McCann FitzGerald

Briefing
Corporate Sustainability Due Diligence Directive: What Irish companies need to know

INSTITUTE OF DIRECTORS IN IRELAND

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The new proposal for a Directive on Corporate Sustainability Due Diligence proposes to introduce new obligations for in-scope companies to identify and, where necessary, prevent, end or mitigate adverse impacts of their activities on human rights and on the environment, and, in the case of certain larger companies, 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.

When adopted, it will have significant implications for many Irish companies. This briefing looks at some of the key provisions.

Background

Following several delays, on 23 February 2022 the EU Commission published its proposal for a Directive on Corporate Sustainability Due Diligence[1].

The proposal aims to foster sustainable and responsible corporate behaviour throughout global value chains by requiring in-scope companies to identify and, where necessary, prevent, end or mitigate adverse impacts of their activities on human rights, such as child labour and exploitation of workers, and on the environment, for example pollution and biodiversity loss, and introduces directors' duties to set up and oversee the implementation of due diligence and to integrate it into the corporate strategy.

1 https://ec.europa.eu/info/publications/proposal-directive-corporate-sustainable-due-diligence-and-annex_en

It also contains provisions requiring certain larger in-scope companies to adopt plans to ensure that their business model and strategy are compatible with limiting global warming to 1.5 °C in line with the Paris Agreement. It also provides that, when fulfilling their duty to act in the best interest of the company, directors will be required to take into account the human rights, climate change and environmental consequences of their decisions.

As originally conceived, this initiative was to have a much broader scope focusing on embedding sustainability into the corporate governance framework. Draft proposals were twice red-flagged by the EU's Regulatory Scrutiny Board with the proposals generating a lot of debate and controversy.

What has now emerged is a proposal with a narrower focus, centred around 'obligations of means' (as distinct from a requirement to ensure that adverse impacts will never occur or that they will be stopped), where companies are required to take appropriate measures which can reasonably be expected to result in prevention or minimisation of the adverse impact taking into account matters such as the company's value chain, sector or geographical area, and the company's power to influence its direct and indirect business relationships.

This initiative should be understood in the context of other existing or proposed due diligence obligations which target specific sectors such as the proposal for a Regulation on deforestation-free products[2] published in November 2021 which is aimed at specific commodities associated with deforestation and some derived products as well as the Conflict Minerals Regulation ((EU) 2017/821) relating to the import of certain minerals and metals that originate in conflict-affected and high-risk areas[3].

Scope

The Directive will apply to:

(a) EU companies (being companies formed in accordance with the legislation of an EU member state) which fulfil one of the following conditions:

  (i) the company had more than 500 employees on average and had a net worldwide turnover of more than €150 million in the last financial year ("**Group 1**"); or

  (ii) the company had more than 250 employees on average and had a net worldwide turnover of more than €40 million in the last financial year provided that 50% of this net turnover was generated in one or more high impact sectors (such as the manufacture of textiles, leather and related products, and the wholesale trade of textiles, clothing and footwear, agriculture, forestry, fisheries, the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food, and

2 https://ec.europa.eu/environment/forests/deforestation-proposal.htm
3 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0821&from=EN

beverages, as well as the extraction of mineral resource, the manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (except machinery and equipment) and the wholesale trade of mineral resources, basic and intermediate mineral products) ("**Group 2**"); and

(b) non-EU companies (being companies formed in accordance with the legislation of a third country) which fulfil one of the following conditions:

(i) the company had a net turnover of more than €150 million in the EU in the last financial year; or

(ii) the company had a net turnover of more than €40 million in the last financial year provided that 50% of this net turnover was generated in one or more high impact sectors listed for Group 2 companies.

The definition of 'company' in the proposed Directive covers:

(a) legal persons constituted as one of the legal forms listed in Annex I to the Accounting Directive (2013/34/EU) (such as Irish public companies limited by shares or by guarantee, private companies limited by shares or by guarantee);

(b) non-EU legal persons in a comparable form to those listed in Annex I and Annex II to the Accounting Directive;

(c) other legal persons constituted as one of the legal forms listed in Annex II to the Accounting Directive where they are composed entirely of undertakings organised in one of the legal forms referred to in (a) or (b) above; and

(d) specified regulated financial undertakings regardless of legal form including credit institutions, investment firms, alternative investment funds and their managers, UCITS and UCITS management companies, and insurance undertakings.

The EU Commission estimates that about 13,000 EU companies and 4,000 non-EU companies will be directly within scope of the Directive.

Due Diligence:

In-scope companies will be required to conduct human rights and environmental due diligence and to carry out certain actions.

Integrate Due Diligence into policies

In-scope companies will be required to integrate due diligence into all corporate policies and have in place a due diligence policy that is updated annually. That due diligence policy shall contain a description of the company's approach, including in the long term, to due diligence, a code of conduct describing rules and principles to be followed by the company's employees and subsidiaries and a description

of the processes put in place to implement due diligence, including the measures taken to verify compliance with the code of conduct and to extend its application to established business relationships.

Identify actual and potential adverse impacts

Companies will be required to take appropriate measures to identify actual or potential adverse human rights and environmental impacts arising from their own operations, or those of their subsidiaries, and where related to their value chains, from their established business relationships.

Adverse environmental impacts is defined as meaning an adverse impact on the environment resulting from the violation of one of the prohibitions and obligations pursuant to certain international environmental conventions listed in Part II of the Annex to the Directive. An adverse human rights impact means and adverse impact on protected persons resulting from the violation of one of the rights or prohibitions listed in Part I, Section 1 of the Annex, as enshrined in the international conventions listed in Part 1, Section 2 of the Annex.

The Directive defines an 'established business relationship' as being a 'business relationship, whether direct or indirect, which is, or which is expected to be lasting, in view of its intensity or duration and which does not represent a negligible or merely ancillary part of the value chain'.

Group 2 companies and their non-EU equivalents will only be required to identify actual and potential severe adverse impacts relevant to the specified high impact sectors in which they operate. These are adverse environmental impacts or human rights impacts that are especially significant by its nature, or affects a large number of persons or a large area of the environment, or which is irreversible, or is particularly difficult to remedy as a result of the measures necessary to restore the situation prevailing prior to the relevant impact.

In addition, where regulated financial undertakings provide credit, loans or other financial services, identification of actual and potential adverse human rights impacts and adverse environmental impacts shall be carried out only before providing that service.

For the purposes of identifying the relevant adverse impacts based on, where appropriate, quantitative and qualitative information, companies shall be entitled to make use of appropriate resources, including independent reports and information gathered through the complaints procedure provided for in the proposed Directive (see further below). Companies shall also, where relevant, carry out consultations with potentially affected groups including workers and other relevant stakeholders to gather information on actual or potential adverse impacts.

Preventing potential adverse impacts/Bringing to an end actual adverse impacts

Companies shall take appropriate measures to prevent, or where prevention is not possible or not immediately possible, adequately mitigate potential adverse human rights impacts or adverse environmental impacts that have been, or should have been, identified in line with the obligations under the proposed Directive to identify actual and potential adverse impacts. In addition, companies shall take appropriate measures to bring actual adverse impacts that have been, or should have been, identified in line with the obligations under the proposed Directive to an end. Where the adverse impact cannot be brought to an end, companies must minimise the extent of such an impact.

This involves companies taking the following actions, where relevant:

(a) in the case of actual adverse impacts, neutralise the adverse impact or minimise its extent, including by the payment of damages to the affected persons and of financial compensation to the affected communities in a manner proportionate to the significance and scale of the adverse impact and to the contribution of the company's conduct to the adverse impact;

(b) developing and implementing a prevention/corrective action plan, prepared in consultation with affected stakeholders and with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement, where necessary due to the nature or complexity or the measures required for prevention or where the adverse impact cannot be immediately brought to an end;

(c) seeking contractual assurances from a business partner with whom it has a direct business relationship that it will ensure compliance with the company's code of conduct and, as necessary, a prevention/corrective action plan, including by seeking corresponding contractual assurances from its partners, to the extent that their activities are part of the company's value chain (contractual cascading). In this regard, the EU Commission will adopt guidance about voluntary model contract clauses;

(d) making necessary investments, such as into management or production processes and infrastructures;

(e) providing targeted and proportionate support for an SME with which the company has an established business relationship where compliance with the code of conduct or the prevention/corrective action plan could jeopardise the viability of the SME;

(f) subject to compliance with EU law, including EU competition law, collaborating with other entities, including where relevant to increase the company's ability to bring the adverse impact to an end, in particular where no other action is suitable or effective.

With respect to any potential or actual adverse impacts that cannot be prevented, brought to an end or adequately mitigated by these measures, the company can seek to conclude a contract with a partner with whom it has an indirect relationship with a view to achieving compliance with the company's code of conduct or a prevention/corrective action plan.
Any contractual assurances or contract referred to above shall be accompanied by appropriate measures to verify compliance. In this context, the company may refer to suitable industry initiatives or independent third-party verification.

Contractual assurances obtained from, or contracts entered into, with SMEs for this purpose shall be on terms which are fair, reasonable and non-discriminatory. Independent third party verification of compliance in relation to SMEs shall be borne by the company.

Where the potential or actual adverse impacts could not be prevented, brought to an end or adequately mitigated/minimised by these measures, the company shall be required to refrain from entering into new or extending existing relations with the partner in connection with or in the value chain of which the impact has arisen and shall, where the law governing their relations so entitles them to, take the following actions:

(a) temporarily suspend commercial relations with the partner in question, while, in the case of potential adverse impacts, pursuing prevention and minimisation efforts, if there is reasonable expectation that these efforts will succeed in the short-term and, in the case of actual adverse impacts, pursuing efforts to bring to an end or minimise the extent of the adverse impact; or

(b) terminate the business relationship with respect to the activities concerned if the potential adverse impact is severe.

In this context, the proposed Directive provides that Member States shall provide for the availability of an option to terminate the business relationship in contracts governed by their laws.

With respect to the above, where a regulated financial undertaking provides credit, a loan or other financial services, they shall not be required to terminate the credit, loan or other financial service contract when this can be reasonably expected to cause substantial prejudice to the entity to whom that service is being provided.

Having regard to the above, the proposed Directive provides that the EU Commission may issue guidelines for specific sectors and specific adverse impacts, in consultation with Member States and stakeholders, the European Union Agency for Fundamental Rights, the European Environment Agency, and where appropriate with international bodies having expertise in due diligence.

Complaints procedure

Companies shall provide for the possibility for certain persons and organisations to submit complaints to the company in case of legitimate concerns regarding those potential or actual adverse impacts, including in the company's value chain.

Companies are required to grant this possibility to persons who are affected or have reasonable grounds to believe that they might be affected by an adverse impact, to trade unions and other workers' representatives representing individuals working in the value chain concerned, and to civil society organisations active in the area concerned.

Monitoring

Companies will be required to periodically assess the implementation of their due diligence measures in order to verify that adverse impacts are properly identified and that preventive or corrective measures are implemented, and to determine the extent to which adverse impacts have been prevented or brought to an end or their extent minimised.

Reporting

In-scope companies that are not subject to reporting requirements under Articles 19a and 29a of the Accounting Directive will be required to report on the matters covered by the Directive and publish an annual statement on their website.

Climate-aligned business model and strategy

Group 1 companies and Non-EU companies with a threshold aligned with Group 1 companies will be required to adopt a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement. That plan should identify (on the basis of information reasonably available to the company) the extent to which climate change is a risk for, or an impact of, the company's operations. That plan shall include emission reduction objectives where climate change is or should have been identified as a principal risk for, or a principal impact of, the company's operations.

Relevant companies will be required to ensure that the fulfilment of these obligations are taken into account when companies are setting variable remuneration, if variable remuneration is linked to the contribution of a director to the company's business strategy and long-term interests and sustainability.

Directors' duties/obligations

Directors of Group 1 and Group 2 companies will, when fulfilling their duty to act in the best interest of the company, be required to take into account the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term. Member States shall ensure that their laws, regulations and

administrative provisions providing for a breach of directors' duties also apply to this provision.

In addition, directors of Group 1 and Group 2 companies shall be responsible for setting up and overseeing the implementation of corporate sustainability due diligence processes and measures referred to in the Directive and to adapt the corporate strategy to take into account the actual and potential adverse impacts identified and the relevant measures to be taken under the Directive with respect to such impacts.

Authorised Representative

The Directive introduces the requirement for in-scope non-EU companies to designate a sufficiently mandated authorised representative in the EU to be addressed by Member States' competent authorities, on all issues necessary for the receipt of, compliance with and enforcement of legal acts issued in relation to the Directive.

Public support

Member States shall ensure that companies applying for public support certify that no sanctions have been imposed on them for a failure to comply with the obligations of the Directive.

Substantiated concerns

Any natural or legal person that has reasons to believe, on the basis of objective circumstances, that a company does not appropriately comply with the provisions of the Directive, shall be entitled to submit substantiated concerns, in particular in the Member State of his or her habitual residence, registered office, place of work or place of the alleged infringement, to the supervisory authorities.

Supervisory Authorities

Member States shall designate one or more national supervisory authorities in order to ensure compliance by companies with their due diligence obligations and their business model and strategy obligations with respect to climate change as implemented under national law and to exercise the powers of enforcement of those obligations. Those supervisory authorities shall have appropriate powers and resources to carry out their tasks of supervision and enforcement and may initiate investigations.

A European Network of Supervisory Authorities composed by the representatives of the supervisory national authorities shall be established, with the aim to facilitate and ensure the coordination and alignment of regulatory, investigative, sanctioning and supervisory practices, and the sharing of information among these supervisory authorities.

Enforcement; Sanctions and Civil liability

The proposed Directive contains public and private enforcement provisions, namely sanctions and a civil liability regime.

Member States will be required to lay down rules on sanctions applicable to infringements of the national provisions adopted pursuant to the Directive, and take all measures necessary to ensure that they are implemented. The sanctions must be effective, dissuasive and proportionate. In deciding whether to impose sanctions and, if so, in determining the nature and appropriate level, due account shall be taken of the company's efforts to comply with any remedial action required of them by a supervisory authority, any investments made or any targeted support provided to SMEs in accordance with the Directive, as well as collaboration with other entities to address adverse impacts in its value chains, as the case may be.

Any pecuniary sanctions shall be based on the company's turnover and any decision of the supervisory authorities containing sanctions related to the breach of the provisions of the Directive should be published.

Civil liability

Companies may be liable for damages if they fail to comply with their obligation to prevent and mitigate potential adverse impacts or to minimise or bring actual adverse impacts to an end, if as a result of any such failure an adverse impact that should have been identified, prevented, mitigated, brought to an end or its extent minimised through the appropriate measures occurred and led to damage.

However, a company shall not be liable for damages caused by an adverse impact arising as a result of the activities of an indirect partner with whom it has an established business relationship where it has obtained verifiable cascading contractual assurances from a business partner with whom it has a direct business relationship, unless it was unreasonable, in the circumstances of the case, to expect that the action actually taken, including as regards verifying compliance, would be adequate to prevent, mitigate, bring to an end or minimise the extent of the adverse impact.

The civil liability of a company for damages under the Directive shall be without prejudice to the civil liability of its subsidiaries or of any direct and indirect business partners in the value chain.

In addition, Member States must ensure that civil liability provided for in provisions of national law transposing the Directive is of overriding mandatory application in cases where the law applicable to claims to that effect is not the law of a Member State. This is designed to avoid jurisdiction disputes where claims are brought against companies for third party acts outside the EU.

Application

The proposal will be presented to the European Parliament and the Council for approval. Once adopted, Member States will have two years to transpose the Directive into national law. The provisions shall apply to Group 1 companies and their non-EU equivalents within 2 years of entry into force of the Directive and within 4 years in the case of Group 2 companies and their non-EU equivalents.

Further information is available from

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