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The proposed EU Corporate Sustainability Due Diligence Directive: Relevant aspects from a third-country company perspective

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The background of the lower half of the cover is a blurred image of the European Union flag, showing the blue field with yellow stars.

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The proposed EU Corporate Sustainability Due Diligence Directive: Relevant aspects from a third-country company perspective

I – Introduction

The question of responsible business conduct and companies' responsibility for sustainability, both in their own operations and in their supply or value chains, has grown in importance over the past 20 years. This evolution has been driven by the work of the United Nations (UN), whose 1999 Global Compact and 2011 Guiding Principles on Business and Human Rights (UNGPs) has resulted in action at the global,¹ national,² and corporate levels. The European Union (EU), which counts respect for human dignity and human rights among its founding values and the improvement of the quality of the environment among its principal aims,³ was a frontrunner in endorsing the UNGPs,⁴ and has been promoting their global implementation. Through its flagship Green Deal,⁵ which was launched in December 2019, the EU has put forward proposals for binding legislation in the area of responsible business conduct, thereby giving the evolution described above a regional dimension.

Through the Green Deal, the EU has set out to be a “global leader by moving first and moving fast” in the just transition to a sustainable and competitive economy and thus “convince other countries to move with” the bloc.⁶ Among the deliverables of the main components of the EU Green Deal⁷ were initiatives on sustainable corporate governance.⁸ Furthermore, the promotion of decent work, ensuring that fundamental principles and rights at work are respected, and the strengthening of responsible management in global supply chains and access to social protection are priorities of the

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¹ See the G7 Leaders' Declaration adopted on 7-8 June 2015 in Schloss Elmau and the G20 leaders' Declaration adopted on 8 July 2017 in Hamburg. See also the G20/OECD Principles of Corporate Governance, the OECD Guidelines for Multinational Enterprises on Responsible Business Conduct (updated in June 2023) and the accompanying OECD Due Diligence Guidance for Responsible Business Conduct, as well as OECD sector-specific Guidance for Responsible Business Conduct.

² See the *Modern Slavery Act 2015* (UK) (2015 c. 30), the French law “loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre” (JORF n° 74 du 28 mars 2017), the Australian *Modern Slavery Act 2018* (Cth) (No. 153, 2018), the Dutch law « Wet zorgplicht kinderarbeid » (Staatsblad 2019, 401), the German law “Lieferkettensorgfaltspflichtengesetz” (BGBl 2021 I, p. 2959) and the Norwegian “Lov om virksomhetens åpenhet og arbeid med grunnleggende menneskerettigheter og anstendige arbeidsforhold (åpenhetsloven)” (LOV-2021-06-18-99). See also the changes introduced to the Swiss Code of Obligations applicable from financial year 2023 and the proposed Dutch law “Wet verantwoord en duurzaam internationaal ondernemen” (35761-2), the proposed Belgian law “loi instaurant un devoir de vigilance et un devoir de responsabilité à charge des entreprises tout au long de leurs chaînes de valeur/wet houdende de instelling van een zorg- en verantwoordingsplicht voor de ondernemingen, over hun hele waardeketen heen”.

³ Articles 2 and 3.3 in the Treaty on the European Union (OJ C 326, 26.10.2012, p. 13). See also recital 1 of the proposed Directive.

⁴ European Commission Communication “A renewed EU Strategy 2011–14 for Corporate Social Responsibility” (COM/2011/681 final).

⁵ European Commission Communication on the European Green Deal (COM 2019/640 final).

⁶ European Commission President Ursula von der Leyen in Brussels on 11 December 2019.

⁷ The European Climate Law (*Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999*, OJ L 243, 9.7.2021, p. 1), The Action Plan on a Circular Economy, The Biodiversity Strategy, The Farm to Fork Strategy, The Chemicals Strategy and The Green Deal Industrial Plan.

⁸ COM 2019/640 final, p. 17.

EU's 2020-2024 Action Plan on Human Rights and Democracy.⁹ The political declarations of the EU Green Deal and the EU Action Plan were followed by activity from the EU legislature,¹⁰ which resulted in the publication of a proposed Directive on Corporate Sustainability and Due Diligence (the CSDD Directive) in February 2022.¹¹ The proposed CSDD Directive is ambitious, far-reaching, and emblematic of the new generation of sustainability legislation under the EU Green Deal, which leverages the EU Single Market to set global precedents and aims to strengthen the EU's global policy influence.

The proposed CSDD Directive introduces obligations for companies—both EU and non-EU domiciled alike—operating in the EU Single Market and covered by the Directive to conduct human rights and environmental due diligence with respect to their own operations, the operations of their subsidiaries, and in their value chain. Enforcement of these obligations will be through both administrative and judicial means. The latter form of enforcement relies on the proposed introduction of an EU-wide ground of civil liability for companies for damages caused by non-fulfilment of their due diligence obligations. The proposed Directive is currently in the process of being adopted by the EU Parliament,¹² with the EU institutions beginning their legislative negotiations in June 2023. This paves the way for the proposed Directive to be adopted by late 2023 or during the first half of 2024.

This paper sets out to explain the relevant aspects of the proposed CSDD Directive from a third-country—that is to say, non-EU—corporate perspective. In this context, a third-country company is understood as being a company that has been formed in accordance with the legislation of a non-EU Member State and with a net turnover generated in the EU that meets the thresholds set out in the Directive (see art 2.2. of the proposed Directive). Firstly, a brief explanation will be given of the legislative context and an overview of the proposed CSDD Directive (II); then the relevant aspects from a third-country company perspective will be examined (III); followed by a more in-depth discussion on the concept of corporate sustainability due diligence in the proposed CSDD Directive (IV); before some brief concluding remarks (V).

II – Legislative context and overview of the proposed EU Corporate Sustainability Due Diligence Directive

A) Legislative context

⁹ Line of action 1.4 i) in the Action Plan. See also *Communication from the European Commission to the European Parliament, the Council and the European Economic and Social Committee on decent work worldwide for a global just transition and a sustainable recovery* (COM 2022/66 final).

¹⁰ Two studies were published by the European Commission in 2020: “Study on due diligence requirements through the supply chain” (conducted by the British Institute of International and Comparative Law, Civic Consulting and LSE Consulting) and “Study on Directors’ Duties and Sustainable Corporate Governance” (conducted by EY). The European Commission then launched an open public consultation on sustainable corporate governance in October 2020. 473 000 responses were received from EU businesses and EU citizens during this public consultation. See also *Council of the European Union Conclusions of 1 December 2020 on Human Rights and Decent Work in Global Supply Chains*, *European Parliament Resolution of 17 December 2020 on Sustainable Corporate Governance* (2020/2137(INI)), *European Parliament Resolution of 10 March 2021 with Recommendations to the Commission on Corporate Due Diligence and Corporate Sustainability* (2020/2129 (INL)), *Joint Declaration of the European Parliament, the Council of the European Union and the European Commission – EU Legislative Priorities for 2022* (OJ C 514 I, 21.12.2021, p. 1).

¹¹ *Proposal for a Directive of the European Parliament and the Council on Corporate Sustainability Due Diligence amending Directive* (EU) 2019/237 (COM (2022) 71 final).

¹² The Council of the European Union and the European Parliament are co-legislators under the ordinary legislative procedure. The Council adopted its preliminary general approach to the proposed CSDD Directive on 1 December 2022. The European Parliament voted on its first-reading opinion on 1 June 2023, and the trilogue negotiations between the European Parliament, the Council and the European Commission started on 8 June 2023.

The proposed CSDD Directive forms part of a wider range of EU legislative initiatives on sustainable corporate governance, which aim to drive changes in corporate behaviour in this area. The most important of these initiatives in this context are the Corporate Sustainability Reporting Directive (CSRD),¹³ applicable to third-country companies which conduct “significant activity” in the EU, the Sustainable Finance Disclosure Regulation (SFDR),¹⁴ applicable to third-country financial market participants, the Taxonomy Regulation,¹⁵ applicable to third-country financial market participants—covered by the CSRD—that offer and distribute financial services in the EU.

Although they are not applicable to third-country companies, the recently adopted EU Deforestation Regulation¹⁶ and the proposed EU Forced Labour Regulation¹⁷ are also worth mentioning in the context of sustainable corporate governance. Both of these regulations set out mandatory due diligence rules for companies.

B) Overview of the proposed EU Corporate Sustainability Due Diligence Directive

The proposed CSDD Directive is binding upon the EU Member States as to the results to be achieved, but leaves to the national authorities the choice of both form and methods.¹⁸ This means that the proposed Directive will not be identically transposed into the respective national legal orders of the Member States. However, Member States must choose the most appropriate legal means to ensure the effectiveness of a Directive, in the light of its objective,¹⁹ and subject to the requirement that the forms and methods chosen are binding and meet the requirement of legal certainty. In practice, this means transposition through statute and that Member States which have already introduced corporate sustainability due diligence laws may

¹³ *Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting* (OJ L 322, 16.12.2022, p. 15). This Directive is applicable to third-country companies with a “significant activity” in the EU (EU net turnover of more than EUR 150 million for two consecutive financial years and with a subsidiary or branch (with a net turnover of at least EUR 40 million) within the EU) from 2029, for the financial year starting on or after 1 January 2028. The Directive will require companies to present sustainability reporting, to have the reported information audited and to perform human rights and environmental due diligence in their own operations, their subsidiaries and in their value chain. The upcoming official publication by the European Commission of the “European Sustainability Reporting Standards (ESRS)” will bring more clarity on what is expected of companies.

¹⁴ *Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector* (OJ L 317, 9.12.2019, p. 1). Under the SFDR companies are required to publish a statement on due diligence policies with respect to adverse impacts of investment on sustainability factors.

¹⁵ *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* (OJ L 198, 22.6.2020, p. 13). The Taxonomy Regulation sets out the criteria for determining whether an investment qualifies as environmentally sustainable. For an investment to be considered as environmentally sustainable under the Taxonomy Regulation, the economic activity in question must, *inter alia*, be carried out in compliance with minimum safeguards in terms of responsible business conduct.

¹⁶ *Regulation of the European Parliament and of the Council on the making available on the Union market and the export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010*, adopted by the Council of the EU on 16 May 2023.

¹⁷ *Proposal for a Regulation of the European and the Council on prohibiting products made with forced labour on the Union market* (COM 2022/453 final).

¹⁸ See art 288 in the Treaty on the Functioning of the European Union.

¹⁹ See Court of Justice of the European Union, judgement of 4 July 2006, *Adeneler*, C-212/04, EU:C:2006:443, paragraph 93 and the case-law cited.

only need to make amendments to these laws in order to comply with the proposed CSDD Directive.

The proposed CSDD Directive can be said to have two primary objectives, one outward-facing and one inward-facing. The outward-facing objective is—in line with the declared aims of the EU Green Deal—to better leverage the potential of the EU Single Market to contribute to the transition to a sustainable economy and enable a strong European voice in policy developments on a global level.²⁰ The inward-facing objective is to influence corporate behaviour in a sustainable direction and to lay down harmonised rules concerning corporate sustainability due diligence in order to avoid the problem of divergent national regulations in the Member States leading to the fragmentation of the EU Single Market, and thereby its very functioning. Additionally, harmonised rules will also increase the legal certainty for companies operating in the Single Market and ensure that these companies have a “level playing field”.²¹

The proposed CSDD Directive is horizontal, meaning that it applies to companies across all sectors, including the financial sector, provided that they meet relevant conditions relating to turnover and number of employees.²² The Council of the EU has proposed that the applicability of the Directive to the financial sector be made optional,²³ whereas the European Parliament’s position is that the financial sector should be included.²⁴ This fundamental question as to the scope of the Directive will thus necessarily have to be settled during the legislative negotiations.

The proposed Directive is structured around four pillars: 1) the corporate sustainability due diligence obligation (arts 1-11 and 16); 2) the obligation for companies to contribute to combatting climate change (art 15); 3) company directors’ duties in relation to due diligence and sustainability (arts 15, 25 and 26); and 4) enforcement of the due diligence obligation (arts 20 and 22). The obligations relating to directors’ duties is not applicable to third-country companies, with the exception of directors’ responsibilities in relation to art 15.

III – Relevant aspects of the proposed EU Corporate Sustainability Directive from a third-country company perspective

A) Which third-country companies does the proposed CSDD Directive apply to?

²⁰ See recital 71 of the proposed CSDD Directive and p. 14 of the Explanatory Memorandum to the proposed Directive.

²¹ The legal basis used for the proposed Directive are art 50 TFEU (freedom of establishment in the Single Market) and art 114 TFEU (the functioning of the Single Market). See also recital 71 of the proposed CSDD Directive and p. 3 of Explanatory Memorandum to the proposed Directive.

²² According to art 2.1 the Directive applies to EU companies that either have a) more than 500 employees on average and a net worldwide turnover of more than EUR 150 million in the last financial year, or b) does not reach the thresholds under a), but have more than 250 employees on average and a net worldwide turnover of more than EUR 40 million, provided that at least 50% of this net turnover was generated in a *high-impact* sector. Concerning the conditions for third-country companies and further explanation about *high-impact* sectors see section III below.

²³ Council of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive* (EU) 2019/1937 – General Approach (2022/0051 COD).

²⁴ Document A9-0184/2023.

According to its art 2.2 the proposed CSDD Directive applies to all third-country companies which have either: a) generated a net turnover²⁵ of more than EUR 150 million²⁶ in the Union in the financial year preceding the last financial year (Group 1); or b) generated a net turnover of more than EUR 40 million,²⁷ but not more than EUR 150 million, in the Union in the financial year preceding the last financial year, provided that at least 50% of the net worldwide turnover was generated in a so called *high-impact* sector (Group 2). The Commission states in recital 24 of the proposed Directive that the turnover generated in the EU creates a territorial connection between third-country companies and the EU territory, and serves as a proxy for the effects that the activities of those companies could have on the EU Single Market. According to the Commission these effects constitute the justification for the application of EU law to third-country companies from an international law perspective.

The *high-impact* sectors for the purposes of the proposed Directive are enumerated in art 2.1(b)(i) and correspond to sectors covered by existing Organisation for Economic Co-operation and Development (OECD) sectoral guidance on responsible business conduct. They are the garment and leather sectors,²⁸ the agricultural, forestry, fisheries, food, and beverages sectors,²⁹ and so-called 'extractive industry' (that is, the extraction of mineral resources and related activities).³⁰ The companies in these sectors that are covered by the proposed Directive are companies active in those stages of the value chain related to manufacturing and wholesale trade.

For a third-country company to be covered by the proposed CSDD Directive it must be constituted in a form that is comparable to the types of legal persons listed in annexes I and II of the EU Accounting Directive,³¹ that is to say, chiefly public and private limited companies. That said, partnerships and unlimited companies can also fall under the proposed Directive.

With the turnover thresholds proposed by the European Commission, it is estimated that around 4,000 third-country companies would be covered by the proposed Directive³².

²⁵ For third-country companies covered by the EU Accounting Directive (*Directive 2013/34/EU of the European Parliament and the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings*, (OJ L 182, 29.6.2013, p. 19) the "net turnover" corresponds to the definition in art 2, point (5) of that Directive, calculated in accordance with rules established in the so called Country-by-Country Reporting Directive (*Directive (EU) 2021/2101 of the European Parliament and of the Council of 24 November 2021 amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches*, OJ L 429, 1.12.2021, p.1) For other-third country companies net turnover means the revenue as defined by or within the meaning of the financial reporting framework on the basis of which the financial statements of the company are prepared.

²⁶ Equivalent to approximately AUD 240 million.

²⁷ Equivalent to approximately AUD 64 million.

²⁸ Defined as "the manufacture of textiles, leather and related products (including footwear), and the wholesale trade of textiles, clothing and footwear".

²⁹ Defined as "agriculture, forestry, fisheries (including aquaculture), the manufacture of food products and the wholesale trade of agricultural raw materials, live animals, wood, food and beverages.

³⁰ Defined as "the extraction of mineral resources regardless from where they are extracted (including crude petroleum, natural gas, coal, lignite, metals and metal ores, as well as all other, non-metallic minerals and quarry products), 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 (including metals and metal ores, construction materials, fuels, chemicals and other intermediate products)".

³¹ *Directive 2013/34/EU of the European Parliament and the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings* (OJ L 182, 29.6.2013, p. 19).

³² See p. 16 in the Explanatory Memorandum to the proposed Directive.

B) What are the obligations for third-country companies under the proposed CSDD Directive?

i) *The principal obligation: Conducting human rights and environmental due diligence*
This obligation is laid down in art 4 of the proposed Directive and will be explained in further detail in section IV of this paper.

ii) *The ancillary obligations to adopt a transition plan for a sustainable economy, to set emissions reduction targets and to link directors' variable remuneration to the achievement of these objectives*

Article 15 of the proposed Directive is entitled "Combating climate change" and provides an obligation for companies in Group 1 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*. Companies already covered by the CSRD³³ are required to present such a transition plan under that Directive. The proposed art 15 mirrors the provision in the CSRD and makes it obligatory for companies not covered by that Directive to adopt such a plan.

In line with a due diligence approach, art 15.1 requires companies to identify the extent to which climate change is a risk for, or is likely to have an impact upon, the company's operations. If climate change is or should have been identified as such a risk or impact, the company shall include emission reduction objectives in its transition plan. The European Parliament has proposed that the EU's 2050 climate neutrality target and its 2030 target of 55% reduction of carbon dioxide (CO₂) emissions should be specifically addressed in the transition plan.³⁴

Article 15.3 requires companies to take duly into account the fulfilment of the obligations regarding the adoption of a transition plan and the setting of emission reduction objectives when setting directors' variable remuneration, if this part of the remuneration is linked to the director's contribution to the company's business strategy, long-term interests, and sustainability. The Council of the EU has announced that it is opposed to this provision, such that it too will be the likely subject of protracted negotiations during the legislative process.³⁵ The European Parliament has proposed that only companies with at least 1,000 employees should be covered by this obligation, however.³⁶

iii) *The ancillary obligation to designate an authorised representative in the EU*

Article 16 of the proposed CSDD Directive requires third-country companies to designate an authorised representative, in the form of a legal or natural person established or domiciled in one of the EU Member States where the company operates. The authorised representative shall be empowered by the company to receive communications from Member States' competent supervisory authorities on all matters necessary for compliance with, and the enforcement of, national provisions transposing the Directive.

³³ See section II A) above.

³⁴ European Parliament, document A 9-0184/2023.

³⁵ Council of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 – General Approach (2022/0051 COD)*.

³⁶ European Parliament, document A 9-0184/2023.

iv) *The ancillary obligation to process personal data in accordance with the General Data Protection Regulation (GDPR)*

Recital 67 of the proposed CSDD Directive explicitly refers to the obligation to process any personal data relating to data subjects within the EU in accordance with the GDPR,³⁷ including requirements of purpose limitation, data minimisation, and storage limitation.

C) When will the obligations for third-country companies under the proposed CSDD Directive be applicable?

Once adopted, the proposed Directive will enter into force on the twentieth day following its publication in the *Official Journal of the European Union* (art 31). Member States then have two years from that date to adopt and publish the regulations and administrative provisions necessary to comply with the Directive. For companies in Group 1, the provisions then become applicable immediately (art 31.1 a). For companies in Group 2, a two-year transition period from the transposition date applies (art 31.1 b), which means that the due diligence obligations will become applicable to companies in that group four years after the Directive has entered into force.

The Council of the EU and the European Parliament are in agreement to extend the transition periods.³⁸ It is therefore likely that longer grace periods for companies will be included in the Directive when it is eventually promulgated.

IV – *The concept of corporate sustainability due diligence under the proposed CSDD Directive*

A) An obligation of means aligned with international standards for responsible business conduct

The proposed CSDD Directive is aligned with international standards for responsible business conduct, such as the *United Nations Guiding Principles on Business and Human Rights*, the *OECD Guidelines for Multinational Enterprises on Responsible Business Conduct*, and the *OECD Due Diligence Guidance for Responsible Business Conduct*. In line with these standards, the proposed CSDD Directive is based on the principles that companies should respect the internationally recognised human rights of those affected by their activities, that they should address adverse human rights impacts with which they are involved,³⁹ and that they should take due account of the need to protect the environment.⁴⁰ The concept of corporate sustainability due diligence under the proposed CSDD Directive is distinct from the traditional concept of transactional (“know your counterparty”) due diligence and also broader than the due diligence concept in such third-country legislative models as Australia’s *Modern Slavery Act 2018* (Cth) as it also encompasses adverse impacts on the environment.

³⁷ Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) (OJ L 119, 4.5.2016, p. 1).

³⁸ Council of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 – General Approach* (2022/0051 COD). European Parliament, document A9-0184/2023.

³⁹ See Chapter II of the *United Nations Guiding Principles on Business and Human Rights* and Chapter II, paragraph A.2 of the *OECD Guidelines for Multinational Enterprises*.

⁴⁰ Chapeau of Chapter VI of the *OECD Guidelines for Multinational Enterprises*.

In order to give effect to these principles, the proposed CSDD Directive imposes in its art 4 on companies covered by the Directive to conduct human rights and environmental due diligence, that is, to establish a due diligence policy and integrate it into all company policies, as well to put in place a process that enables them to identify, prevent, mitigate, bring to an end, and minimise the extent of actual adverse human rights and environmental impacts arising from, their own or their subsidiaries' operations or from their value chain. The obligation to conduct human rights and environmental due diligence is an obligation of means. Companies are required to take appropriate measures; they are not required to guarantee that adverse impacts will never occur or that they will cease.⁴¹ "Appropriate measure" is defined as a measure that is capable of achieving the objectives of due diligence, is commensurate with the degree of severity and the likelihood of the impact, is reasonably available to the company, and which takes into account the specific circumstances of the case and the need to ensure prioritisation of action. When assessing if a measure is reasonably available to the company the specific circumstances of the case, including the characteristics of the economic sector and of the specific business relationship and the company's influence thereof must be taken into account (art 3(q)).

B) What are the adverse human rights and adverse environmental impacts that the due diligence process should cover?

- i) *A concentric and rightsholder focused notion of "adverse human rights impact"*
According to recital 25 the proposed CSDD Directive aims for a "comprehensive coverage of human rights". In the proposed Directive this has resulted in a concentric or two-tiered notion of "adverse human rights impact". At its core are a number of specifically enumerated rights and prohibitions that are listed in section I, part I of the annex to the proposed Directive and enshrined in the 22 international human rights instruments listed in section II of part I of the annex. However, the notion of "adverse human rights impacts" also covers violations of prohibitions or rights not specifically enumerated in section I in part I in the annex, but included in the international human rights instruments listed in section II. For such violations to be considered "adverse human rights impacts", they must "directly impair a legal interest" protected in those instruments, and "the company concerned could have reasonably established the risk of such impairment and any appropriate measures to be taken in order to comply with the [due diligence obligations laid down in the proposed Directive]".⁴² This "outer layer" of adverse human rights impacts thus considerably enlarges the scope of the due diligence concept and makes it difficult to precisely define the scope of the obligation. However, both the Council of the EU and the European Parliament have proposed amendments in this regard, with the Council insisting on a thorough clarification to ensure "maximum predictability".⁴³

The rights and prohibitions specifically enumerated and thus directly covered by the due diligence obligation in the proposed Directive are human rights enshrined in the *Universal Declaration of Human Rights*,⁴⁴ the International Labour Organisation's

⁴¹ Recital 15 of the proposed CSDD Directive.

⁴² Point 21 in Section I of Annex I to the proposed CSDD Directive.

⁴³ Council of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 – General Approach (2022/0051 COD)*, p. 11.

⁴⁴ The right to life and security; the prohibition of torture, cruel and inhuman or degrading treatment; the right to liberty and security; the prohibition of arbitrary or unlawful interference with a person's privacy, family, home

fundamental conventions,⁴⁵ the *International Covenant on Civil and Political Rights*,⁴⁶ the *International Covenant on Economic Social and Cultural Rights*,⁴⁷ the *Convention of the Rights of the Child*,⁴⁸ the *Palermo Protocol supplementing the UN Convention against Transnational Organized Crime*,⁴⁹ and the *UN Declaration on the Rights of Indigenous Peoples*.⁵⁰

The notion of “adverse human rights impact” is expressly rightsholder focused, as it is defined in art 3.1 of the proposed Directive as an adverse impact on protected persons, which results from the violation of one of the rights or prohibitions directly or indirectly covered by the due diligence obligation.

ii) *A tripartite notion of “adverse environmental impact”*

An “adverse environmental impact” is defined in art 3(b) of the proposed Directive as “an adverse impact on the environment resulting from the violation of one of the prohibitions and obligations pursuant to the international environmental conventions listed in the Annex, Part II”.

These conventions concern three specific areas of environmental protection: 1) the protection of biodiversity and endangered species of wild flora and fauna; 2) the production and handling of hazardous and environmentally harmful chemicals; and 3) the handling of hazardous waste. These areas align with some of the most severe global sustainability risks which are within the control of companies, namely biodiversity loss and human environmental damage.⁵¹

Two adverse impacts on the environment are covered by the first area—a violation of the obligation to take necessary measures to avoid biodiversity loss or damage,⁵² as well as a violation of the prohibition to import or export endangered species of wild flora and fauna without a permit.⁵³ The second area covers the prohibitions of

or correspondence; the prohibition of interference with the freedom of thought, conscience and religion; the prohibition of all forms of slavery; the prohibition of causing any measurable environmental degradation.

⁴⁵ The prohibition of the employment of a child under the age of which compulsory schooling is completed; the prohibition of child labour (including the worst forms of child labour); the prohibition of forced labour; the right to freedom of association, assembly, the rights to organize and collective bargaining; the prohibition of unequal treatment in employment.

⁴⁶ The people’s right to dispose of land’s natural resources and not be deprived of means of subsistence.

⁴⁷ The right to enjoy just and favourable conditions of work; the prohibition to restrict worker’s access to adequate housing, food, clothing, water and sanitation in the workplace; the prohibition of withholding an adequate living wage; the prohibition to unlawfully evict or take land, forests and waters;

⁴⁸ The right of the child to have his or her best interests given primary consideration in all decisions and actions that affect children; the right of the child to develop his or her full potential; the right of the child to the highest attainable standard of health; the right to social security and an adequate standard of living; the right to education; the right of the child to be protected from all forms of sexual exploitation and sexual abuse and to be protected from being abducted, sold or moved illegally.

⁴⁹ The prohibition of human trafficking.

⁵⁰ Indigenous peoples’ right to the lands, territories and resources which they have traditionally owned, occupied or otherwise used or acquired.

⁵¹ See the World Economic Forum, *The Global Risks Report 2022, 18th Edition*.

⁵² Article 10(b) of the 1992 Convention on Biological Diversity, including obligations under the Cartagena Protocol on Biosafety and the Nagoya Protocol.

⁵³ Specimens included in an Appendix of the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES).

handling mercury under the *Minamata Convention*,⁵⁴ the prohibition of the production and use of persistent organic pollutants, the prohibition on the non-environmentally sound handling, collection, storage and disposal of waste,⁵⁵ and the prohibition of import of hazardous chemicals and pesticides under the *Rotterdam Convention*.⁵⁶ The third area covers violation of the prohibition of exports of hazardous waste under the *Basel Convention*.⁵⁷

iii) *An effects-based and prospective notion of “severe adverse impact”*

A “severe adverse impact” is defined in art 3(l) as “an adverse environmental impact or an adverse human rights impact that is especially significant by its nature, or affects a large number of people 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 impact”.

This notion is thus based either on an evaluation of the concrete effects of the adverse impact in question or a prospective evaluation of the measures necessary to restore the situation. It is used in connection with companies operating in *high-impact* sectors (who are only required to identify actual or potential severe adverse impacts), in connection with the obligation for companies to bring actual adverse impacts to an end (where the company shall terminate a business relationship with the partner in question, when a severe adverse impact could not be adequately prevented or mitigated), and in connection with the complaints procedure (where complainants have the right to meet with company representatives if the potential or actual adverse impact is severe).

C) What is the scope of the due diligence obligation under the proposed CSDD Directive?

The due diligence process is described in arts 5-11 of the proposed Directive. It is centred on risk management and modelled on the six steps of the due diligence process outlined in the *OECD Due Diligence Guidance for Responsible Business Conduct*.⁵⁸

According to art 4 companies covered by the proposed Directive have the following obligations, to:

- Integrate due diligence into their policies, including by adopting a code of conduct (art 5);
- Identify actual or potential adverse impacts (art 6);
- Prevent and mitigate potential adverse impacts, and bring actual adverse impacts to an end and minimise their extent (arts 7 and 8);
- Establish and maintain a complaints procedure (art 9);
- Monitor the effectiveness of their due diligence policy and measures (art 10); and

⁵⁴ The prohibition of the manufacture of mercury-added products (art 4.1 and Annex A Part I of the Minamata Convention), the prohibition of the use of mercury and mercury compounds in manufacturing processes (art 5.2 and Annex B Part I of the Minamata Convention), the prohibition of the treatment of mercury waste (art 11.3 of the Minamata Convention).

⁵⁵ Article 3.1 and Annex A of the 2001 Stockholm Convention on Persistent Organic Pollutants.

⁵⁶ Chemicals listed in Annex III of the Rotterdam Convention on the Prior Informed Consent Procedure for Certain Hazardous Chemicals and Pesticides in International Trade.

⁵⁷ Articles 4.1 b, 4.1 c, 4.5 and 4.8 and 4A of the Basel Convention on the Control of Transboundary Movement of Hazardous Wastes and their Disposal.

⁵⁸ Embed responsible business conduct into policies and management systems; Identify and Assess adverse impacts; Cease, Prevent or Mitigate adverse impacts; Track implementation and results; Communicate how impacts are addressed; Provide for or Cooperate in remediation when appropriate.

- Publicly communicate on due diligence. This obligation applies to companies not already covered by the CSRD and requires them to annually publish a statement on corporate sustainability due diligence on their websites (art 11).

i) *How far does the company's obligation to avoid causing or contributing to adverse impacts extend?*

The due diligence obligation covers the company's own operations, the operations of its subsidiaries, and its value chain (art 6). With relation to the value chain the obligation is limited to adverse impacts arising out of "established business relationships". In art 2(g) an "established business relationship" is defined as direct or indirect business relationships which, in view of their intensity or duration, are lasting or which are expected to be lasting, provided that they do not constitute a negligible or merely ancillary part of the value chain. The nature of the business relationship as "established" is to be reassessed periodically, and at least every 12 months,⁵⁹ within the framework of the monitoring obligation in art 10.

Special rules apply to companies in *high-impact* sectors and to companies in the financial sector that provide credit, loan, or other financial services. Companies in the former category are only required to identify potential and actual severe adverse impacts relevant to their sector (art 6.2). Companies in the latter category are only required to identify actual or potential adverse impacts before providing the financial service in question (art 6.3).

The Council of the EU has proposed to replace the term "value chain" with the term "chain of activities", since there is no consensus among the Member States on whether the scope of the due diligence obligations should cover a company's "value chain" or be limited to its "supply chain".⁶⁰ The proposal in the so called McMillan Report⁶¹ to replace the term "operations and supply chains" in s. 16 of the *Modern Slavery Act 2018* (Cth) with the term "operations and supply networks" would align the Australian definition with the proposed EU term of "value chain".

ii) *The proposed EU Directive on Corporate Sustainability Due Diligence imposes obligations on companies to take substantive action to prevent, mitigate, bring to an end and minimise adverse impacts*

Article 7 of the proposed Directive lays down an obligation for companies to take appropriate measures to prevent or adequately mitigate potential adverse impacts that have been, or should have been, identified pursuant to art 6. Article 8 lays down a corresponding obligation to take appropriate measures to bring actual adverse impacts to an end or to minimise such impacts. Both these articles list a number of substantive measures that companies must take to comply with these obligations. The most important measures are:

⁵⁹ Recital 20.

⁶⁰ Council of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive* (EU) 2019/1937 – General Approach (2022/0051 COD), p. 6.

⁶¹ Report of the statutory review of the *Modern Slavery Act 2018* (Cth), recommendation 8.

- In consultation with affected stakeholders, to develop and implement a prevention action plan,⁶² or a corrective action plan;⁶³
- To neutralise the adverse impact or minimise its extent, including by paying damages to affected persons and financial compensation to affected communities;
- To contractually oblige direct business partners in the value chain to ensure compliance with the company's sustainability code of conduct (*contractual cascading*) and combine this with appropriate measures for verifying compliance;
- To make necessary investments in order for any action plan to comply with the required standards;
- To provide targeted and proportionate support for small and medium-sized enterprises (SMEs) in the company's value chain, if the business relationship is established and the SME's compliance with the sustainability code of conduct and/or an action plan would jeopardise the viability of that enterprise;
- In compliance with competition law, to collaborate with other entities to increase the effectiveness of the company's actions; and
- A prohibition on deepening the involvement with a business partner who, or whose value chain, is connected to an adverse impact that could not be prevented, mitigated, minimised or brought to an end. In such a case, the company should temporarily suspend commercial relationships with the partner in question or terminate the business relationship when the adverse impact is severe.

D) How is the due diligence obligation under the proposed CSDD Directive enforced?

Two ways of enforcing the due diligence obligation are foreseen in the proposed CSDD Directive: judicial enforcement through civil liability, and administrative enforcement through supervisory authorities. The former option will mean that companies covered by the proposed Directive risk civil liability lawsuits in the EU brought by individuals and entities that have suffered damage because of a failure to comply with the due diligence obligations.

i) *Judicial enforcement through civil liability*

Under art 22.1 of the proposed CSDD Directive, companies are liable for damages if they fail to comply with the due diligence obligations and, as a result of this failure, an adverse impact has occurred which should have been managed through the due diligence process and which has led to damage. A special rule in art 22.2 applies to damages that result from adverse impacts in a company's value chain that are connected to partners with whom the company has an indirect established business relationship. In such cases, the company is not liable unless it was unreasonable, in the circumstances of the case, to expect that the action actually taken would be adequate to prevent, mitigate, bring to an end, or minimise the said adverse impact. Civil liability for a company under this provision does not exclude civil liability for its subsidiaries or business partners in its value chain, nor does it exclude civil liability founded on EU or national *lex specialis* (art 22.3 and 22.4).

⁶² This plan should be implemented where "necessary due to the nature or complexity of the measures required" and should include reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvements (art 6.1 a).

⁶³ This plan should be implemented where an adverse impact "cannot be immediately brought to an end" and should include reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement (art 8.3 b).

In its current form, art 22 does not specify which type of liability would apply to companies which fail to comply with their due diligence obligations. Under the EU principle of national procedural autonomy, this means that this question is decided according to the national procedural laws of the respective EU Member States. The type of liability, and other important aspects of this key provision are likely to change during the legislative process, as the Council of the EU has proposed an amendment to art 22 that specifies that the liability for companies should be founded on fault (intent or negligence) and that the damage must correspond to a damage to a legal interest protected under national law. The Council of the EU has also proposed a reduction of the scope of the liability by expressly providing that a company cannot be held liable if the damage was caused only by its business partners in its chain of activities.⁶⁴ Additionally, the Council of the EU has proposed a prohibition on the overcompensation of victims.⁶⁵

The European Parliament's recently adopted position introduces a number of elements that would make companies' civil liability for non-compliance stricter. To this end, the European Parliament proposes to explicitly mention that Member States may reverse the burden of proof in civil liability cases brought under the Directive,⁶⁶ to clearly link civil liability under the Directive to the fundamental right to an effective remedy, to introduce an EU-wide right for class actions brought by trade unions and civil society organisations on behalf of a group of victims,⁶⁷ and to introduce an EU-wide minimum statute of limitations of 10 years for bringing claims.

The proposed CSDD Directive also introduces an EU-wide conflict of laws rule in art 22.5. According to this rule, liability provided for in provisions in Member States' laws transposing art 22 shall be of overriding mandatory application in cases where the law applicable to the claim is the law of a third country.

In line with the EU principle of procedural autonomy, the practical implementation of this rule will take place according to the procedural and private international law of the different Member States.

ii) *Administrative enforcement through supervisory authorities*

Member States shall designate one or more supervisory authorities to monitor companies' compliance with the Directive (art 17.1). The fact that Member States may designate more than one authority means that sectors requiring special regulatory expertise—such as the financial sector—can be supervised by the appropriate national authority.

⁶⁴ For a discussion concerning this term proposed by the Council of the EU, see section IV C) i) above.

⁶⁵ Council of the European Union, *Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 – General Approach* (2022/0051 COD).

⁶⁶ Proposed recital 58.

⁶⁷ Class actions do not exist in the national procedural laws of all Member States. The Representative Actions Directive (*Directive (EU) 2020/1828 of the European Parliament and of the Council of 25 November 2020 on representative actions for the protection of the collective interests of consumers and repealing Directive 2009/22/EC*, OJ L 409, 4.12.2020, p. 1) introduces an EU-wide right to class actions for consumers in order to enable them to protect their collective rights in areas such as data protection, financial services, travel and tourism, energy and telecommunications. The EU Member States' implementation legislation of that Directive is applicable from 25 June 2023. Any corresponding right for class actions in the finally adopted version of the CSDD Directive would complement the Representative Actions Directive.

For third-country companies the competent supervisory authority shall be that of the Member State in which the company has a branch. If the company does not have a branch within the EU, the competent supervisory authority shall be that of the Member State in which the company generated most of its net turnover in the EU (art 17.3).⁶⁸ If there is a change in circumstances that leads a third-country company to generate most of its EU turnover in a different Member State, the company has a right to make a duly reasoned request to change the competent supervisory authority.

Under the proposed CSDD Directive, supervisory authorities shall be given adequate powers by Member States (to conduct on-site inspections, to order the cessation of infringements, to impose pecuniary sanctions and to adopt interim measures) and they may initiate investigations either of their own motion or after having been informed of substantiated concerns that a company is failing to comply with the national provisions implementing the Directive (art 18.1, 18.2, 18.3, and 18.5). If a supervisory authority identifies that a company has failed to comply with relevant provisions, the authority shall grant the company the opportunity to take remedial action if possible. Remedial action does not preclude civil liability or the imposition of pecuniary sanctions (art 18.5).

Any sanctions adopted by a supervisory authority must be effective, proportionate, and dissuasive (art 20.1). Supervisory authorities have the obligation to take due account of the company's efforts to comply with any remedial actions the company has been ordered to take and the efforts—in terms of investments, support to SMEs, and collaboration with other entities—that the company has made to comply with its obligations (art 20.2). Pecuniary sanctions shall be based on the company's turnover (art 20.3), but no further detail has yet been iterated in this regard.

V - Conclusion

By leveraging the importance of the highly integrated EU Single Market, the proposed CSDD Directive aims to achieve the EU Green Deal's objectives of the EU being a global first mover and a norm-setter in the terms of sustainability.

This ambitious legislative initiative imposes far-reaching obligations on non-EU companies that cover not only the conduct of corporate sustainability due diligence in its operations and value chain, but also requires them to assess their business model and strategy in order to ensure that it is compatible with the transition to a sustainable economy and with the Paris Agreement. The corporate due diligence obligations under the proposed CSDD Directive require companies to take substantive actions to make their measures effective. These actions include adopting a code of conduct, mapping out their value chain in order to identify adverse impacts, engaging with affected stakeholders and with suppliers, making investments in order to ensure measurable impact of prevention and corrective action plans, and supporting vulnerable small and medium-sized companies in the value chain.

Some measures are foreseen in the proposed Directive to support companies with their compliance. The European Commission shall issue guidance on the model contract clauses that companies may use for contractual cascading, and the Commission may also issue guidelines, including for specific sectors or for specific adverse impacts. It is also proposed that Member States should have obligations in this regard—that they would be required to take “accompanying measures” to support companies, such as setting up dedicated websites, platforms, or portals. It is also proposed that companies would be

⁶⁸ The relevant turnover shall be the net turnover of the company in the financial year preceding the last financial year before the entry into force of the relevant provisions with regard to the company or the date when the company first fulfilled the criteria to be covered by the Directive, whichever comes last.

able to rely on industry schemes and multi-stakeholder initiatives to fulfil their due diligence obligations.

In light of the General Approach adopted by the Council of the EU and the European Parliament's first-reading opinion, some key provisions of the proposed CSDD Directive are likely to change as the legislative process moves along. These provisions concern:

- the horizontal nature of the Directive—whether it would apply across all sectors or whether Member States will be given the option not to include the financial sector;
- the turnover thresholds for the Directive to be applicable;
- the scope of the due diligence obligation—whether it will cover the company's entire value chain or its supply chain;
- the conditions for companies' civil liability—whether companies will have a fault-based liability, and whether they will be exonerated from liability for damages that are exclusively caused by business partners in their supply chains. Furthermore, whether victims of adverse impacts caused by companies covered by the Directive will have access to class actions in every Member State; and
- the transition periods for the application of the Directive which would be increased to give companies more time to put in place their due diligence processes.

The practical implementation of the provisions of the proposed CSDD Directive will, under all circumstances, be reliant on national law because of its legal form as a Directive and the EU principle of procedural autonomy. As an example, the rule on civil liability for companies in art 22 of the proposed Directive will be subject to requirements in national procedural law in terms of *locus standi*, time limits for bringing actions, evidence, and burden of proof. This is likely to mean that some EU jurisdictions may be considered more open to upholding claims for civil liability against companies than others. The European Parliament's position is to limit the procedural autonomy of the Member States concerning these important aspects, likely in order to avoid (or at least forestall) companies with complex and potentially problematic value chains relocating their operations to jurisdictions of the latter category.

It is likely that the legislative negotiations towards the CSDD will gain momentum under the Spanish presidency of the Council of the EU during the second half of 2023, and that the Directive may be adopted either at that time or under the Belgian presidency in the first half of 2024. Due to its significant impact for those non-EU companies that would be covered by the proposed CSDD Directive, it would be prudent for such companies to start taking the necessary compliance measures now.

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