Professional Perspective

EU Mandatory Corporate Due Diligence & Accountability

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The European Union rapidly marched toward a requirement that companies doing business in the EU conduct broad human rights due diligence across their operations and value chains. On Feb. 11, 2021, the European Parliament's Committee on Legal Affairs (JURI Committee) published a revised report containing a draft directive that MEPs described as "ambitious," "broad," and "comprehensive."

Indeed, it is vast in scope, would require many EU-based and global businesses—including those providing financial products and services—to create new internal systems and processes, and contemplates potential penalties and liability for companies, managers, and even directors. As we await the Commission's formal proposal, which would then be considered by the European Parliament and Council, we now have a clear roadmap of what seems likely to follow.

Below are the top 10 questions that the European Parliament's text tries to answer:

1. If I am a non-EU business with global operations, including in the EU, would the draft Directive apply to me?

Almost certainly. The report stresses the need to cover businesses that are outside of the EU but active on the EU's internal market. The draft directive applies to large businesses and publicly listed or high-risk SMEs, whether based in the EU or selling goods or providing services in the EU (Art. 2). Accordingly, regardless of where the company is headquartered, if it does business in the EU, the Directive would apply.

The report recommends that the directive should cover all sectors. It includes state-owned or controlled enterprises, and calls upon states to require these undertakings to procure services only from businesses that have complied with due diligence obligations. The text encourages states not to provide state support (including through aid, public procurement, export credit or loans) to "undertakings that do not comply with the objectives of [the draft] Directive."

2. Is the Directive limited to human rights issues?

No.

Although colloquially referred to as a "mandatory human rights due diligence" measure—likely influenced by existing frameworks and standards—the Commission has described a potential new due diligence duty as addressing companies' adverse sustainability impacts more broadly, including "climate change, environmental [and] human rights (including workers and child labour) harm."

This is unsurprising, given that the initiative is part of the EU's European Green Deal policy framework and is in keeping with other normative and policy developments combining environmental and social matters. The Commission's Inception Impact Assessment and public consultation used the term "governance," not as a separate category of possible impacts, but to describe how corporates should ensure they meet their sustainability obligations in practice.

The European Parliament has framed its draft Directive as being "on Corporate Due Diligence and Corporate Accountability," and it has a still broader scope. It covers three categories of potential or actual adverse impact (Art. 1), which it defines (Art. 3) as those on:

- **Human rights**, defined broadly to include "any potential or actual adverse impact that may impair the full enjoyment of human rights," including social, worker, and trade union rights. While these rights would be set out in an Annex to the Directive, and reviewed on a regular basis to ensure consistency with the EU's evolving objectives on human rights, the preamble refers to the International Bill of Human Rights, UN human rights instruments relating to vulnerable groups, principles in ILO core conventions, regional conventions on human rights, and "national constitutions and laws recognising or implementing human rights."
- **The environment**, meaning "any violation of internationally recognised and EU environmental standards." Again, while these would be set out in an Annex, the preamble states that the impacts should include—but not be limited to—"production of waste, diffuse pollution and greenhouse emissions that lead to a global warming of more than

1.5°C above pre industrial levels, deforestation, and any other impact on the climate, air, soil and water quality, the sustainable use of natural resources, biodiversity and ecosystems."

- **Good governance**, concerning "the good governance of a country, region or territory, as set out in [an] Annex." On this point, the preamble makes it clear that the Directive is intended to cover corruption and bribery, and to include situations in which a business "becomes improperly involved in local political activities, makes illegal campaign contributions or fails to comply with the applicable tax legislation."

While companies may have diligence processes that consider some of these issues, few companies cover them all. A February 2020 Commission study found that only 16% of business respondents said their due diligence currently takes into account all human rights and environmental impacts covering the entire value chain. The number who also include risks to good governance, including corruption, illegal campaign contributions and compliance with tax laws—for their own operations and throughout their business relationships—will be decidedly less.

3. What does the draft Directive actually require?

At its core, the draft would require EU Member States to introduce rules to compel businesses to "carry out effective due diligence with respect to potential or actual adverse impacts on human rights, the environment and good governance in their operations and business relationships" (Art. 4), as defined above. The due diligence obligation would be subject to the principles of "reasonableness and proportionality" (Preamble and Art. 4), although interpretations of those terms will obviously be subject to debate.

Specifically, the draft requires that businesses "make all efforts within their means to identify and assess" on an ongoing basis and through risk-based monitoring, "whether their operations and business relationships cause or contribute to or are directly linked to any of those potential or actual adverse impact[s]" (Art. 4). Businesses would be expected not to pass their due diligence obligations on to their suppliers (Preamble).

If the business concludes that it does not cause, does not contribute and is not directly linked to such potential or actual adverse impacts, it would have to publish a statement to that effect, along with its risk assessment, which must be reviewed if new risks emerge or the business enters new business relationships that can pose risks.

However, if the business concludes that it does cause, does contribute or is directly linked to such potential or actual adverse impacts, it must establish and effectively implement a due diligence strategy. As part of this strategy, the business would have to:

1. Specify the potential or actual adverse impacts identified and assessed, and their level of severity, likelihood, and urgency, together with the data, information, and methodology on which such conclusions are based

2. Map its value chain (upstream and downstream) and, with due regard for commercial confidentiality, publicly disclose "relevant information" about its value chain, "which may include names, locations, types of products and services supplied, and other relevant information concerning subsidiaries, suppliers and business partners";

3. Adopt and indicate all proportionate and commensurate policies and measures with a view to ceasing, preventing, or mitigating the identified potential or actual adverse impacts

4. Develop an approach to prioritization if all the risks cannot be addressed at once

5. Ensure that their business strategy and their policies are in line with their due diligence strategy, and explain this is their due diligence strategy

6. Ensure that their business partners put in place and carry out human rights, environmental, and good governance policies that are in line with its own due diligence strategy, for instance by using framework agreements, contractual clauses, codes of conduct, and certified and independent audits

7. Ensure that its purchase polices do not cause or contribute to potential or actual adverse impacts

8. "Regularly verify" that subcontractors and suppliers comply with their relevant obligations

The strategy or risk assessment would have to be made public and communicated to workers' representatives, trade unions, business relationships and—on request—to a relevant national authority (Art. 6). The business should evaluate the strategy and its implementation for "effectiveness and appropriateness" at least annually, and revise it as necessary (Art. 8).

Coupled with the broad substantive scope—see #2 above—few companies are currently in a position to meet this core requirement. It would require a detailed mapping of operations and business relationships, a methodology to assess associated potential impacts, the development of policies, procedures and mitigating measures across operations and third parties, and audits to assess compliance. It would also necessitate extensive substantive expertise across a range of subjects. For all but perhaps a few companies, the draft Directive would be transformative in its demands, legally mandating that responsible business conduct becomes an imperative integrated into the company's planning and activities on a global basis.

Indeed, the Commission's initiative has been heralded in these terms by some policymakers, civil society organizations, and business leaders.

4. Is this core requirement limited to assessing my EU operations only, or is it broader? Does it cover risks associated with non-EU business activities?

While the draft Directive does not prescribe who the reporting entity should be, it does state that subsidiaries shall be deemed to be complying with the obligation to create a due diligence if their parent company includes them in its own due diligence strategy.

The draft Directive does not specify whether the "operations" in question can mean just EU operations or if global operations unrelated to the EU must be taken into account, but the broader interpretation appears to be the better one. Certainly, it is clear that the Directive would extend beyond a company's own operations, and at least will extend to all business relationships associated with activities conducted in the EU.

Further, the report is clear that businesses would be required to make "all proportionate and commensurate efforts within their means to identify their suppliers and subcontractors" and "due diligence should not be limited to the first tier downstream and upstream in the supply chain but should encompass those that, during the due diligence process, might have been identified by the undertaking as posing major risks."

5. In developing our due diligence strategy, could we rely on our own internal assessment activities, or must we consult external stakeholders?

The draft provides that companies would have to consult with relevant stakeholders, including trade unions, when establishing, implementing and revising their due diligence strategy (Arts. 5 and 8). In fact, it says that trade unions and workers' representatives should have a right to be involved in these activities "in good faith," although businesses may prioritize discussions with the most impacted stakeholders. The draft strongly implies that a failure to engage in "good faith effective, meaningful and informed" stakeholder consultations would be considered a legal breach, giving rise to potential penalties.

6. Must the report be signed or approved at the board level, like Modern Slavery Act statements? Are there other corporate governance requirements?

There is no explicit requirement that the due diligence strategy or risk assessment be approved or signed at board level.

The European Parliament envisages that for due diligence to be embedded in the culture and structure of an undertaking, the "members of the administrative, management and supervisory bodies" of the business should be responsible for adopting and implementing its sustainability and due diligence strategies (Preamble).

However, several significant provisions from earlier drafts of the report did not feature in the final adopted text, including text stating that:

- It would be the collective responsibility of a company's executives and directors, and any other administrative, management and supervisory bodies, to ensure that the diligence processes and business decisions—including remuneration policies—are consistent with the Directive

- Domestic laws should apply to such executives and directors, with the prospect of individual liability for company breaches
- The board of directors should have the appropriate knowledge, training, and experience in due diligence matters
- Large companies must establish an advisory committee, composed of stakeholders and experts, to inform the board "on due diligence matters and propose measures to cease, monitor, disclose, address, prevent and mitigate risks"

While some may be relieved to see these provisions omitted, the European Commission has placed significant emphasis on directors' duties, including publishing a separate study in July 2020. Indeed, one of the Commission's stated objectives is to "help companies' directors to establish longer-term time horizons in corporate decision-making … strengthen the resilience and long-term performance of companies through sustainable business models and help reducing adverse impacts." To achieve this, one of its identified policy options is director's duties to define, take into account and integrate stakeholders' interests and social and environmental risks.

7. What happens when someone believes a company is connected to serious risks, or has caused or contributed to a negative impact?

The draft Directive would require companies to provide grievance mechanisms that enable any stakeholder to "voice reasonable concerns regarding the existence of a potential or actual adverse impact on human rights, the environment or good governance" (Art. 9). It states expressly that grievance mechanisms should meet the criteria in UNGP Principle 31—e.g., it must be legitimate, accessible, predictable, safe, equitable, transparent, rights-compatible and adaptable.

While a grievance mechanism can be provided through collaborative arrangements with other undertakings or organizations, multi-stakeholder mechanisms, or a global framework agreement, the business would be obliged to "take decisions informed by the position of stakeholders, when developing grievance mechanisms".

The draft also requires EU member states to ensure that when a business identifies that it has caused or contributed to a relevant harm, it "provides for or cooperates with the remediation process," and when the business identifies that it is directly linked to such an adverse impact, it must "cooperate with the remediation process to the best of its abilities." Remedies may include financial or non-financial compensation, reinstatement, public apologies, restitution, rehabilitation or "a contribution to an investigation"—and prevent additional harm through "guarantees of non-repetition" (Art. 10).

8. Are there penalties for failing to conduct adequate diligence or for negative impacts? Can a company be liable where negative impacts are caused by entities in a value chain?

Liability can accrue for a failure to meet the diligence requirements, and can include the activities of business relationships.

The draft Directive states that each EU country would have to designate a competent governmental authority to oversee application of the Directive (Art. 12) and empower that authority to conduct investigations to ensure compliance, including examining due diligence strategies and the functioning of grievance mechanisms, and on-the-spot checks (Art. 13).

Where the competent authority identifies a failure to comply, the business would be given an opportunity to take remedial action (Art. 13) but will be liable to a "proportionate sanctions" if it does not do so. Sanctions should be "effective, proportionate and dissuasive" and should take into account the severity of the infringements committed and any repetition of the infringements (Art. 18). Sanctions may include fines calculated based on the business' turnover, exclusions from public procurement, State aid and public support schemes, including export credit and loans), seizure of commodities and "other appropriate administrative sanctions."

EU countries would be required to ensure they have a domestic liability regime that can hold businesses liable—and provide for remediation—for any harm arising out of potential or actual adverse impacts on human rights, the environment or good governance that they, or undertakings under their control, have caused or contributed to by acts or omissions.

This liability regime should ensure that businesses that "prove that they took all due care in line with this [draft] Directive to avoid the harm in question, or that the harm would have occurred even if all due care had been taken" are not held

liable for that harm, although respect by a business of its due diligence obligations would not constitute a defense to other civil liability under national law (Art. 19).

The JURI Committee's report had envisaged an expansion of the jurisdiction of EU courts to cover relevant civil cases and to introduce the principle of "forum necessitatis" to provide victims with access to a court, and accordingly proposed changes to the Brussels I and Rome II regulations. As expected, these provisions were dropped during the Parliament's plenary debate.

Instead, the report specifies that relevant provisions of the directive would be considered "overriding mandatory provisions" for the purposes of the Rome II regulation. This means that the requirements of the Directive, if passed by the EU and transposed, i.e., implemented, by EU member states, would have effect notwithstanding the law otherwise applicable in any tort of delict case, where a breach of a non-contractual obligation is alleged) that comes before a domestic court within the EU.

9. Will there be guidance in terms of reporting obligations?

The draft Directive repeatedly states that guidelines should be created to assist companies to understand and meet the new due diligence requirements. That would include:

- Guidance provided in consultation with Member States and the OECD (Art. 14)
- The establishment of a European Due Diligence Network of EU competent authorities to help to ensure "coordination and convergence of regulatory, investigative and supervisory practices, the sharing of information, and [to] monitor the performance of national competent authorities" (Art. 18)
- Giving EU Member States discretion to encourage the adoption of voluntary sectoral or cross-sectoral due diligence action plans to coordinate due diligence strategies (Art. 11)

Of note, and as expected, the draft states that the guidelines should take "due account" of other existing international standards, including the UNGPs, the OECD Guidelines for Multinational Enterprises, and various other ILO and OECD due diligence standards.

10. What are the next steps?

The European Parliament's recommendations and draft Directive will be sent to the European Commission, with a request that the Commission submits a formal legislative proposal following the recommendations in the draft report. The Commission will consider this alongside the results of its own public consultation process. The report will also be sent to the Council of Ministers and the governments of EU member states.

The Commission is expected to submit a legislative proposal in Q2 2021, which would then be debated by the European Parliament and the Council. Once finalized, each member state must transpose directives into its domestic law, and the draft provides that states would have 24 months to achieve this from the date the Directive is adopted. One point that remains to be seen is how this EU initiative will interact with the various national laws already adopted (France, Netherlands) or expected to be adopted in 2021 (Germany, Switzerland, Norway).

Jurisdiction	• EU-based enterprises, and non-EU enterprises doing business in the EU • Applicable to SMEs and state-owned companies
Scope	Potential and actual adverse impacts on: • Human rights • The environment • Good governance

Core Requirement	• Diligence on adverse impacts in their operations and business relationships. • If no such impacts identified, publish a statement so stating, with the risk assessment. • If impacts identified, establish and effectively implement a due diligence strategy that: o Specifies and explains impacts and underlying methodology o Maps the value chain, o Adopts and indicates proportionate measures to address the risks o Develops risk prioritization approach • Businesses must: o Ensure their due diligence strategy and policies are aligned with their business strategy o Ensure business partners put in place and implement relevant policies in line with its own due diligence strategy o Ensure that its purchase policies do not cause or contribute to adverse impacts o Regularly verify that subcontractors and suppliers comply with their relevant obligations
Grievances	• Companies to establish grievance mechanisms meeting UNGP 31 criteria • Where companies have caused or contributed to harm, they should provide for or cooperate with remediation • Where companies are directly linked to harm, they should cooperate with the remediation process to the best of their ability
Sanctions	• Liability for not meeting diligence requirements • Where a state identifies a failure to comply, it should give businesses time to remediate. If remedial action not taken, states can impose effective, proportionate and dissuasive sanctions taking into account severity and any repeat infringements. • Diligence is not a defense to civil liability, and Directive provisions would override any contrary applicable law in domestic courts of EU countries
Civil liability	• EU countries to ensure domestic liability regimes that can hold businesses liable—and provide for remediation—for harms from relevant impacts, caused or contributed to by a company's acts or omissions • Where a business took all due care to avoid the harm, or where taking due care would not have avoided the harm, should not be held liable • Respect by a business of its due diligence obligations would not constitute a defense to other civil liability under national law
Next Steps	• Draft Directive sent to the European Commission, with a request that the Commission submits a formal legislative proposal • The Commission's proposal is expected in Q2 2021