Due diligence in value chains: What to expect in the future?

João Tiago Silveira and **João Bernardo Silva** of **Morais Leitão** explore the differences between the EU Parliament's Draft and the Commission's Draft on corporate sustainable due diligence to identify what to expect from the outcome of the EU's legislative procedure

Companies typically perform due diligence on a transactional basis when seeking to acquire a new company, establish business relationships, or develop and commercialise a new product or service. Transactional due diligence mainly aims to identify the legal or accounting risks potentially entailed and may be triggered by legal provisions or good business practice.

In 2011, the United Nations Human Rights Council approved the United Nations Guiding Principles on Business and Human Rights (UNGP) – a set of guidelines for states and companies to prevent, address and remedy human rights abuses committed in business operations.

Along with these guiding principles, other legal instruments also form the framework of international principles in this subject. This is the case of the International Labour Organization Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (ILO Tripartite Declaration) and the OECD Guidelines for Multinational Enterprises (OECD Guidelines), a set of non-binding principles and standards for responsible business conduct in a global context addressed by governments to multinational enterprises operating in or from adhering countries.

These instruments recommend companies to integrate due diligence strategies into their activities and value chain concerning human rights (UNGP and OECD Guidelines), labour rights (OECD Guidelines and ILO Tripartite Declaration) and environment, governance, bribery and corruption, transparency and consumer interests (OECD Guidelines).

A breakthrough is on the way on this subject. An EU legislative process on sustainable corporate may lead to the world's more important binding instrument on this topic. It aims to approve a directive establishing mandatory due diligence exercises on human rights, environment and

MORAIS LEITÃO
GALVÃO TELES, SOARES DA SILVA & ASSOCIADOS

www.mlgts.pt

João Tiago Silveira
Partner
Morais Leitão
T: +351 210 050 555
E: joao.tiago.silveira@mlgts.pt

João Tiago Silveira is a partner at Morais Leitão. He coordinates the public law, urban planning and environment department.

On the academic circuit, João is a professor at the University of Lisbon School of Law in Public Law and Administrative Law. He regularly speaks in postgraduate courses and conferences on administrative law, administrative licensing and better regulation.

João is a vice-president of the *Instituto de Ciências Jurídico-Políticas* and the International Association of Legislation. He also integrates the lists of arbitrators of the Economic and Social Council and the Administrative Arbitration Centre.

João Bernardo Silva
Associate
Morais Leitão
T: +351 213 817 480
E: jbsilva@mlgts.pt

João Bernardo Silva is an associate at Morais Leitão. He is a member of the administrative, public and environmental law team. Previously he worked with the corporate and M&A and litigation and arbitration teams.

João regularly lectures and participates in courses and conferences in his practice and research areas and was a guest lecturer at NOVA School of Law. He has continuously attended several specialization courses, mainly in consumer law, litigation and arbitration and human rights and has been involved in projects related to social innovation, social economy, fiscal justice and social policy.

governance in companies' value chains, with impact both in companies based in EU member states and in companies from non-EU member states acting in the EU.

Currently, there is already legislation in force in France (*Loi n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre*), Germany (*Gesetz über die unternehmerischen Sorgfaltspflichten zur Vermeidung von Menschenrechtsverletzungen in Lieferketten*), the Netherlands (*Wet Zorgplicht Kinderarbeid*) and the United Kingdom (*Modern Slavery Act 2015*). These laws go beyond the voluntary recommendations in the aforementioned soft law instruments. They set forth concrete obligations on companies' implementation of vigilance or due diligence procedures to prevent, mitigate, monitor and correct impacts on human rights, environment and corporate governance in their activities and value chain. EU legislation on this subject will include all the 27 member states as well as setting the trend for other jurisdictions.

The concept of due diligence in these contexts and legislation has a different scope from transactional due diligence to which companies are usually used. It is no longer a punctual and pre-investment process intended to identify and assess legal, financial, or operational risks but rather a continuous, dynamic and inclusive process to identify, prevent, mitigate, monitor, correct and manage adverse impacts on human rights, environment and corporate governance.

The reasoning of the due diligence is also different: while in transactional due diligence, the risk analysis is oriented towards the company and its competitive or market gains; the risk analysis on human rights and environmental due diligence is mainly oriented toward the impact of the company's activities on society and the environment.

As the EU legislative initiative advances, the integration of mandatory due diligence on human rights and environment into the activities of companies and their value chains will certainly have an impact on their organisation, business models, procurement strategies and value chain management, as well as on the definition and prioritisation of investments, including for companies in the financial sector.

In fact, the world is changing. National courts are starting to judge companies for actions that impact human rights or the environment of their subsidiaries in other countries, or even activities of other foreign companies integrated into their value chains.

In February 2021, a court of the United Kingdom declared itself competent to judge proceedings brought by tens of thousands of Nigerians from the Ogale and Bille communities against the parent company of an Anglo-Dutch multinational company operating in the oil and gas sector. This case was presented on the ground that their health and quality of life had been affected for years by oil leaks from the operations of the multinational group's Nigerian subsidiary, with harmful effects on the environment and the livelihood of the communities living in that region. The court found that the parent company of the targeted multinational had a duty of care towards its subsidiaries and therefore agreed to judge this proceeding in the United Kingdom courts.

In December 2020, thousands of farmworkers in Malawi filed a case in the UK courts against two multinational tobacco companies for integrating into their value chain. The case was filed on the ground that these suppliers exploited workers in inhumane conditions and used child and forced labour.

In other words, a fundamental change is underway: companies will need to assess the actions of other companies of their group or companies with whom they contract irrespective of the countries where they are based.

EU legislative process: similarities and differences

In March 2021, the European Parliament approved a resolution with recommendations to the European Commission on the content of a future Directive on corporate due diligence and corporate accountability (EU Parliament's

Draft). In February 2022, the European Commission unveiled the Draft Directive, which started the EU legislative procedure (Commission's Draft).

The differences between the EU Parliament's Draft and the Commission's Draft led us to foresee that the final version of the Directive will probably undergo some amendments. This article aims to point out the differences between them to identify what to expect from the outcome of this EU's legislative procedure.

On what concerns its scope, the EU Parliament's Draft is particularly ambitious in its subjective scope when compared with the Commission's Draft, which excludes several companies from its scope. Following the example of the French and German legislation, it establishes thresholds regarding the number of employees and the company's net turnover to exclude small and medium-sized enterprises from its scope.

In fact, the EU Parliament's Draft suggests that the due diligence duties shall apply to the activities, operations, business relations and value chains of (i) large undertakings governed by the law of a member state or established in the territory of the Union; (ii) all publicly listed and high-risk small and medium-sized companies; and (iii) large companies and small and medium-sized companies with shares admitted to trading on a regulated market or operating in high-risk sectors, which are governed by the law of a third country and operate in the internal market.

Under the Commission's Draft, the Directive would only apply to large European companies with significant commercial activity in the EU internal market, i.e. companies incorporated under the legislation of a member state with more than 500 employees (including part-time employees) and a worldwide net turnover of more than €150 million euros in the last financial year. Two years after the entry into force of the Directive, it would be applied to European companies with more than 250 employees (including part-time employees) and a worldwide net turnover of more than €40 million euros in the last financial year, provided that at least 50% of this net turnover was generated in high-risk sectors, such as the manufacture and trade of textiles, clothing and footwear, agriculture, forestry, fisheries, the manufacture of food products and trade of agricultural raw materials, live animals, wood, food and beverages, or the extraction and wholesale trade of mineral resources.

The global purpose of both drafts is confirmed by including in their scope certain companies incorporated under the legislation of a third country. The EU Parliament's Draft proposes that the legislation shall apply to limited liability undertakings governed by the law of a non-member state and not established in the territory of the Union when they operate in the internal market selling goods or providing services. The Commission's Draft, for its part, follows the escalated approach and provides for its application to companies that are formed under the legislation of a third country and fulfil one of the following conditions: (i) generated a net turnover of more than €150 million euros in the Union in the financial year preceding the last financial year; or (ii) generated a net turnover of more than €40 million euros but not more than €150 million euros in the Union in the financial year preceding the last financial year, provided that at least 50% of its worldwide net turnover was generated in one or more of the high-risk sectors.

Taking into account this information, one may expect (i) discussions between the Commission, the European Parliament and the Council on a wider scope than proposed in the Commission's Draft and (ii) third countries' companies to be included in the scope.

Both drafts address due diligence on human rights and the environment. However, the European Parliament draft also includes governance topics that may lead to discussions on the integration of some good governance issues during the legislative procedure, such as compliance concerns regarding anti-bribery.

In addition, the Commission's Draft sets out, in an annex, a list of human rights and environmental violations, by reference to recognised objectives and prohibitions included in international conventions and agreements, that should be identified and assessed in the due diligence. This includes the violation of the right to enjoy just and favourable conditions of work, including a fair wage, a decent living, safe and healthy working conditions and reasonable limitation of working hours, the violation of the prohibition of child and forced labour or human trafficking, the breach of the obligation to take the necessary measures related to the use of biological resources to avoid or minimise adverse impacts on biological diversity, violation of the prohibition of the handling, collection, storage and disposal of waste in a manner that is not environmentally sound, or bans on exports of hazardous wastes or some specimens.

Considering that subject matters such as human rights and the environment are very wide and often imprecise, this effort of listing issues to be addressed in due diligence is of paramount importance and should be included in the Directive.

The implementation of mitigation and prevention measures for human rights and environmental risks inevitably implies the conformity of the corporate governance structure with those requirements. Therefore, the Commission's Draft establishes the duty of the company's directors to introduce appropriate supervisory mechanisms in the company's structure and organisation for putting in place and overseeing the due diligence actions and policy, with due consideration for relevant input from stakeholders and civil society organisations, but also to consider the consequences of their decisions for sustainability matters within their duty to act in the best interest of the company. The EU Parliament's Draft is less ambitious and broader, establishing only that the member states shall ensure that the members of the administrative, management and supervisory bodies of an undertaking have collective responsibility for ensuring that the due diligence process and the undertaking's business decisions, including remuneration policies, are compatible with the aims and objectives of the Directive.

According to that draft proposal, the company's governing body shall have the necessary qualifications, knowledge, and expertise regarding the due diligence requirements and purposes. Large companies should also set up an advisory committee tasked with advising the governing body of the undertakings on due diligence matters and propose measures to cease, monitor, disclose, address, prevent and mitigate risks.

Regarding the duties of companies, both drafts refer to the requirement for companies to develop and integrate due diligence strategies, which includes conducting annual risk analyses to identify and assess potential or actual impacts on human rights and the environment, and directly or indirectly, on the good

governance of companies and their value chains.

Both drafts further endorse the need for companies to establish and publish an appropriate monitoring methodology, whereby the risks or adverse impacts identified as being likely to be present in their operations and business relationships should be listed, along with the policies and measures the company intends to adopt to cease, prevent or mitigate those risks and adverse impacts. They also set forth the duty to establish a concrete due diligence strategy in their operations and business relationships. Companies should also seek contractual assurances from their business partners to comply with the codes of conduct and respect the implemented prevention and remediation plans.

However, the European Commission's Draft is more thorough and even requires that, if the adverse impacts on human rights or environment cannot be brought to an end, member states shall ensure that companies minimise the extent of such an impact, requiring them to take concrete actions, such as (i) neutralise the adverse impact or minimise its extent, including by the payment of damages to the affected persons and of financial compensation to the affected, or communities; (ii) develop and implement a corrective action plan with reasonable and clearly defined timelines for action and qualitative and quantitative indicators for measuring improvement; or (iii) seek contractual assurances from a direct partner with whom it has an established business relationship that it will ensure compliance with the code of conduct and, as necessary, a corrective action plan.

Furthermore, and regarding actual adverse impacts that could not be brought to an end or the extent of which could not be minimised by some of the measures abovementioned, the company shall refrain from entering into new or extending existing relations with the partner in connection to or in the value chain. Companies should also, where the law governing their relations so entitles them to, take one of the following actions: either temporarily suspend commercial relationships with the partner in question while pursuing efforts to bring to an end or minimise the extent of the adverse impact or even terminate the business relationship with respect to the activities concerned, if the adverse impact is considered severe.

The Commission's Draft also goes further on environmental sustainability by requiring that obliged companies with a worldwide net turnover of more than €150 million euros shall 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. The fulfilment of the obligations relating to the companies' sustainability and fighting climate change plan should be considered by the companies if the variable remuneration of the company's directors is linked to their contribution to the company's business strategy and long-term interests and sustainability.

Regarding companies' liability, both the EU Parliament's Draft and the Commission's Draft provide for companies to be held effectively liable for the adverse effects they cause or to which they or their value chain contribute. Both Drafts seek to ensure that the victims of those impacts have access to justice to pursue the offending companies and be compensated for the damages they cause.

From the sanctioning point of view, the Drafts set forth that companies could be subject to fines proportional to the impacts applied by the national supervisory authorities created for that purpose and calculated based on the company's turnover. The EU Parliament's Draft is more ambitious and provides for the company's temporarily or indefinitely exclusion from public procurement, state aid, or public support schemes, including schemes relying on Export Credit Agencies and loans, resort to the seizure of commodities and other appropriate administrative sanctions. Therefore, we may expect discussions to include further sanctions into the Commission's Draft.

Moreover, given that both drafts point in this direction, it is very likely that companies will have to set up complaint mechanisms enabling interested parties to report their concerns about the occurrence of risks or adverse impacts, notwithstanding their right to resort to extra-judicial or judicial remedies. The Commission's Draft specifies that complaints may be submitted by (i) persons who are affected or have reasonable grounds to believe that they might be affected by an adverse impact; (ii) trade unions and other workers' representatives representing individuals working in the value chain concerned; or (iii) civil society organisations active in the areas related to the value chain concerned.

The designation or setting up of supervisory authorities for the due diligence obligations in each of the member states is also fairly certain. These supervisory authorities shall have adequate powers and resources to carry out the tasks assigned to them, including the power to request information and carry out investigations related to compliance with the due diligence obligations or to impose the respective sanctions or interim measures.

Although the wording of the Commission and EU Parliament Drafts is usually geared toward direct commercial and contractual relationships established between suppliers or service providers and buyers or purchasers of those goods or services, the financial sector, private equity firms and investors are also covered by the new requirements and obligations.

There is already a legal and regulatory expectation that investors and private equity firms build and exert their influence to leverage their invested companies to undertake measures to prevent and mitigate potential or actual human rights and environmental impacts.

On the one hand, they should positively influence the companies in which they invest or are involved and encourage them to integrate ESG metrics into their investment decision-making process. Setting corporate or investment policies that indicate their ESG expectations can be a valuable way to support or guide the due diligence processes of the companies in which they invest or set risk priorities.

On the other hand, funds, private equity firms and investors may prefer to target their capital or long-term investments to more sustainable companies and seek to engage in industry, regulatory, or geographic initiatives that promote or define measures to prevent and mitigate the most common ESG risks.

In a concluding remark, even though the EU legislative process on corporate sustainable due diligence is still ongoing, the integration of due diligence strategies in companies and their value chains, in addition to anticipating financial and reputational risks and the legal framework that will soon come into force, will improve risk management processes and help foster and materialise environmental sustainability and human rights, and thus a better world.