and environmental harm that occurs at a distance, both geographically and in contractual terms. On the one hand, companies may object that their ability to monitor indirect partners and prevent them from causing harm is limited. On the other hand, companies may strategically outsource the most dangerous activities to indirect partners to minimise liability exposure.

The proposed Directive envisages a fault-based civil liability regime, without considering disparities between companies and individuals. The European Commission included indirect partners in the scope of the Directive, but only if they were part of "established commercial relationships".

The Council's political compromise ruled out this approach altogether, but also limited the scope of liability in two important ways. One was to exclude indirect partners from due diligence, establishing supply chain liability rather than value chain liability. Secondly, liability could only be imposed in case of intent or negligence on the part of the company and if the business partner was not the sole tortfeasor. Like the Commission, the Council left the question of the burden of proof to the Member States, a particularly complex issue that could render liability ineffective.

The European Parliament's version differs considerably in terms of scope and conditions of liability. The scope of due diligence includes the entire value chain, including indirect partners. As the scope of due diligence is no longer limited to "established business relationships", the Parliament limited the scope of due diligence obligations, making them risk-based. That is, companies are expected to avoid or mitigate potential adverse human rights and environmental impacts to the extent that they are "likely" and "serious". Moreover, given their scarce resources compared to potentially long value chains, companies can prioritise adverse impacts based on these criteria. Although the Parliament has strengthened the definition of likelihood and severity, these criteria remain vague and could allow companies to escape liability.

The Parliament adopted a stricter position in terms of liability than the Council. Article 22 provides for liability for damages if the company contributed to adverse human rights or environmental impacts by failing to take adequate due diligence measures. The notion of "contribution to an adverse impact" differs significantly from the Council's position, eliminating the defence of exclusive causation and considering that the company may have caused, facilitated or encouraged the adverse impact. This approach could address strategic outsourcing of hazardous activities. However, it may be problematic if claimants must demonstrate not only the inadequacy of due diligence, but also that the company's procedures "encourage or motivate an adverse impact by another entity", as victims and their representatives may not be aware of these procedures.

This is why the Parliament has also addressed the burden of proof by encouraging Member States (by removing the matter from EU competence) to some extent to reverse the burden of proof.

Secondly, in an amendment to Art. 22 CSDD, the Parliament asked Member States to allow national courts to order the disclosure of additional evidence under the control of the undertaking if the claimant "provides elements justifying the likelihood of an undertaking's liability" under the Directive.

V. The scope of criminal sanctions for non-compliance

Under the Commission's proposals, which are in line with traditional practice in this respect, Member States would designate supervisory authorities that would determine coercive sanctions. In other words, EU Member States retain considerable discretion in the implementation of the Directive, together with the obligation to set up a national supervisory regulatory body to enforce it.

Parliament's proposal would extend the scope of sanctions to provide for public statements of censure against companies and the suspension of their products from normal free circulation rights in the single market and export rights. Parliament also proposes that the ceiling for monetary penalties should not be less than 5% of the overall turnover of the company concerned in the financial year preceding the decision to impose such a penalty. It also proposes that companies from third countries (i.e. those established outside the EU/EEA) may be excluded from public procurement procedures if they fail to comply with the Directive.

In short, there are many controversial issues to be addressed in this trilogue phase. The successful resolution of these issues is crucial to the achievement of the CSDD's goal of correctly defining the scope and achieving full harmonisation in order to avoid fragmentation of the EU single market and to ensure a level playing field. This is a continuing concern for the European Union and for the member states. Some countries have already made progress internally, such as France, which legislated for the first time on due diligence in 2017 (*Loi sur le devoir de vigilance*) or Germany, which passed its due diligence law in July 2021 (*Sorgfaltspflichtengesetz*). In Spain, there is also a draft bill on the protection of human rights, sustainability and due diligence in transnational business activities. Although gradual progress can be observed in this regard, there are certain shortcomings that need to be addressed in order to achieve correct and effective implementation, and the CSDD needs to be able to meet this challenge.

There is a general consensus that the Directive could be finally adopted in the course of 2024 given the broad public support and the 2022 Joint Statement of Legislative Priorities of the European Parliament and the Council.