# Corporate Sustainability Due Diligence Directive: finding the right balance

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On 23rd February 2022, the European Commission presented a new phase of its initiative on sustainable corporate governance with the proposal for a Corporate Sustainability Due Diligence Directive (CSDD). The proposal was introduced by Commissioner for Justice Didier Reynders as 'a real game-changer in the way companies operate their business activities throughout their global supply chain.'

The proposed rules aim at advancing the green transition and at better protecting human rights in Europe and beyond by establishing a corporate sustainability due diligence duty on the companies over a certain threshold. If such a proposal is accepted by the co-legislators, it would represent a significant step forward in using corporate law to fight climate change and human rights violations, given its binding nature, its extraterritorial scope and the economic significance of activities covered through the value chains. There have been already concerns expressed by the corporate sector about the absence of clarity in some of these rules and the risk of a heavy burden on the companies concerned and even indirectly on SMEs. At this stage the proposal demonstrates shortcomings in terms of legal clarity and coherence with other EU and international rules and seems to fall short of achieving harmonization in the EU. The balance found by the EC will certainly impact the financial sector, despite many exceptions accorded to it.

## 1. The CSDD

The CSDD will apply to companies over certain thresholds, namely all EU limited liability companies with more than 500 employees and more than EUR 150 million in net turnover worldwide; limited liability companies operating in defined high impact sectors, which do not meet both thresholds but have more than 250 employees and a net turnover of more than EUR 40 million worldwide; non-EU companies active in the EU with EU generated turnover thresholds, similar to those for EU companies.

These thresholds make narrow the direct scope of the proposal, as it excludes all SMEs, it only covers approximately 13,000 EU companies and 4,000 third-country companies. However, the proposal has a much broader scope by indirect application. Indeed, covered companies will need to follow the directive's requirements in their own operations, those of subsidiaries and their 'value chain operations', which are their direct and indirect established business relationships.

The CSDD is a bold and innovative text as it goes beyond reporting duties and requires covered companies to integrate due diligence into policies; identify actual or potential adverse human rights and environmental impacts; prevent or mitigate potential impacts; bring to an end or minimise actual impacts; establish and maintain a complaints procedure; monitor the effectiveness of the due diligence policy and measures; and publicly communicate on due diligence. The proposed directive contains many controversial aspects, including new obligations upon directors and administrative law enforcement in the Member States.

## 2. Lack of clarity causing legal uncertainty

One of the flaws of the proposed directive underlined by many economic actors, is its lack of clarity on some aspects. For instance, directors have an obligation to 'take into account the consequences of their decisions for sustainability matters'. The term 'sustainability matters' is arguably very broad and may lead to legal uncertainty. It is important to clarify that this duty to consider 'sustainability matters' should only apply within the scope of directors' responsibilities in national corporate governance law, otherwise the CSDD risks affecting the national corporate governance frameworks that have already been adopted by many Member States (France, Germany…). Plus, the notion of 'directors' needs to be clarified, as despite the definition given, no difference is made between executive and nonexecutive directors. The proposed rules set a non-exhaustive list of rights and a list of instruments in its Annex, in order to define human rights and environmental impacts. This approach can cause challenges of interpretation and clarity. It may even limit the scope of the proposal by encouraging a 'box ticking' attitude.

## 3. Lack of coherence with other instruments

### 3.1 Lack of coherence with international guidelines on corporate sustainability

The CSDD proposal intervenes in a context where legal definitions of due diligence already exist and are being followed across the world. Particularly, there are due diligence frameworks with the UNGPs (UN Guiding Principles Reporting Framework), the 2011 OECD guidelines, and the 2018 OECD guidance. The proposed rules of the European Commission should be more aligned with these frameworks, especially with the UNGPs, rather than introducing a 'new, UNGP-resembling definition of due diligence'. In addition, the CSDD introduces undesirable

deviations from the UNGPs, with the concept of direct and indirect established business relationships. It is intended to induce more effective due diligence, as risks are generally less known when further in the global value chain. There exist specialized organisations monitoring human rights abuses in subsidiaries outside Europe. NGOs have a key role there too.

Yet, it has been argued that UNGPs' approach focusing on prioritization of likelihood and severity of adverse impacts throughout the entire global-value-chain is more appropriate and would avoid different standards between EU and international scale. Despite these shortcomings, the CSDD rightly mirrors the cycle of due diligence described by the UNGPs and complements it with greater details, as could have been expected.

### 3.2 Lack of consistency with related European legislation

In the Preamble, the proposed rules are closely related to the Corporate Sustainability Reporting Directive (CSRD), the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy's minimum social safeguards. It is essential that the EU adopts a holistic approach to these regulations along with the CSDD and that the CSDD is consistent with them. Indeed, CSRD regulates reporting requirements; SFDR regulates financial market requirements, valuation and ratings; and CSDD regulates due diligence requirements. In particular, to ensure complementarity and coherence, the legislator should carefully monitor that the CSDD requirements such as the transition plan requirement, are mirrored in the CSRD.

## 4. Lack of sufficient harmonization

The proposed rules allow for a rather large room for Member States transposition. Even though this difficulty is to be expected considering the nature itself of a directive, it is believed that more harmonization would avoid excessive fragmentation.

Regarding supervisory authorities, their allocated power to impose penalties based on the company's turnover and defined by each Member State will lead to different national rules and may drive a 'race to the bottom' amongst them.

In addition, the CSDD does not legislate on the burden of proof but leaves the choice to national law. This has the risk of creating very unequal level playing fields in the Member States and will undermine liability's effectiveness. Indeed, companies might rearrange their supply chains in order to minimize their liability exposure. Finally, a minimum harmonized framework for civil liability is needed in order to limit gaps between Member States.

## 5. The CSDD and the financial sector

There is a specific regulation for the sustainable reporting of the financial sector (SFDR). The major difficulty of implementation of this regulation since 2021 is the lack of sustainable data from the non-financial firms. Together, with the CSRD, which has been approved by the Council and the European Parliament in June 2022, the CSDD will increase the pressure on non-financial firms to publish sustainable data which will help the financial sector for the implementation of SFDR.

The CSDD features specific rules for the financial sector.

Article 6 of the CSDD introduces the general duty to identify actual and potential adverse impacts. However, this duty is limited for the companies of the financial sector (article 6(3)), which only must conduct *ex ante* rather than ongoing risk identification in relation to financial activities.

Plus, while under the draft directive, the companies in the scope are prohibited from extending existing business relations or from entering new business relations with second entities when it has not applied appropriate measures to prevent or mitigate potential adverse impacts. Covered companies must also 'temporarily suspend commercial relations' and 'terminate the business relationship' if a potential adverse impact is severe, the financial sector benefits from important exceptions. Notably, financial services companies do not need to terminate or suspend the relationship where termination of loans, credits or other financial services could cause 'substantial prejudice'. This provision might raise questions considering that the same practical consequences may arise from suspensions and terminations of commercial relationships in other sectors. Similarly, the financial sector does not have to refrain from entering new or extending existing relations if adverse impacts cannot be prevented or mitigated when providing credit, loan and other financial services. Once again, no apparent justification is put forward by the European Commission for this exemption.

## 6. The difficulty of finding the right balance

### 6.1 A too bold initiative?

The CSDD proposal introduces some ground-breaking provisions that have caused vivid debates.

The European Banking Federation (EBF) has notably underlined several key points that it would like to see removed. For instance, it stands against the obligation to terminate a contract when potential adverse impacts could not be prevented or mitigated or when actual adverse impacts could not be ended. The EBF argues that such an obligation would breach the fundamental contract law principle pacta sunt servanda (meaning that commitments made in an agreement must be kept by the parties to this agreement) which is not 'reasonable', nor 'pragmatic' from a commercial perspective.

In addition, the EBF takes position against the "obligation of means" to bring actual adverse impacts to an end, underlining that it would create potentially very onerous obligations. This position is shared with the risk management profession (FERMA), which underlines the practical challenges of the proposed rules.

The EBF 'strongly oppose' the inclusion of civil liability and the payment of damages to affected groups, claiming such obligations would create an 'unaccountable and uncertain

legal risk for companies.' It also asks that subsidiaries are exempted from covered companies' liability.

Similarly, the risk management profession does not seem fully ready to embrace as many new obligations as established in the proposed CSDD. They ask the European Commission for more time in order to ensure that companies have the appropriate systems and processes in place to comply with the new provisions without overburdening the SMEs.

Other criticisms have been formulated towards the proposed rules, notably on their cross-border and competitive impacts. Indeed, since many European companies would be responsible for their subsidiaries and business relationships outside the EU, there is a risk of putting the covered European entities at a competitive disadvantage compared to their non-European competitors. This risk is limited inside the European market since many third-country competitors would be subject to the same obligations. Yet, there is a risk (probably limited, but still) to disadvantage the EU markets if third country companies decide to leave these markets to avoid the CSDD obligations.

### 6.2 A too shy initiative?

Some economic actors (such as the International Federation of the Economy for the Common Good) have noted key points of potential improvement of the Commission's proposal by the European Parliament and the Member States in the Council, in order to 'make a significant contribution to better sustainability due diligence'. The main criticism made is that restricting due diligence to 'established' business relationships carries the risk of undermining the relevance of CSDD, as covered companies may lack 'established' relationships at lower tiers of their supply chain. In addition, the limited scope of the proposed rules questions the relevance of the text. Indeed, even though SMEs are indirectly covered through their relationships with covered companies, they could have been included in the scope of CSDD on a risk-based approach. Another criterion put forward was that due diligence requirements should be extended to all companies covered by the obligation of financial reporting.

## Conclusion

In a nutshell, the CSDD is a considerable step forward in the European Commission's acknowledgement that companies need to be involved in building a sustainable economy and society. It has an ambitious goal. Indeed, the proposed rules will effectively oblige and empower companies to mitigate the risks across their value chains. Yet, the upcoming discussions in the European Parliament and Council should focus on the room of improvement left in the Commission's proposal, particularly regarding legal clarity; coherence with other frameworks and legislation; harmonization; implementation challenges and possible scope adjustments.

## Bibliography


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