

Introduction

In February 2022, the European Commission (EC) [published the proposal for an EU Sustainable Corporate Due Diligence Directive](#), a long-awaited and long-debated piece of legislation that will bring forward obligations for companies to carry out due diligence across their supply chain and incorporate sustainability and human rights considerations within their business strategies, decisions and oversight.

The proposal's main objective is to improve the corporate governance practices and increase corporate accountability by introducing a set of tools and procedures that would contribute to prevent and remedy human rights violations, as well as environmental damage. The proposal also introduces remedies for stakeholders affected by the direct and indirect operations of businesses and proposes a number of civil liability and other types of penalties.

However, the provisions laid out in this proposal cannot be seen in isolation, as it counteracts the plethora of legal obligations across the EU. The duty to perform due diligence will complement the current requirements incorporated within the proposed [Corporate Sustainable Reporting Directive](#) (still under negotiation), while at the same time it will complement the [Taxonomy Regulation](#) and underpin the [Sustainable Finance Disclosure Regulation](#).

In this client alert, we will review and analyse the content of the legislative act, which has already caused important political commentary even before its publication. The proposed directive will certainly influence current business structures and will bring a new range of duties underpinning any business decision a company must take. If you are interested to understand the impact this legislation can have on your business, understand the interplay of the regulatory regime or wish to be informed or influence the ongoing policy debate, please do not hesitate to reach out to us.

Proposed Regulation on Sustainable Corporate Due Diligence

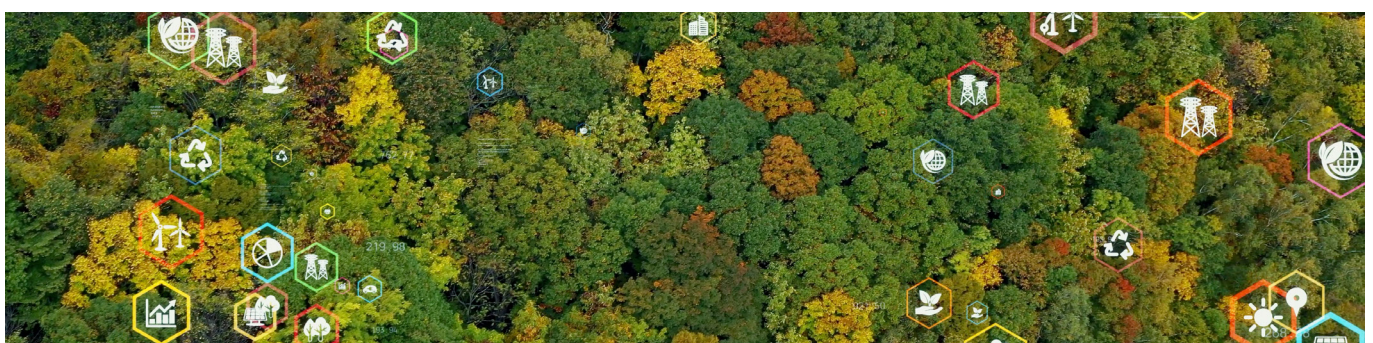
The scope of the directive has been a contentious element of the proposal that was amended during the preparatory drafting phase of the legislation. As proposed by the EC, there are three categories of companies for which the rules would apply:

- EU companies with more than 500 employees with a net turnover of more than €150 million
- Companies with more than 250 employees with a net turnover of more than €40 million, for which at least 50% of that net turnover was derived from a high-risk sector (textile manufacturers, agriculture, forestry, fisheries, extraction and trading of minerals)
- Non-EU companies with a net turnover of more than €150 million generated in the EU or non-EU companies with a net turnover of more than €40 million generated in the EU where at least 50% of the net worldwide turnover was generated in the high-risk sectors

The EC estimates that the directive will apply to 13,000 EU companies and about 4,000 non-EU companies. It is worth noting that SMEs (i.e. companies with less than 250 employees and with an annual turnover under €150 million) are exempted from the proposed rules, but could be indirectly impacted as a result of the actions taken by large companies with respect to this regulation.

Due Diligence Processes

The due diligence duties will be applied across companies' own operations, as well as their value chain. However, due diligence obligations are limited to established business relationships of companies, meaning direct and indirect business relationships. As such, companies will need to ensure the appropriate structures and processes are in place for their business relations (contractors and subcontractors), to guarantee appropriate actions can be taken when adverse environmental and human rights impacts are linked to such business relations.



In this context, companies must conduct human rights and environmental due diligence by:

- Integrating due diligence into their corporate policies
- Identifying actual or potential adverse impacts
- Preventing and minimising potential adverse impacts through developing and implementing prevention action plans
- Establishing and maintaining a complaint mechanism
- Monitoring the effectiveness of their due diligence policies and measures and reporting on these in their annual statements

To implement these due diligence requirements, companies in scope must establish a due diligence policy – to be updated annually – describing the approach to due diligence and a code of conduct detailing the rules and principles, as well as the processes to implement due diligence. The due diligence policy must also describe how to verify compliance with the code of conduct and how its application is extended to established business relationships.

Importantly, companies will be required to carry out periodic assessments of their own operations and measures, as well as those of their subsidiaries and their business relations (related to their value chain), to monitor the effectiveness, prevention, minimisation and mitigation of human rights and environmental adverse impacts. These assessments shall be based on qualitative and quantitative indicators and shall be executed at least yearly, or whenever there are reasonable grounds or risks that such adverse impacts can occur. Companies shall update their diligence policy to reflect the outcome of these periodic assessments.

Next to the due diligence duties, companies will be required to adopt measures to combat climate change. In particular, a plan shall be adopted to ensure the company's business model and strategy are compatible with the transition to a sustainable economy and the limiting of global warming to 1.5 degrees Celsius in line with the Paris Agreement. Such a plan will need to identify the extent to which the company's operations can pose a risk or have an impact on climate change, including with respect to the company's emission reduction objectives.

Directors' Duty of Care

The proposal introduces a duty of care that directors have towards their company. In accordance with the proposed rules, directors must take into account the consequences of their corporate decisions for sustainability matters, including – where applicable – human rights, climate change and environmental consequences in the short, medium and long term.

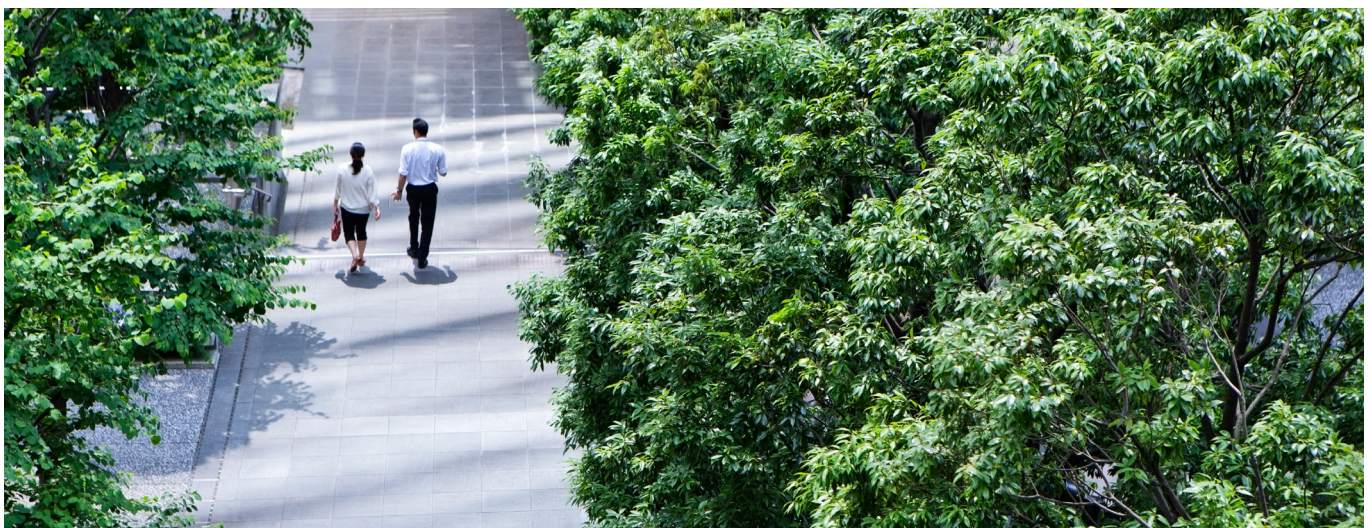
Company directors will also be responsible for setting up and overseeing the due diligence actions and the due diligence policy, and shall take into consideration the input from stakeholders and civil society organisations. Based on the due diligence actions and policy, directors would also have duties to take steps to adapt the corporate strategy and integrate the actual and potential adverse impacts linked to human rights, climate change and the environment. Directors must also report to the board of the company with respect to the implementation of the corporate sustainability due diligence actions.

Penalties

The proposed directive offers Member States the discretion to designate one or more national supervisory authorities to monitor the implementation of companies' due diligence obligations. Powers to the national supervisory authorities are also granted to carry out investigations, either on their own initiative or based on complaints or substantiated concerns raised under this directive. In the latter case, a civil liability for the company can be considered in case a company fails to carry out adequate due diligence, and will be limited to established business relationships with which a company has cooperation.

Member States will be required to incorporate provisions with respect to the breach of directors' duties, within their national implementation of the directive.

Finally, penalties for non-compliance with the law can be decided by national supervisory authorities, either in the form of remedial actions or financial penalties based on turnover. Close cooperation between the national supervisory authorities is also recommended within the proposed rules, to ensure EU-wide coordination and harmonised enforceability of the rules.



How We Can Help

This is an ambitious and far-reaching legislative proposal, which, when enacted, will have a lasting effect on the ways companies conduct their business and corporate behaviour. Transparency is being used as a lever to deliver change. The exclusion of SMEs will reduce the impact to an extent, but as noted above, the effect of the legislation will affect SMEs indirectly. Companies operating in the EU can expect to be held to account to higher standards of environmental, social and governance (ESG) performance.

The EC proposal will require businesses to develop or reassess existing responsible sourcing programmes within their business to ensure they will be prepared to comply with the duties embedded in the proposal. Naturally, as the EU-level negotiations progress, it can be expected that some of these duties will be extended, or even become more stringent (some MEPs have criticised the Commission proposal as not setting high enough standards). As such, it will be advisable for companies to put in place preparatory mechanisms to ensure they will be adequately prepared when the legislation is adopted. This can include processes to audit supply chains for adverse human rights and environmental impacts, as well as introducing robust, risk-based supply chain due diligence practices as a mitigating tool.

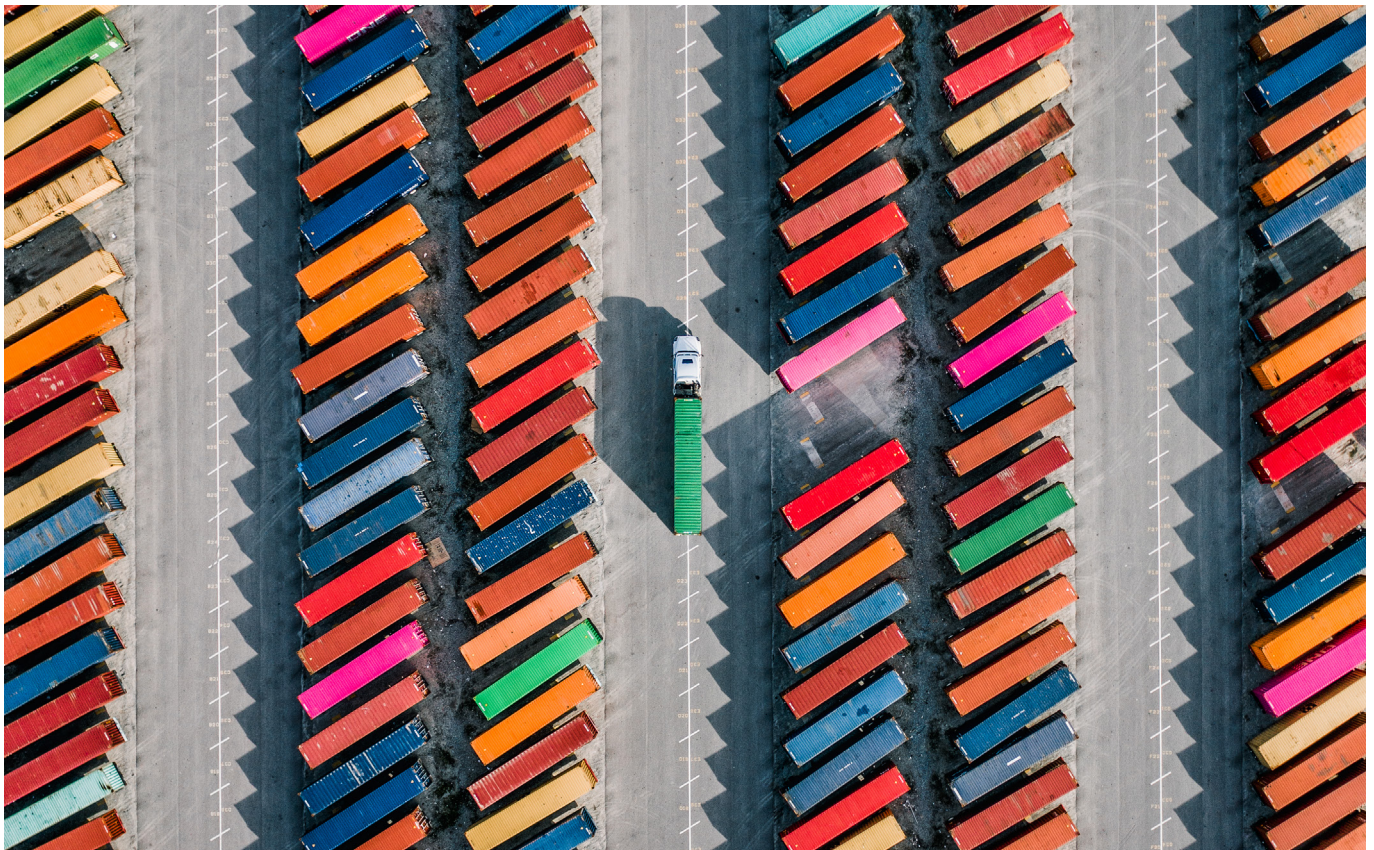
More importantly, as outlined above, the fact that this proposal will work in tandem with existing EU legislation will be an important factor to consider to completely understand the complex puzzle of obligations that companies will be required to comply with from a corporate reporting obligation perspective.

This is relevant, as under the Corporate Sustainability Reporting Directive, companies will be required to report the outcome of the due diligence that was conducted in relation to the risks, impacts and measures taken within the sustainability reporting standards.

We can also help you understand the interplay with existing EU law, considering the economic activities and the financial products that can qualify as sustainable defined in the Taxonomy and the Sustainable Finance Disclosure Regulations will need to be supported by appropriate due diligence as set out in this proposal. Similarly, it will be crucial to monitor the delegated acts that will be coming out after the publication of the law, as well as the guidance issued by the EC, such as the guidance on model contractual clauses and any sector-specific guidelines to be drafted.

Monitoring the negotiations as they progress will be crucial to grasp the depth of new obligations and due diligence duties to be imposed. While the length of negotiations is at this point difficult to predict, the rules are unlikely to become applicable before 2024.

With us as your trusted advisors, you will be able to spot, assess and understand the risk and opportunities for your organisation from the proposed Sustainable Corporate Due Diligence Directive. We can support you with any legal or policy request you may have. Please do not hesitate to reach out to us for a discussion.



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We combine sound legal counsel with a deep knowledge of our clients' businesses to resolve their legal, public policy and political challenges. We care about the quality of our services, the success of our clients and the relationships that are forged through those successes. Our client base spans every type of business, both private and public, worldwide. We advise a diverse mix of clients, from Fortune 100 and FTSE 100 corporations to emerging companies, and from individuals to local and national governments. Leveraging local connections, while exerting global influence, we are commercial, connected and committed.

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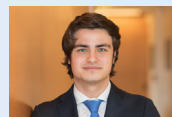
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