EU CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE: FIVE STEPS TO TAKE NOW

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The text of the proposed EU Corporate Sustainability Due Diligence Directive ("CSDDD") has not been finally agreed and its full impact will depend on how it is implemented in each of the Member States. However, as the European Parliament adopted amendments to the text of the directive on 1 June, businesses would be well advised to begin preparations, given the extent of the obligations on qualifying companies and the significant impact this will also have on companies within their "chain of activities" (both upstream and downstream supply chains) and others doing business with them. Businesses should consider well in advance:

> "Businesses would be well advised to begin preparations."

- its impact on new and existing business relationships;
- the potential need for investment to address systemic issues in supply chains (particularly where there are no alternative suppliers available);
- its impacts on business models and strategies, including potential risks involved in moving towards more integrated circular economy models; and
- how these may need to be reflected in contractual documents, particularly those which may remain in force for a significant period.

THE CSDDD IS SET TO APPLY TO:

- companies domiciled in EU member states with:
  - 500+ employees on average and a net worldwide turnover of €150m+ in the last financial year; or
  - 250+ employees on average and a net worldwide turnover of €40m in the last financial year and where at least €20m was generated in specified high risk sectors including textiles, agriculture and extractives.
- Companies domiciled outside the EU which:
  - Generated a net turnover of more than €150m in the EU in the financial year preceding the last one; or
  - Generated a net turnover of more than €40m in the financial year preceding the last one and at least €20 m was generated in one or more of the specified high risk sectors.

So, if you are a qualifying company or fall with the chain of activities of a qualifying company, what are the practical steps which you should consider?

MAP YOUR BUSINESS RELATIONSHIPS

"This may be an operational burden for companies with a large number of suppliers and or customers."

Companies will be required to take measures which are "reasonably available" and "capable of achieving the objectives" to identify actual and potential adverse impacts arising from their own operations and those of their direct (i.e. contractual) and indirect business partners, which relates to their chain of activities, both upstream (i.e. raw materials, manufacture etc.) and downstream (including distribution and waste/ recycling) where that activity is carried out on behalf of the company.

This will be a challenge for businesses with complex products and those who have made efforts towards circularity of their products including through closed loop recycling. Also, this may be an operational burden for companies with a large number of suppliers and or customers, such as distributor companies. Although a number of businesses have already taken steps to map their supply chain, this is often limited to "first tier" suppliers, namely those suppliers with a direct contractual relationship to the company. Particularly where long-term agreements are likely to be in place, businesses may need to consider now how they are going to gather information to facilitate mapping. This may potentially be through the introduction of contractual clauses which require upstream suppliers to identify their own suppliers (and guarantee that the raw materials or other inputs supplied to the company are derived from those suppliers). Further or alternatively, suppliers could be required to provide a guarantee that all raw materials or other inputs are from a certified source. This can quite often result in long and challenging discussions as companies will not be prepared to disclose their own suppliers to avoid being "circumvented" in the future. Contractual solutions for this dilemma can include specific warranties or disclosure to and statements of compliance from third parties.

As it can take a number of years for suppliers to bring themselves into line with certification standards, early warning of future requirements, potentially paired with incentives to facilitate and reward steps taken towards certification could be helpful to ensure that key supply chain links are able to be maintained following the coming into force of the directive, without becoming a headache for regulated companies.

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Companies are expected to gather information on actual and potential adverse impacts from a number of sources, including independent reports and consultations with potentially affected groups, including workers and other relevant stakeholders. As a result, contracts may also need to be modified to allow for auditors to gather information and for access to be given to workers, as well as appropriate protections for workers, such as guarantees that they will not face any penalties for providing accurate information as part of the process.

REVIEW YOUR POLICIES AND UPDATE WHERE NECESSARY (INCLUDING COMPLAINTS MECHANISMS)

Companies will be required to “integrate due diligence into all their policies and risk management systems” in addition to having a separate due diligence policy in place.

Many companies will already have a due diligence policy in place (often integrated into procurement policies) as well as a code of conduct. However, these will need to be updated to make sure the specific requirements under the regulation are covered, and care will need to be taken to ensure that compliance with the code of conduct is mandated through all other relevant policies and procedures and that compliance can be verified.

As the code of conduct is to apply to all employees, subsidiaries and direct and indirect business partners, this will require amendments to significant numbers of other policies, ideally with built in measurement and incentivisation measures. For example, amendments may be necessary to employment contracts, review guidelines, bonus schemes, contractual clauses (including the requirement to cascade provisions to onwards contractors in the supply/ value chain), reporting schemes etc.

Complaints’ mechanisms are also a key part of the new requirements, including as a source of information for mapping purposes. Although the regulation specifically provides for a link with the whistleblowing regulation, existing whistleblowing schemes are unlikely to cover off all of the requirements for the regulation and will need to be updated.

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Because the complaints mechanism will need to be open to considering issues not only within the operations of the company itself, but also the operations of its business partners, contractual provision will need to be made for the company to be able to gather information on complaints made, as well (where appropriate) for indemnities where redress is to be given to affected individuals, either through the complaints mechanisms or under the new civil liability regime established by the regulation.

Finally, training for key account managers needs to be provided as it is of utmost importance to inform key accounts at an early stage about potential changes in the business relations. This may also include discussing sensitive topics.

UPDATE PRECEDENT CONTRACTS

Contractual terms are the main method by which the CSDDD expects companies to be able to (a) gather information on potential issues and whether mitigation measures are effective and (b) exert “leverage” on business partners and others to undertake mitigation measures. Some of the contractual clauses which might need to be considered are discussed above. The regulation recognises that it might not be possible to negotiate clauses which give the expected level of insight and leverage to companies caught by the regulation, but it will be important for companies to show that they have made an effort to incorporate relevant clauses where at all possible.

The Commission is also expecting to put together its own precedent clauses, which businesses would be well advised to consider inserting straight into their standard contract terms where the context allows. However, for the reasons set out above, businesses may not wish to wait for these clauses to be released before starting to equip themselves with the necessary contractual powers to get ready for implementation.

"Important for companies to show that they have made an effort."

PUT IN PLACE STRINGENT RECORD-KEEPING

For companies with complex supply chains and those operating in high-risk sectors, there are likely to be a number of points where the company will be expected to take a decision on what is "reasonable". As these are some of the decisions most likely to be challenged, either as a matter of principle or in order to seek to deny a company of defences where faced with a civil liability claim (as expressly provided for in the directive), it will be important to have a record of the data collected on which such decisions were based, the advice taken (and why it was reasonable to rely on that advice), the reasoning behind the decision and when the decision would be re-visited (including time for preparation, information gathering etc.).

Having contemporaneous notes on all of these matters will make it much easier to respond to requests for information from civil society organisations, respond to complaints, provide information to regulators and (if necessary) defend civil claims.

INVESTIGATE PROJECTS DESIGNED TO ADDRESS UNDERLYING ISSUES

Where issues arise, even if they are not directly within the control of the company, the company will be expected to take action to address them. That is particularly the case where the entity closest to the issues is an SME. The directive states that companies should make a relevant "investment". Although the meaning of this is not clear, there is also reference to the provision of "financing, such as direct financing, low-interest loans, guarantees of continued sourcing, or assistance in securing financing, or guidance, such as training or upgrading management systems". Further consideration would, of course, also need to be given as to whether such measures would be possible for companies which are not licensed to provide regulated financial services in applicable jurisdictions.

"Many human rights and environmental issues do not have a single cause."

Many human rights and environmental issues do not have a single cause and addressing those issues can necessitate long-term, consistent investment from a number of parties, including states. Companies are therefore unlikely to be able to either fully mitigate issues immediately on the coming into force of the directive or by themselves. Companies may therefore consider the potential to leverage capital to make "impact" investments, where the financial return on the investment should allow for evergreen investment in existing and new initiatives, but the "impact" return could also help to show a real outcome from efforts taken to address systemic issues. This will be particularly important where a company is unable, for example, to source raw materials for its products from alternative sources which do not engender human rights issues and/or withdrawal of the company from a particular supplier has the potential to cause more issues.

Get in touch with the authors or your usual WFW contact to find out how we can support you in understanding the likely impacts of the CSDDD and how this might be implemented throughout contractual relationships.

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