European Parliament's recommendation to the European Commission on ESG due diligence and corporate accountability

Simon Salter

Consultant, Vivien & Associés, Paris

Flora Pitti-Ferrandi

Competition Partner, Vivien & Associés, Paris

On 10 March 2021, the European Parliament presented its legislative initiative report calling for the adoption of an EU law which ensures that companies who access the EU internal market, including those established outside the EU, are held accountable and liable when they harm – or contribute to harming – the environment, human rights and good governance (ESG).[1] The Commission has announced it will present its legislative proposal later this year. This will be in the form of a directive requiring the 27 Member States to achieve the objects of the directive through the enactment of national laws.

The report is comprised of a resolution, with recitals and an annex with a draft of the directive and recitals; references to 'Articles' are to provisions in this draft.

It should be stressed that the European Parliament does not, in principle, have the power to initiate legislation. It is for the European Commission to submit a legislative proposal to the Parliament and the Council, who must agree on the text in order for it to become EU law. The report therefore requests the Commission to submit 'without undue delay a legislative proposal on mandatory supply chain due diligence' following the proposed draft directive, but the Commission will be the one to define precisely the scope and content of the upcoming directive. However, the draft directive is a good indication of the current trend of discussions in Europe and, given its massive support in the Parliament (passing by a vote of 504 in favour, 79 against and 112 abstentions), it is reasonable to anticipate that it will have some influence on the Commission's text.

Background

This initiative from the European Parliament follows up on a stated intention by the European Commission to legislate, with respect to a general ESG due diligence obligation for companies. In 2020, the European Commission commissioned two studies on this subject matter[2] and publicly announced in April 2020, through the voice of the European Commissioner for Justice, that it would introduce new legislation on mandatory human rights and environmental due diligence for companies. It also commenced in October 2020 a public consultation on sustainable corporate governance that concluded in February 2021.[3]

The report of the European Parliament, whilst having regard to current EU ESG rules, has now identified for the first time the specific legal obligations and responsibilities that it considers should be imposed under any future mandatory human rights and environment due diligence law that may be introduced by the European Commission.

The resolution recites the history and development of ESG regulation at an international level through the UN and in the EU, concluding that:

> [t]his alarming situation has highlighted the urgency regarding making businesses more responsive to, responsible and accountable for the adverse impacts they cause or contribute or are directly linked to, and prompted a debate as to how to do so, while underlining the need for a proportionate and harmonised Union-wide approach to these matters, which is also necessary to be able to achieve the United Nations (UN) SDGs (Sustainable Development Goals).[4]

Whilst France and the Netherlands have legislated to enhance corporate accountability in certain areas and other Member States are currently considering the adoption of

1 European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)).

2 British Institute of International and Comparative Law, CIVIC Consulting and the London School of Economics and Political Science 'Study on due diligence requirements through the supply chain' (January 2020); Ernst & Young 'Study on directors' duties and sustainable corporate governance' (July 2020).

3 European Commission 'Public consultation on sustainable corporate governance' (26 October 2020–8 February 2021).

4 Resolution (n 1) recital U.

similar rules[5] and the EU has adopted due diligence legislation for specific sectors, such as the Conflict Minerals Regulation (which entered into force on 1 January 2021)[6] and the Timber Regulation,[7] the Forest Law Enforcement, the Governance and Trade (FLEGT) Regulation,[8] the resolution considers that voluntary due diligence standards have 'limitations and have not achieved significant progress in preventing human rights and environmental harm and in enabling access to justice'.[9]

This statement is true in a wide spectrum of sectors and particularly in today's evolving energy sector. On 5 May 2021, the International Energy Agency (IEA) issued a special report on the challenges the world faces in transitioning to clean energy focusing on the role of critical minerals such as copper, lithium, nickel, cobalt and rare earth elements – the Role of Critical Minerals in Clean Energy Transitions.[10] In the foreword to the report, the IEA says:

> Today, the global energy system is in the midst of a major transition to clean energy. The efforts of an ever-expanding number of countries and companies to reduce their greenhouse gas emissions to net zero call for the massive deployment of a wide range of clean energy technologies, many of which in turn rely on critical minerals.

The IEA identifies six key recommendations for a new, comprehensive approach, including:

> Tackling the environmental and social impacts of mineral developments will be essential, including the emissions associated with mining and processing, risks arising from inadequate waste and water management, and impacts from inadequate worker safety, human rights abuses (such as child labour) and corruption. Ensuring that mineral wealth brings real gains to local communities is a broad and multi-faceted challenge, particularly in countries where artisanal and small-scale mines are common. *Supply chain due diligence, with effective regulatory enforcement*, can be a critical tool to identify, assess and mitigate risks, increasing traceability and transparency.[11]

Non-governmental organisations (NGOs) have also called for ESG due diligence to be made a legal obligation:

> Crucial is that environmental due diligence does not remain a guidance and that concrete duties for corporation derive from a binding legislation. Therefore, it is very welcome that the European Council recently agreed that Europe needs to work on a Human Rights and Environmental Due Diligence Legislation and also EU Commissioner for Justice, Didier Reynders, announced such a regulation to be presented in early 2021. It is key that the draft the European Commission will include civil liability.[12]

The report of the European Parliament thus calls for the EU as matter of urgency to legislate to require undertakings to 'identify, assess, prevent, cease, mitigate, monitor, communicate, account for, address and remediate potential and/or actual adverse impacts on human rights, the environment and good governance in their value chain'.[13]

According to the report, the advantages of such action to business include the establishment of a level playing field and the mitigation of unfair competitive advantages of third countries that result from lower protection standards, the enhancement of the reputation of EU undertakings and of the EU as a standard setter and the benefits of better risk-management leading to a lower cost of capital, overall.[14]

Accordingly, companies will be obliged to undertake an ESG risk assessment and adopt a due diligence strategy to identify and take proportionate measures to address and remedy the adverse ESG aspects of their value chains.

However, the report 'stresses' that due diligence is primarily a 'preventative mechanism', and while it is the duty of companies to respect human rights and the environment, it is the responsibility of states and governments to protect human rights and the environment, and 'this responsibility should not be transferred to private actors'.[15]

The report further underlines that the environmental due diligence strategies should be aligned with the UN's SDGs and Union policy objectives, including the European Green Deal, and the commitment to reduce greenhouse gas emissions by at least 55 per cent by 2030, and Union international policy, especially the Convention on Biological

5 Child Labour Due Diligence Act in the Netherlands; law on the duty of vigilance in France; current legislation initiatives in Germany, Sweden, Austria, Finland, Denmark and Luxembourg. Following the resolution, Germany adopted on 11 June 2021 an Act on Corporate Due Diligence in Supply Chains, in the spirit of the EU ESG initiative.

6 Regulation (EU) 2017/821 of the European Parliament and of the Council of 17 May 2017 laying down supply chain due diligence obligations for Union importers of tin, tantalum and tungsten, their ores, and gold originating from conflict-affected and high-risk areas.

7 Regulation (EU) No 995/2010 of the European Parliament and of the Council of 20 October 2010 laying down the obligations of operators who place timber and timber products on the market.

8 Council Regulation (EC) No 2173/2005 of 20 December 2005 on the establishment of a FLEGT licensing scheme for imports of timber into the European Community.

9 Resolution (n 1) recitals Y and Z.

10 See https://www.iea.org/reports/the-role-of-critical-minerals-in-clean-energy-transitions.

11 IEA Report 'The role of critical minerals in clean energy transitions' (May 2021) page 15 (emphasis added).

12 Germanwatch 'Why environmental due diligence matters in mineral supply chains' (November 2020).

13 Resolution (n 1) para 1.

14 ibid.

15 ibid para 2.

Diversity and the Paris Agreement and its goals to hold the increase in the global average temperature to well below 2°C above pre-industrial levels and pursue efforts to limit the temperature increase to 1.5°C above pre-industrial levels.[16]

Scope and purpose of the directive

Which companies will be affected?

The law will apply to three groups of entities (undertakings).[17]

The first group is 'large undertakings' which, on their balance sheet dates, exceed at least two of the following three criteria – balance sheet greater than €20 million, net turnover greater than €40m and more than 250 employees.

The second group are all publicly listed small and medium-sized undertakings (SMEs) which, on their balance sheet dates, fall within at least two of the following three parameters – balance sheet total of between €4 million and €20 million, net turnover of between €8 million and €40 million and between 50 and 250 employees.

The final group comprises SMEs (same balance sheet criteria as publicly listed SMEs) operating in high-risk sectors. The high-risk sectors are sectors of economic activity with a significant impact on human rights, the environment and good governance, taking into account the sector of the undertaking or its type of activities, and should be identified by the Commission in its proposed directive.

These three groups of companies will be concerned whether established in the EU or not, provided they operate in the internal market selling goods or providing services.

All undertakings will have the same general obligations under the directive, subject to the principle of proportionality[18] developed further below (see 'The prevention and mitigation of adverse ESG impacts').

The purpose of the directive

The purpose of the directive will be to ensure undertakings when operating in the EU 'fulfil their duty to respect human rights, the environment and good governance and do not cause or contribute to potential or actual adverse impacts on human rights, the environment and good governance through their own activities or those directly linked to their operations, products or services by a business relationship or in their value chains, and that they prevent and mitigate those adverse impacts'.[19]

The five following aspects of this provision should be noted.

Potential or actual adverse impacts on human rights, the environment and good governance

In respect to human rights, potential or actual impacts are those which may impair the full enjoyment of human rights by individuals or groups of individuals in relation to human rights, including social, worker and trade union rights. These will be set out in an Annex to the directive.[20]

Potential or actual adverse impacts on the environment are those which violate internationally recognised and EU environmental standards. These will also be set out in an Annex and must be consistent with the EU's objectives on environmental protection and climate change mitigation. Impacts must also be 'reasonable and achievable', consistent with Regulation (EU) 2020/852[21] and include 'production of waste, diffuse pollution and greenhouse emissions that lead to a global warming of more than 1.5°C above pre-industrial levels, deforestation, and any other impact on the climate, air, soil and water quality, the sustainable use of natural resources, biodiversity and ecosystems'.[22]

Potential or actual adverse impacts on good governance are those adverse impacts on the good governance of a country, region or territory, and, again, these will be the subject of an Annex to the directive.[23]

Contribution to potential or actual adverse impacts

An undertaking must neither cause potential or actual adverse ESG impacts, nor 'contribute to' such impacts.

For the purposes of the directive an undertaking's contribution will need to be substantial (so minor or trivial contributions will not be taken into account) and must either:

- in combination with the activities of other entities, be a cause of the adverse impact; or
- alone, cause, facilitate or incentivise another entity to cause an adverse impact.[24]

The directive will acknowledge that assessing the substantial nature of the contribution and understanding when the actions of an undertaking may have caused, facilitated or incentivised another entity to cause an adverse impact can involve the consideration of multiple factors. In assessing 'contribution', the following factors will be taken into account:

16 ibid para 12.
17 Directive recital 17 and art 2.
18 ibid art 1.2.
19 ibid art 1.1 (emphasis added).
20 ibid recitals 21, 22 and 28 and art 3.6.
21 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.
22 Directive recital 23 and art 3.7.
23 ibid recital 24 and art 3.8.
24 ibid art 3.10.

- the extent to which an undertaking may encourage or motivate an adverse impact by another entity, ie the degree to which the activity increased the risk of the impact occurring;
- the extent to which an undertaking could or should have known about the adverse impact or potential for adverse impact, ie the degree of foreseeability; and
- the degree to which any of the undertaking's activities actually mitigated the adverse impact or decreased the risk of the impact occurring.

However, the mere existence of a business relationship or activities which create the general conditions in which it is possible for adverse impacts to occur does not in itself constitute a relationship of contribution. The requirement will be that the activity in question should 'substantially increase the risk of adverse impact'.

An undertaking will be held liable for harm arising out of adverse ESG impacts that either they, or the entities they control, have caused or contributed to by acts or omissions, unless they can prove they complied with the directive.[25]

The concept of 'control' is the possibility for an undertaking to exercise decisive influence on another undertaking, in particular by ownership or the right to use all or part of the assets of the latter, or by rights or contracts or any other means, having regard to all factual considerations, which confer decisive influence on the composition, voting or decisions of the decision-making bodies of an undertaking.[26] This definition resembles the notion of 'control' under EU merger control rules.

The link between the activities of an undertaking's 'business relationships' and its operations, products or services

An undertaking's 'business relationships' will be its subsidiaries and its commercial relationships throughout its 'value chain',[27] including:

- 'suppliers', ie any undertaking that provides a product, part of a product, or service to another undertaking, either directly or indirectly, in the context of a business relationship;[28] and
- 'sub-contractors', which are defined as all business relationships that perform a service or an activity that contributes to the completion of an undertaking's operations,[29] which are directly linked to the undertaking's business operations, products or services.

This definition lacks clarity. While the term 'business relationships' is defined to include entities, and so comprises undertakings and business relationships that are 'directly linked' to the undertaking's operations, products or services, the term 'supplier' includes undertakings that both 'directly and indirectly' provide products or services to the undertaking. It should be clarified whether a 'business relationship' should extend beyond direct relationships, ie beyond tier one suppliers.

The link between the activities of an undertaking's 'value chain' and its operations, products or services

A 'value chain' comprises 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:

- supply products, parts of products or services that contribute to the undertaking's own products or services, or
- receive products or services from the undertaking.[30]

The definition of 'value chain' is clearer than the term 'business relationships' in that it should extend to include all entities (and not just undertakings) within the value chain, whether tier one suppliers or indirect suppliers. This extension beyond tier one suppliers will certainly cause implementation difficulties. Companies known to have had a particular transparent policy on mapping their supply chains generally, and understandably, limit those to tier one suppliers.[31]

It should also be noted that while the definition of 'supplier' is limited to an 'undertaking', the 'value chain' definition encompasses all 'entities' and the 'sub-contractors' definition aims at 'business relationships' with no specific detail as regards their actual form. The text would be improved if these semantic differences were avoided or explained.

The prevention and mitigation of adverse ESG impacts

In order to prevent or mitigate adverse ESG impacts, undertakings will be required to comply with the due diligence obligations laid down by the directive, generally defined as an obligation to 'take all *proportionate and commensurate* measures and make *efforts within their means* to prevent potential or actual adverse [ESG] impacts from

25 ibid art 19.2.
26 ibid art 3.9.
27 ibid art 3.2.
28 ibid art 3.3.
29 ibid art 3.4.
30 ibid art 3.5.
31 See eg the 'Find out More' section in Marks & Spencer 'Interactive supply chain map' https://interactivemap.marksandspencer.com/.

occurring in their value chains and to properly address such adverse impacts when they occur'.[32]

'Proportionate and commensurate'

The report 'stresses' that the framework of the EU ESG law should be based on the obligation for undertakings to take all 'proportionate and commensurate measures and make efforts within their means'.[33]

To satisfy the requirement of proportionality a range of factors will be taken into account, including the undertaking's size, business model, position in the value chain as well as the sector of its activity, the nature of its products and services and the severity and likelihood of ESG risks intrinsic to its operations and to the context of its operations, including geographic[34]. The directive further points to the length of the value chain, and the capacity, resources and leverage of the concerned undertaking.[35]

The report recommends that undertakings be required to make all proportionate and commensurate efforts within their means to identify suppliers and subcontractors noting that to be fully effective, due diligence should not be limited to the first tier downstream and upstream in the supply chain but should encompass those identified by the undertaking as posing major risks. The report appears to accept that not all undertakings have the same resources or capabilities to identify all their suppliers and subcontractors and therefore this obligation should be made subject to the principles of reasonableness and proportionality. However, this view is not to be interpreted as a pretext not to comply with their obligation to make all necessary efforts in that regard.[36]

The report recognises that a 'one size fits all' approach is not appropriate and that some undertakings, notably publicly listed SME undertakings and high-risk SME undertakings may 'need less extensive and formalised due diligence processes' or require specific technical assistance.[37] Accordingly, the directive will require Member States to provide SME undertakings with:

- a specific portal where they may seek guidance and obtain further support and information about how best to fulfil their due diligence obligations; and
- financial support to perform their due diligence obligations under the EU's programmes to support SME undertakings.[38]

Whilst the report suggests such assistance should be limited to EU SMEs,[39] the current draft of Article 15 of the directive does not restrict its application.

The directive contemplates other forms of assistance to undertakings which are described below (see 'Practical assistance').

'Within their means'

An undertaking will be required to 'make all efforts within their means' to prevent potential or actual adverse ESG impacts.[40] The same standard will be applicable to the conduct of a risk assessment study,[41] to the identification of suppliers and subcontractors and the provision of relevant information accessible to the public.[42]

The term 'within their means' is not defined. It will be a subjective test to be applied in respect of an undertaking at the time the obligation arises and so precise definition is difficult. If it is given its common meaning, it may mean that an undertaking would not be obliged to borrow funds to prevent a potential or actual adverse ESG impact. However, it is unlikely that Member States' national laws will allow undertakings to avoid compliance on the basis that an undertaking says it can't afford to conduct an ESG risk assessment let alone meet the cost of preventing or mitigating adverse ESG impacts.

Implementing the due diligence requirements

Risk assessment

Member States' laws will be required to establish rules to ensure that an undertaking carries out effective due diligence with respect to potential or actual adverse ESG impacts in its operations, business relationships and value chains.[43]

The initial compliance obligation will be a risk assessment. Undertakings will be required to '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 human rights, the environment or good governance, 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 impacts'.[44]

32 Directive art 1.2 (emphasis added).
33 Resolution (n 1) para 2.
34 ibid para 11; Directive recital 18.
35 Directive art 4.7.
36 ibid recital 44.
37 Resolution (n 1) paras 11 and 27.
38 Directive art 15.
39 Resolution (n 1) para 11.
40 Directive recital 20.
41 ibid art 4.2.
42 ibid recital 44.
43 ibid art 4.1.
44 ibid art 4.2.

If a large undertaking, whose direct business relationships are all domiciled within the Union, or a SME undertaking concludes from its risk assessment that it does not cause, contribute to, or that it is not directly linked to any potential or actual adverse ESG impact, it will be required to publish a statement to that effect including its risk assessment with the relevant data, information and methodology that led to this conclusion (Article 4.3 Statement). Such an undertaking may conclude that it has encountered no adverse ESG impacts if its risk assessment determines that all of its direct suppliers perform due diligence in line with the directive.[45] An Article 4.3 Statement must be reviewed if new risks emerge or if it enters into new business relationships that can pose risks.

In practice, an Article 4.3 Statement is likely to be mainly used by SMEs with only EU direct suppliers. Indeed, for large undertakings, the condition that all direct business relationships be established within the Union will likely hinder the possibility to have recourse to the Article 4.3 Statement. For SMEs, the proof that direct suppliers comply with ESG due diligence standards of the directive will be more easily met with EU established suppliers.

Due diligence strategy

Unless an undertaking issues an Article 4.3 Statement, it will be required to establish and effectively implement a due diligence strategy which will require the undertaking:

- to specify the potential or actual adverse ESG impacts it has identified and assessed in its risk assessment and that are likely to be present in its operations and business relationships, the level of their severity, likelihood and urgency and the relevant data, information and methodology that led to these conclusions;
- to map its value chain and, with due regard for commercial confidentiality, publicly disclose 'relevant' information about the chain, which may include names, locations, types of products and services supplied, and other relevant information concerning subsidiaries, suppliers and business partners in the value chain;
- adopt and indicate all proportionate and commensurate policies and measures with a view to ceasing, preventing or mitigating potential or actual adverse ESG impacts; and
- set up a prioritisation strategy on the basis of Principle 17 of the UN Guiding Principles on Business and Human Rights if it is not in a position to deal with all the potential or actual adverse ESG impacts at the same time.[46]

In respect of the second obligation above, the identification of the 'relevant' information will certainly be an area of attention. H&M provides an innovative example of transparency along its supply chain. On 23 April 2019, H&M announced that it will be providing information about the suppliers of every piece of garment, becoming the first major retailer to do so. Information provided includes the country of production, the supplier and factory names and addresses, as well as the number of workers in the factory. Nevertheless, without further particulars about the human rights and environmental conditions under which suppliers operate, information about the factual details of suppliers may not be sufficient for customers to make informed choices. For this reason, Anna Bryher of Labour Behind the Label suggested that the company could consider 'adding information … about wages paid at suppliers and comparing that to the living wage benchmarks or their promises on living wages'.[47]

In addition to their own due diligence strategy, undertakings must ensure that their business relationships put in place and carry out ESG policies that are in line with their due diligence strategy, and regularly verify that subcontractors and suppliers are in compliance with these obligations, as well as ensuring their purchase polices do not cause or contribute to potential or actual adverse ESG impacts. In this respect, the directive provides examples of the types of mechanisms undertakings may use to achieve this objective, namely framework agreements, contractual clauses, the adoption of codes of conduct or by means of certified and independent audits.[48] These are considered further below (see 'Framework agreements, contracts, codes of conduct and audits').

Stakeholder engagement

Whilst an undertaking may conduct its risk assessment unilaterally, developing a due diligence strategy in response to that assessment will require extensive consultations.

To establish a due diligence strategy, undertakings will be required to hold 'good-faith, effective, meaningful and informed discussions' with all relevant stakeholders[49] being 'those individuals, and groups of individuals whose rights

45 ibid art 4.3.

46 ibid art 4.4.

47 Sonia Elks 'Fashion giant H&M lists suppliers for all garments to tackle worker abuses' Thomson Reuters Foundation (24 April 2019) http://news.trust.org/item/20190424114703-zfxmp.

48 Directive arts 4.8 and 4.9.

49 ibid art 5.1.

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'.[50]

Discussions with stakeholders who are indigenous peoples must be conducted in accordance with international human rights standards, such as the United Nations Declaration on the Rights of Indigenous People, including 'free, prior and informed consent and indigenous peoples' right to self-determination'.

Member States will be obliged to ensure that their national laws will entitle stakeholders to request the undertaking to discuss potential or actual adverse ESG impacts that are relevant to them.[51] Undertakings will have to ensure that affected or potentially affected stakeholders are not put at risk due to their participation in those discussions.[52] National laws with respect to procedures to raise concerns must ensure the anonymity or confidentiality of those concerns, as well as the safety and physical and legal integrity of all complainants, including human rights and environmental defenders, is protected. Whistleblowers' rights and protections should be in line with directive (EU) 2019/1937.[53]

The directive recommends that relevant information on the due diligence strategy should be communicated to potentially affected stakeholders in a manner appropriate to their context, for instance by taking into account the official language of the country of the stakeholders, their level of literacy and of access to the internet.[54] However, there should be no obligation on an undertaking to 'proactively disclose their entire due diligence strategy in a manner that is not appropriate to the stakeholder's context', and the requirement to communicate relevant information should be 'proportionate to the nature, context and size of the undertaking'.[55]

Workers' representatives must be informed by the undertaking on the due diligence strategy and will be able to contribute to it with the right to bargain collectively 'to be fully respected'.[56] The resolution recommends that trade unions should be given the necessary resources to exercise their rights in relation to due diligence, including in order to establish connections with trade unions and workers in the undertakings with which the principal undertaking has business relationships.[57]

All of the provisions relating to discussions on the establishment of the strategy equally apply to its implementation.

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 stakeholders (eg children and indigenous peoples) it may be necessary for them to be provided with independent legal or other advice to ensure that these discussions are 'informed'.

In the context of corporate law, 'meaningful and informed discussions' with an 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 relationships) to enable them to claim standing as 'relevant stakeholders' and so involve themselves in the discussion with the ability to allege that they were neither meaningfully consulted nor informed.

Furthermore, once established, parties to a value chain may 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 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 value chain may have to be suspended in whole, or in part, depending on the particular circumstances.

A change in the operations of a value chain may have similar consequences. A decision to alter the method, scale or production area of a supplier's operations as they were described in the due diligence strategy may be required. The operations of the value chain 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.

The legislation does not provide guidance as to how disagreements with stakeholders over the development of a due diligence strategy will be resolved. Compulsory

50 ibid art 3.1.
51 ibid art 5.2.
52 ibid art 5.3.
53 Directive (EU) 2019/1937 of the European Parliament and of the Council of 23 October 2019 on the protection of persons who report breaches of Union law.
54 Directive recital 42.
55 ibid.
56 ibid art 5.4.
57 ibid recital 57.

mediation or expert determination might be helpful in some situations. The grievance mechanism required to be established by an undertaking (see below) 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 on a due diligence strategy and so will not exist during the negotiations.

Publication of the due diligence strategy

Member States' national laws will require undertakings to make their most up to date due diligence strategy (or Article 4.3 Statement) publicly available, and accessible free of charge, especially on its website[58] and also require undertakings to upload their due diligence strategy or the Article 4.3 Statement on a European centralised platform, supervised by the national competent authorities contemplated by the new law.[59]

Undertakings will have to communicate their due diligence strategy to their workers' representatives, trade unions, business relationships and, on request, to the relevant competent authority.[60]

Potentially affected stakeholders may require relevant information concerning a due diligence strategy upon request and in a manner appropriate to their context, for example translated into the official language of their country.[61]

Review of the due diligence strategy

The effectiveness and appropriateness of a due diligence strategy and its implementation must be reviewed and evaluated at least once a year, and revised as necessary as a result of the evaluation.

Evaluation and revision will involve the same process and stakeholders that were involved when it was established.

Commercial confidentiality

Commercial confidentiality of information will be respected in connection with the mapping of a value chain,[62] the publication of a due diligence strategy or Article 4.3 Statement,[63] the identification of suppliers and sub-contractors[64] and the publication by competent authorities of an annual activity report of the most serious cases of non-compliance.[65]

Commercial confidentiality will be limited to information which is considered a 'trade secret' under directive (EU) 2016/943.[66] Accordingly, the information must be secret, in the sense that it is not, 'as a body or in the precise configuration and assembly of its components', generally known or readily accessible to persons within the circles that normally deal with the kind of information in question, that it has commercial value because it is secret, and that it has been subject to reasonable steps under the circumstances, by the person lawfully in control of the information, to keep it secret.[67]

Grievance mechanism

Undertakings will be required to establish a grievance mechanism, which will have two functions – to act as an 'early-warning mechanism for risk-awareness' and as a mediation system, allowing stakeholders to voice their reasonable concerns regarding the existence of potential or actual adverse ESG impacts. Grievance mechanisms will be able to be set up through collaborative arrangements with other undertakings or organisations, by participating in multi-stakeholder grievance mechanisms or joining a Global Framework Agreement.[68] An undertaking will be required to 'take decisions informed by the position of stakeholders', when developing a grievance mechanism.[69]

A grievance mechanism will require timely and effective responses to stakeholders' concerns and will provide a forum for proposals to the undertaking on how potential or actual adverse ESG impacts may be addressed.[70]

Undertakings will be required to report on reasonable concerns raised via their grievance mechanisms and on progress made on those matters. Information will have to be published in a manner that does not endanger the stakeholders' safety, including by not disclosing their identity.[71]

A sectoral due diligence action plan may provide for a single joint grievance mechanism (informed by the position of the relevant stakeholders) for undertakings within its scope.[72]

Framework agreements, contracts, codes of conduct and audits

As we have seen, a fundamental principle of the proposed new law is that an undertaking must ensure that its business

58 ibid art 6.1.
59 ibid art 6.3.
60 ibid art 6.2.
61 ibid.
62 ibid art 4.4(ii).
63 ibid art 6.1.
64 ibid recital 18.
65 ibid art 13.8.

66 Directive (EU) 2016/943 of the European Parliament and of the Council of 8 June 2016 on the protection of undisclosed know-how and business information (trade secrets) against their unlawful acquisition, use and disclosure.
67 Resolution (n 1) para 33.
68 Directive art 9.1.
69 ibid art 9.6.
70 ibid arts 9.3 and 9.5.
71 ibid art 9.4.
72 ibid arts 11.3 and 11.4.

relationships put in place and carry out ESG policies that are in line with the due diligence strategy. The draft directive 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.[73]

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 value chain will 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. Such an arrangement may be appropriate with respect to the oversight of the ESG obligations of a value chain, the management of reporting and disclosure compliance obligations and the compulsory annual review and evaluation of the due diligence strategy.

The more effective the legal structure of a value chain is in addressing events or circumstances of non-compliance with the due diligence strategy, the more likely it is that evidence of 'control' of one party over another or the 'contribution' of one party to another's non-compliance may be established resulting in direct liability. Whilst structuring a value chain as a series of connected but essentially standalone contracts may lessen this, it 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.

In practice 'codes of conduct' as such may have little practical application in a value chain, as misconduct in the context of the proposed law may have serious legal consequences and should therefore be the subject of a contractual clause rather than a code of conduct unless compliance with the code is made a legal obligation.

The proposed law also contemplates the possibility that each link may also need to be the subject of a 'certified and independent audit' which will require a physical inspection of the operations, 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.

Practical assistance

The draft directive contemplates several initiatives that may be of practical benefit to undertakings, including:

- the adoption of voluntary sectoral or cross-sectoral due diligence action plans at national or EU level aimed at coordinating the due diligence strategies of undertakings (although participation in such schemes will not exempt an undertaking from its obligations in the directive);[74]
- the publication of general non-binding guidelines for undertakings on how best to fulfil their due diligence obligations by providing practical guidance on how proportionality and prioritisation, in terms of impacts, sectors and geographical areas, may be applied to due diligence obligations depending on the size and sector of the undertaking and specific non-binding guidelines for undertakings operating in certain sectors;[75]
- publicly available and regularly updated country fact-sheets providing up-to-date information on the international Conventions and Treaties ratified by each of the EU's trading partners;[76] and
- the publication of trade and customs data on origins of raw materials, and intermediate and finished products, and information on potential or actual adverse ESG impacts risks associated with certain countries or regions, sectors and sub-sectors, and products.[77]

However, the directive warns that due diligence should not be a 'box-ticking' exercise but should consist of an ongoing process and assessment of risks and impacts, which are dynamic and may change on account of new business relationships or contextual developments.[78] The report notes that certified industry schemes offer SMEs opportunities to efficiently pool and share responsibilities. The resolution confirms that whilst third-party certification schemes can complement due diligence strategies, they will not constitute grounds for justifying a derogation from the obligations set out in the directive or affect an undertaking's potential liability in any way.

73 ibid art 4.8.

74 ibid art 11.1.
75 ibid arts 14.2 and 14.3.
76 ibid art 14.4.
77 ibid art 14.4.

The resolution stresses that future due diligence legislation should focus on digital solutions to minimise bureaucratic burdens and calls on the Commission to investigate new technological solutions that establish and improve traceability in global supply chains and recommends the Commission should evaluate and propose tools in order to help undertakings with the traceability of their value chains, such as blockchain.[79]

The management and reporting functions of an undertaking

The resolution makes a number of recommendations which apply to the internal management of undertakings in relation to their ESG obligations:

- for due diligence to be embedded in the culture and structure of an undertaking, the members of the administrative, management and supervisory bodies of the undertaking should be responsible for the adoption and implementation of its sustainability and due diligence strategies;[80]
- undertakings should set up an internal value chain-mapping process that involves making all proportionate and commensurate efforts in order to identify their business relationships in their value chain;[81] and
- large undertakings are encouraged to set up advisory committees tasked with advising their governing bodies on due diligence matters, and including stakeholders in their composition.[82]

Control and sanctions

Accountability and supervision

The directive aims to ensure that undertakings will be held accountable and liable in accordance with national law for the adverse ESG impacts that they cause or to which they contribute in their value chain, and that victims have access to legal remedies.[83]

The report recommends that Member States either use existing liability regimes in their national laws or, if necessary, introduce further legislation to ensure that undertakings can, in accordance with national law, be held liable for any harm arising out of adverse ESG impacts that they, or entities they control, have caused or contributed to by acts or omissions, unless the undertaking can prove it took all due care in line with the directive to avoid the harm in question, or that the harm would have occurred even if all due care had been taken.[84] In relation to human rights, the recommendation is that the burden of proof be shifted from a victim to an undertaking to prove that an undertaking did not have control over a business entity involved in the human rights abuse.[85]

Each Member State will be required to designate one or more national competent authorities responsible for the supervision of the application of the directive, as transposed into its national law,[86] and for the dissemination of due diligence best practices. Competent authorities will be required to cooperate to enforce the obligations provided for in the directive.[87]

The report also recommends the establishment of a European Due Diligence Network of competent authorities to ensure the coordination and convergence of regulatory, investigative and supervisory practices, the sharing of information, and to monitor the performance of national competent authorities.[88]

Self-reporting and remediation

The national laws will require an undertaking which identifies that it is directly linked to an adverse ESG impact to cooperate with a remediation process to 'the best of its abilities'.[89] The remedy may be proposed as a result of mediation via the grievance mechanism,[90] but will be determined in consultation with the affected stakeholders.[91] Remedies will include financial or non-financial compensation, reinstatement, public apologies, restitution, rehabilitation, a contribution to an investigation and the provision of guarantees that the harm in question will not be repeated.[92]

However, a remediation proposal by an undertaking will not prevent affected stakeholders from bringing civil proceedings in accordance with the applicable national law including when there are ongoing proceedings under a grievance mechanism. While national courts will be required to consider decisions issued by the grievance mechanism, they will not be bound by them.[93]

Investigations

The competent authorities established by each Member State to supervise the national laws will have the power to

78 Recital 34 to the Directive.
79 Paragraph 24 of the Resolution and recital 29 to the Directive.
80 Directive 45.
81 ibid recital 32.
82 ibid recital 56.
83 ibid art 1.3.
84 ibid art 19.3.
85 Resolution (n 1) para 58.
86 Directive art 12.1.
87 ibid art 16.1.
88 Resolution (n 1) para 23; Directive art 16.1.
89 Directive art 10.1.
90 ibid art 10.2.
91 ibid art 10.3.
92 ibid arts 10.3 and 10.4.
93 ibid art 10.5.

carry out investigations to ensure that undertakings comply with their obligations, with conduct checks on undertakings (including the due diligence strategy, the grievance mechanism, and 'on-the-spot' checks) and interviews with affected or potentially affected stakeholders or their representatives.[94]

An investigation may be conducted if a competent authority has relevant information regarding a suspected breach by an undertaking of its obligations. Information may be based on 'substantiated and reasonable concerns' raised by any third party. The Commission and competent authorities will be required to facilitate the submission of a third party's substantiated and reasonable concerns and to ensure their confidentiality or anonymity.[95]

If, as a result of an investigation a competent authority identifies a failure to comply with the directive, it will be required to grant the undertaking an appropriate period of time to take remedial action,[96] if such action is possible. If remedial action is not taken within the period of time granted, fines may be imposed.[97] These fines are encouraged to be comparable in magnitude with fines for breaches of competition law (up to 10 per cent of the undertaking's worldwide turnover: to date the highest fine is €4 billion in 2018 imposed on Google for abuse of dominance) and data protection law (up to 4 per cent of the undertaking's worldwide turnover: to date the highest fine is €50 million, imposed in the French 2019 Google case).

Member States' national laws will be required to provide that if the failure to comply with the directive could directly lead to irreparable harm, the ultimate sanction may be the temporary suspension of activities. For foreign undertakings operating in the EU, the temporary suspension of its activities may imply a ban on operating in the EU.[98]

Conclusion

The report of the European Parliament and its draft directive provides a good sense of the breadth and reach of the forthcoming EU legislation on mandatory due diligence requirements along value chains of companies operating in the EU. The legislation will be a 'first of its kind' and will require the urgent attention of top management of companies operating in the EU to ensure that their ESG due diligence strategy is properly and effectively established in the first place and then subject to review and audit to ensure ongoing compliance throughout their value chains.

94 ibid art 13.1.
95 ibid art 13.2.
96 ibid art 13.5.
97 ibid art 13.7.
98 ibid art 13.6.