European Union: Proposal for a Corporate Sustainability Due Diligence Directive

Market Report

APRIL
2022

Prepared by the New Zealand Embassy and Mission in Brussels

Summary

- On 23 February 2022 the European Commission released a long-awaited legislative proposal for a Corporate Sustainability Due Diligence Directive. European consumers are increasingly demanding goods produced in a sustainable and fair way that ensures decent work, and pressure has been increasing for the EU to take action to enforce this expectation.
- The Directive will oblige Member States to adopt or adapt their own corporate due diligence laws in order to ensure companies identify, prevent and mitigate adverse impacts of their activity on human rights and the environment throughout their global value chains.

Report

- The European Commission (the Commission) has published a proposal for a Corporate Sustainability Due Diligence Directive. The Directive will create new EU-wide rules to ensure businesses operating in the EU contribute to the respect of human rights and the environment in their own operations and throughout their supply chains. Companies operating in the EU will be legally required to identify, prevent and mitigate "actual and potential" adverse human rights and environmental impacts of their operations (including their subsidiaries and value chains), such as child labour, exploitation of workers, pollution and biodiversity loss. In addition, certain large companies will be required to have a plan to ensure that their business strategy is compatible with limiting global warming to 1.5°C in line with the Paris Agreement.
- The Commission's proposal comes in the wake of a wave of EU Member States enacting their own national due diligence laws in recent years (including France, Germany and the Netherlands) while others (Austria, Belgium, Finland, and Denmark) had also expressed their intention to follow suit. The scope and level of ambition of these national laws has varied greatly, however, leading to calls for a harmonised legal framework across the EU in order to provide legal certainty and a level playing field for companies in the Single Market.

Scope

- The EU believes that its economic policies have implications for the well-being of workers around the globe and wants to act internally to "set standards that are frontrunners for corporate responsibility and transparency globally". The proposed new due diligence rules tick many boxes already present in international voluntary guidelines on sustainable corporate behaviour, which could now become compulsory in the EU and subject to penalties in case of non-compliance. The EU believes that its economic policies have implications for the well-being of workers around the globe and wants to act internally to "set standards that are frontrunners for corporate responsibility and transparency globally".
- If passed, the EU due diligence rules will apply to around one percent of companies operating in the EU (according to a Commission estimate), based on the following criteria:
  - **EU companies**:
    - **Group 1**: all EU companies of "substantial size and economic power" (over 500 employees and over EUR 150 million in net turnover worldwide).
    - **Group 2**: other EU companies which operate in defined "high impact" sectors (such as agriculture,

forestry, fisheries, textiles and mining), and which still have more than 250 employees and a net turnover of EUR 40 million worldwide.
    - **Non-EU companies** which have generated a net turnover of more than EUR 150 million in the EU in the preceding financial year, or which have generated between EUR 40-150 million turnover in the EU and are operating in a high impact sector. The Commission estimates the Directive will cover only about 4,000 foreign companies.
    - **Small and medium enterprises (SMEs)** are exempt from the scope of the Directive. Nevertheless, they may be indirectly affected by the new rules because of the effect of large companies' actions across their value chains.
- Notably, the Commission has proposed that these new due diligence requirements would apply across a company's entire supply chain, including subsidiaries and value chain operations carried out by entities with whom the company has an "established business relationship". This has been a key ask of civil society groups, who have argued that excluding parts of the supply chain creates too many loopholes – but opposed by business stakeholders, who argue that it imposes an unreasonable compliance burden. The Commission's proposal will also capture more companies than some existing national due diligence legislation. Germany's 2021 law, for example, will initially only apply to companies with 3,000 employees. And French legislation in place since 2017 only kicks in for companies with over 5,000 employees in France or over 10,000 worldwide.
- The proposal also introduces duties for directors of companies, who need to set up and oversee the implementation of due diligence as part of their corporate strategy. When corporate directors enjoy variable remuneration, they will be incentivised to contribute to combating climate change by reference to the corporate plan. The proposal also includes accompanying measures to help affected companies in the EU, and potentially in third countries: for example, the Commission could offer financial support to indirectly affected SMEs, as well as guidance such as model contract clauses.

Enforcement

- The rules on due diligence will be enforced in two ways:
    - **Administrative supervision** by Member States' national authorities, who will be able to impose "effective, proportionate and dissuasive" sanctions, including fines and compliance orders. At the EU level, a European Network of Supervisory Authorities will be established to ensure a coordinated approach; and
    - **Civil liability**: Member States will ensure that ensure that companies are liable for damages resulting from the failure to comply with the new obligations.

Initial reactions

- While some NGOs have welcomed the Commission proposal, others argue it does not go far enough. Commentators believe that some major grey areas and safeguards for companies mean that EU due diligence might be more like 'soft law' in practice. The European Coalition for Corporate Justice said that the Commission's proposal was "ground-breaking" in that it is the first initiative of its kind, but that it "fails to deliver on the potential" citing the limited scope of coverage, and the "dangerous loophole" created by permitting companies to shield themselves from lawsuits if they include clauses in contracts and sign up to an industry audit program.
- Industry stakeholder groups have also been critical. While generally in favour of having an EU framework on due diligence rather than a patchwork of national legislation, bodies such as BusinessEurope have said that the Commission's proposal falls short on "delivering workable rules" and will add to the "excessive cumulative burden imposed on European businesses in past years", further undermining the global competitiveness of European companies – in particular because the rules will apply not only to subsidiaries but also to third party suppliers (which businesses argue they cannot control).
- Reactions from the European Parliament have been mixed. In the centre-left Socialists and Democrats (S&D) group, the Dutch MEP Lara Wolters, who leads on the file, said the European Parliament would work to make sure the proposal becomes more ambitious, adding "we need to make sure this law has teeth". She stressed that companies should not be allowed to hide behind smaller businesses down the supply chain, for example via contractual clauses. The centre-right European People's Party (EPP) initially welcomed the proposal. The German MEP Axel Voss, who is Vice-Chair of the Delegation to Australia and New Zealand (DANZ), said: "in an increasingly globalised world, business

comes with responsibility…However, not every company is in a position to control every single one of its possibly thousands of suppliers…It is important to take action in cases of real risks while avoiding unnecessary reporting obligations”.

What happens next?

- The European Parliament and the Council will need to discuss and approve this legislative proposal in the coming months. **Once adopted, EU Member States will have two years** to start implementing the Directive in their national legislation – either by introducing new laws, or adapting existing legislation.
- These new due diligence rules could affect certain New Zealand businesses trading with the EU (particularly those in the agriculture sector), or which are part of global value chains headed by EU companies.

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