European and UK Critical Raw Materials (CRM) Supply Chains – The Weakest Links

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In our second article of this series (access here) we looked at the geological, geopolitical and ESG considerations involved in the establishment of UK and EU non-Chinese rare earth elements (REE) to permanent magnet supply chains (NCSC). To be of value, a NCSC must be able to demonstrate its "resilience" to both internal and external events and disruptions. The Covid pandemic shone a spotlight on global supply chains and their "resilience" in the face of diverse disruptions such as lockdown and quarantine, confirming the truth of the aphorism that "a chain is no stronger than its weakest link".

REE supply chain resilience

Resilience in the context of a supply chain is the management of risk to that chain from both internal and external sources. The cost of managing that risk to the point where a supply chain can be said to be "resilient" can be significant. In the context of a NCSC resilience may be difficult to achieve.

A supply chain involves a series of steps, or links that in combination enable a product to be manufactured and delivered to a customer. President Biden's Executive Order of February 2021 defines a "supply chain" for critical raw materials (CRM) to include "exploration, mining, concentration, separation, alloying, recycling, and reprocessing of minerals".

The EU's proposed ESG legislation and its impact on resilience.

As we explained in the previous article, the EU is proposing to introduce ESG due diligence legislation this year. Companies that want access to the EU market, including those established outside the EU, will have to prove that they comply with the required due diligence obligations in respect to human rights, the environment and good governance (in short, ESG). The ESG legislation will require undertakings to take all proportionate and commensurate measures and make efforts within their means to prevent adverse impacts on ESG from occurring in their value chains, and to properly address such adverse impacts when they occur.

A NCSC undoubtedly qualifies as a "value chain" for the purposes of the legislation. Thus, compliance with the ESG legislation will be a pre-condition to the establishment of an EU NCSC and once established, how successful it is in ensuring continued compliance, will be a key factor to its resilience.

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The ESG legislation applies to:

(a) "large undertakings" - companies that, on their balance sheet dates, exceed at least two of the following three criteria - balance sheet greater than 20 €m, net turnover greater than 40€m and more than 250 employees; and

(b) publicly listed SMEs that, on their balance sheet dates, fall within at least two of the following three parameters - balance sheet total of between 4€m and 20€m, net turnover of between 8€m and 40€m and between 50 and 250 employees, as well as non-EU entities operating in high-risk sectors ("undertakings").

Undertakings will be required to:

(a) undertake an ESG risk assessment – "in an ongoing manner make all efforts within their means to identify and assess, by means of a risk-based monitoring methodology that takes into account the likelihood, severity and urgency of potential or actual impacts on [ESG], the nature and context of their operations, including geographic, and whether their operations and business relationships cause or contribute to or are directly linked to any of those potential or actual adverse impact[s]";

(b) establish and effectively implement a due diligence strategy, unless their ESG risk assessment concludes there are no potential or actual adverse ESG impacts;

(c) ensure ESG compliance throughout the value chain – "ensure that their business relationships put in place and carry out [ESG] policies that are in line with their due diligence strategy, including for instance by means of framework agreements, contractual clauses, the adoption of codes of conduct or by means of certified and independent audits"; and

(d) put in place a grievance mechanism – "provide a grievance mechanism, both as an early-warning mechanism for risk-awareness and as a mediation system, allowing any stakeholder to voice reasonable concerns regarding the existence of a potential or actual adverse [ESG] impacts". A grievance mechanism can be provided through collaborative arrangements with other undertakings or organisations.

In the context of a NCSC, given the nature of the activity at stake (the mining and processing of minerals), it is unlikely that a NCSC ESG risk assessment will identify no potential or actual adverse ESG impacts. Accordingly, an effective due diligence strategy will be required to be implemented.

The ESG risk assessment and due diligence strategy are required to be published and regularly updated.

An undertaking's NCSC due diligence strategy must:

(a) specify the potential or actual adverse ESG impacts of its operations and business relationships;

(b) map and publicly disclose relevant information about the NCSC including its business partners;

(c) state how it will deal with potential or actual adverse ESG impacts; and

(d) outline its prioritisation strategy if it is unable to deal with all the potential or actual adverse impacts at the same time.

Value chain due diligence must be proportionate and commensurate to the likelihood and severity of the potential or actual adverse ESG impacts. It is not a 'box-ticking' exercise and should be an ongoing process in light of the assessment of risks and impacts, which may change due to new business relationships or other developments.

The establishment and implementation of a due diligence strategy requires "good-faith, effective, meaningful and informed discussions" with all relevant stakeholders i.e. those individuals, and groups of individuals whose rights or interests may be affected by the potential or actual adverse ESG impacts posed by the undertaking or its business relationships, as well as organisations whose statutory purpose is the defence of ESG. Stakeholders can include workers and their representatives, local communities, children, indigenous peoples, citizens' associations, trade unions, civil society organisations and the undertakings' shareholders.

Care will need to be taken to ensure that "all relevant stakeholders" are accurately identified and that those who claim to be speaking for or representing a group or a class of stakeholders are duly authorised to do so. For some classes of relevant stakeholder (e.g. children and indigenous peoples) it may be necessary for them to be provided with independent legal or other advice to ensure that any discussions are "informed".

In the context of corporate law, "meaningful and informed discussions" with the undertaking's shareholders raises some difficult legal and practical questions as to how this can be effectively achieved, other than through traditional means such as a general meeting. It also opens up the possibility of "greenmail" by parties opposed to the particular operation who acquire small parcels of shares in the undertaking (and/or companies with which it has business relationship) to enable them to claim standing as "relevant stakeholders" and so involve themselves in the discussion with the ability to allege that it was neither meaningfully consulted nor informed.

The legislation does not provide guidance as to how disagreements with stakeholders over the due diligence strategy will be resolved. Compulsory mediation or expert determination might be helpful in some situations. The grievance mechanism required to be established by an undertaking may operate as a mediation system, thereby allowing any stakeholder to voice "reasonable concerns" regarding the existence of a potential or actual adverse ESG impact. But such a mechanism is more likely to be an agreed outcome of negotiations and so will not exist during the negotiations.

Undertakings will need to give consideration as to whether they have the necessary experience and resources to conduct the risk assessment and identify the relevant constituency of stakeholders or should engage third parties to assist. Negotiations with stakeholders on the due diligence strategy may lead to demands for legally enforceable obligations with certain of them.

Framework agreements, contracts, codes of conduct and audits

Undertakings must ensure their business relationships put in place and carry out ESG policies that are in line with the due diligence strategy. The ESG legislation provides examples of the types of legal structures or provisions that undertakings should employ in order to ensure compliance - framework agreements, contracts, codes of conduct and audits.

The legislation defines a 'value chain' as all activities, operations, business relationships and investment chains of an undertaking and includes entities with which the undertaking has a direct or indirect business relationship, upstream and downstream, and which either:

(a) supply products, parts of products or services that contribute to the undertaking's own products or services, or

(b) receive products or services from the undertaking.

It is these entities that the undertaking has to ensure will carry out its ESG policies in line with a due diligence strategy that has been negotiated with the relevant stakeholders. To enable it to meet this obligation, the undertaking will require a contractual relationship with each entity in the value chain.

A "framework agreement" that equips an undertaking with all the necessary rights to effectively and legally address events or circumstances of non-compliance with the due diligence strategy at each link in the NCSC will, in the context of the value chain, more likely be in the nature of a multi-party joint venture agreement with many moving parts, including provisions that will enable the undertaking to "regularly verify that sub-contractors and suppliers comply with their obligations" to carry out ESG policies that are in line with the due diligence strategy. It may be necessary for many of these rights to be enforceable under the applicable local laws of a relevant party.

Joint venture agreements typically provide for their operations to be managed on behalf of the joint venturers. We consider that such an arrangement may be appropriate with respect to the oversight of the ESG obligations of a NCSC and the management of reporting and disclosure compliance obligations.

Structuring a NCSC by way of a series of connected but essentially standalone contracts will make it difficult to establish and maintain the necessary control to oversee and ensure ESG compliance throughout the value chain or deal effectively with situations affecting each link requiring structure and agility in decision-making (e.g. a decision to exercise "step-in" rights to avoid the collapse of the mining company). Each link in a NCSC has "skin in the game".

In practice we suspect "codes of conduct" as such will have little practical application in a NCSC, as conduct in the context of the ESG legislation may have serious legal consequences and should therefore be the subject of a contract term rather than a code of conduct unless compliance with the code is itself a legal obligation.

As provided by the legislation, each link may also need to be the subject of "certified and independent audits" requiring a physical inspection of the operations, the review of source materials on site and interviews with executives and employees. Accordingly, express provisions will be required to ensure the audit team has access to property, records and people in accordance with applicable local law. "Certified" suggests that the auditor may need to be appropriately qualified by a professional organisation.

Therefore, we believe that complying with the new ESG legislation will require some substantial legal and contractual structuring.

Once established, parties to a NCSC will be reluctant to alter its composition by the introduction of a new party (whether as an additional party or as a substitute for an outgoing party) as that will necessitate a new ESG risk assessment and identification of the new "relevant stakeholders" with whom to negotiate a new due diligence strategy. Until that process is completed the operations of the NCSC may have to be suspended in whole, or in part, depending on the particular circumstances.

A change in the operations of a NCSC may have similar consequences. A decision to alter the method, scale or area of the mining operations as they were described in the due diligence strategy may be required. The operations of the NCSC may be adversely impacted if it lacks the agility and flexibility to react promptly to changed circumstances by having to undertake a new ESG risk assessment or negotiate a revised due diligence strategy.

A NCSC is also vulnerable to investigation by the competent authority established under the legislation that suspects a breach including through the "substantiated and reasonable concerns raised by any third party." A competent authority has powers to investigate compliance with the law, to require the undertaking to take remedial action and in cases of irreparable harm, to order the "temporary suspension of activities" and impose "proportionate" sanctions. The resilience of a NCSC may be brought into question where suspected breaches of the ESG law are raised.

The UK and the EU's proposed ESG legislation

The EU legislation will not apply to the UK. ESG compliance is a very important issue to the UK government (particularly in the context of government subsidies) capital and equity markets and investors generally. It remains to be seen to what extent the market will look to aspects of the EU ESG legislation as the appropriate standard for a UK NCSC.

Government licences

Aside from the impact of the EU ESG legislation, conducting due diligence on title and regulatory compliance is a process with which the mining industry and debt and capital markets

are very familiar. If these elements of the due diligence programme confirm the miner's title and related regulatory compliance, does that mean this, the first link in a NCSC is "resilient" in those respects?

Changes in the mining policy of the host government may have adverse effects and so impact adversely on the resilience of the NCSC. A very recent example is the announcement from the party that won the most seats in Greenland's general election that the development of the large REE mining project in Kvanefjeld (described by its ASX-listed owner as a "future cornerstone to the global rare earth supply") will be stopped because of environmental and community concerns. Whilst some forms of government action such as expropriation of a mining licence may enable the mining company to seek redress though international arbitration under a Bilateral Investment Treaty (through ICSID) the process is both long and very expensive.

Local ownership, other operations and relationships

In some jurisdictions the local law may require the mining company to be incorporated in that jurisdiction and allow for local participation in its ownership and management. A change in the ownership structure resulting from a transfer of shares by the current local participant to another with a different agenda may hamper operations and so frustrate the ability of the miner to deliver or perform as expected by others in the NCSC. Whilst the actions of a hostile shareholder may occasion action in the local courts, that course of action will not result in a speedy resolution which may be fatal to the NCSC. In the context of the EU ESG legislation, the full and ongoing cooperation of the mining company (and indeed each other entity in the NCSC) with the settled terms of the due diligence strategy will be required.

If the REE mining operation is owned by a mining company with other mining operations that are not part of an EU value chain, those other operations may impact on the company to such an extent that its capacity to deliver REE product to the next link in the NCSC is compromised and the resilience of the NCSC challenged. Upstream participants in the NCSC will need to ensure that the REE mining operation is legally and financially ring-fenced from those other operations so that their failure or ESG non-compliance will either have no legal or commercial consequences for the REE operation or, if there are consequences, they are able to be satisfactorily addressed by them.

Of particular significance will be the rights of upstream parties in the case of a downstream default that triggers rights in parties who are not themselves part of the NCSC. If the mining company in the NCSC is reliant on a third party to finance its mining operations, an event of default or the non-fulfilment of a condition precedent to drawdown by the company may interrupt operations and give rise to recovery and enforcement rights for the financier. In these circumstances, upstream NCSC members will need to consider whether they should acquire "step-in" rights from the financier to enable them to try and remedy this type of situation during a standstill period to avoid the closure and possible sale of the mining operations.

Dealing with the "weakest link"

Issues of ESG, regulatory compliance, difficult government relations, shareholder disputes, problems with third party financiers or investors and group company failures are not unusual

commercial circumstances, although they may be more challenging when they occur in a distant or unfamiliar location.

In many supply chains, the chain itself may be able to satisfactorily deal with the problem through the exercise of contractual rights by one or more of the other participants in the chain, including as a last resort, the removal of the "weakest link" from the chain and the appointment of another (stronger) link in its place.

The capacity to "multi-source" is the key to the resilience of a supply chain.

However, as we have seen, REE are rarely found in economically extractable concentrations. Consequently, "multi-sourcing" in a NCSC at the mining company level may not be feasible. Substituting another mining company into a NCSC that is ESG "compliant" (particularly in the EU), with the capacity to supply the required REE, to the right specification, at the times and in the quantities required that will ensure the manufacture of the permanent magnet, will be a very difficult task.

"Resilience" is not only required at the mining company link but at each other link in the NCSC. Just as it may not be possible to readily substitute another miner in a NCSC, it may be impossible to substitute another processor in the chain to replace a "weakest link" processor. The great majority of all REE processing in the world is currently undertaken by Chinese processors in China.

Ingenuity will be required to anticipate all the scenarios that may threaten a NCSC's resilience and to develop solutions (legal, commercial and diplomatic) to address them.

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