Muscles from Brussels: Compromise reached on EU “Supply Chain Act”

AFTER MUCH WRANGLING, THE EU COUNCIL UNDER THE BELGIAN COUNCIL PRESIDENCY REACHED AN AGREEMENT ON CORPORATE SUSTAINABILITY OBLIGATIONS ON 15 MARCH 2024

Executive Summary

- More than two years ago, on 23 February 2022, the Commission of the European Union in Brussels presented the draft[1] for a directive on new corporate obligations to respect human rights and environmental protection[2].

- This proposal for the first EU-wide specification of corporate sustainability obligations – the Corporate Sustainability Due Diligence Directive (CSDDD or CS3D) – was even stricter than the German Supply Chain Due Diligence Act (LkSG), which came into force on 1 January 2023 for companies with at least 3,000 employees and expanded its scope in a further step as of 1 January 2024 to include companies with at least 1,000 employees[3].

- Following intensive trilogue negotiations, an agreement was initially reached between the three EU institutions on 14 December 2023[4].

- Despite the abstention of the German federal government, the EU Member States adopted the EU CS3D on 15 March 2024 with a qualified majority of 15 countries with a population share of at least 65%.

- The EU Parliament still has to give its approval, which it is expected to do on 24 April 2024.

- The compromise on the CS3D[5], which the Belgian Council Presidency managed to secure before the EU parliamentary elections on 9 May 2024, includes seven key changes:

  1. Raising the employee threshold from 500 to 1,000 employees
  2. Increased turnover threshold of EUR 450 million net turnover p.a. instead of EUR 150 million.
  3. Phased introduction staggered according to company size after five years at the latest
  4. Abandonment of the high-risk sectors approach
  5. Restriction of the extent of the value chain or “chain of activities” covered by due diligence obligations
  6. Variable remuneration systems no longer tied to climate targets
  7. Adjustment of “genuine” civil liability for companies

[1] Proposal for a directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937.
[2] See our GSK Update dated 25 February 2022 at GSK-Update-EU-Sustainability-Directive.pdf.
[3] See our GSK Update dated 21 June 2021 at https://www.gsk.de/de/das-neue-gesetz-ueber-die-unternehmerischen-sorgfaltspflichten-in-lieferketten/.
[4] Available at https://www.consilium.europa.eu/en/press/press-releases/2023/12/14/corporate-sustainability-due-diligence-council-and-parliament-strike-deal-to-protect-environment-and-human-rights/.
[5] “Final compromises text” dated 13 March 2024, available for download at CSDDD_COREPER_text_13_March_2024.pdf (bvi.de)

Background

Since the beginning of 2023, the German Supply Chain Due Diligence Act (LkSG) has applied to companies based in Germany with more than 3,000 employees; since 1 January 2024, the scope of application has been extended to companies with more than 1,000 employees. Companies subject to the LkSG must implement a whole range of due diligence obligations throughout their global value chains in order to prevent human rights violations and certain environmental damage associated with their business activities. In adopting the LkSG, Germany became part a global legislative movement with the goal of regulating the effects of corporate activities on protected rights under human rights and environmental law, with rules that in some cases diverge significantly. Outside of Europe, the US state of California became a pioneer back in 2010 by passing the Transparency in Supply Chains Act[6]. In the United Kingdom, the Modern Slavery Act[7] stipulating transparency requirements for corporate value chains came into force in 2015 and could potentially be replaced by much stricter regulations in the future. For instance, a draft for a Commercial Organisations and Public Authorities Duty (Human Rights and Environment) Bill[8], which in many respects goes considerably further than the German LkSG, has already been submitted. In France, the *Loi de vigilance*[9] was passed in 2017. After a comparable regulation to prevent child labour was implemented in the Netherlands in 2019,[10] Norway followed suit in 2021 with the *Apenhetsloven*[11]. As shown by this brief overview, the European Commission's approach since 2022 to harmonise the individual Member State regulations is therefore by no means a far-sighted initiative. The CS3D is a response to developments at Member State level intended to prevent any further fragmentation of the legal framework within the single market.

Key points and changes in a nutshell

1. Applicability thresholds

Companies from the EU with more than 1,000 employees and EU-wide net turnover of at least EUR 450 million per year fall under the scope of the legislation. This covers an estimated 5,000 companies in the EU. Under the draft directive prior to the compromise agreement, an estimated 13,000 companies would have been directly affected. The previous high-risk sectors approach, which would have resulted in lower turnover and employee thresholds, has been abandoned. The question of whether special regulations are nevertheless required for certain sectors, such as the financial sector, is to be reexamined no later than two years after the CS3D comes into force.

[6] Senate Bill No. 657, available at https://oag.ca.gov/sites/all/files/agweb/pdfs/cybersafety/sb_657_bill_ch556.pdf.
[7] Available at https://www.legislation.gov.uk/ukpga/2015/30/contents/enacted.
[8] Available at https://bills.parliament.uk/publications/53150/documents/4066.
[9] LOI n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, https://www.legifrance.gouv.fr/jorf/id/JORFTEXT000034290626/.
[10] Wet Zorgplicht Kinderarbeid, available at https://www.eerstekamer.nl/behandeling/20170207/gewijzigd_voorstel_van_wet.
[11] Prop. 150 L Lov om virksomheters åpenhet og arbeid med grunnleggende menneskerettigheter og anstendige arbeidsforhold (åpenhetsloven), available at https://www.regjeringen.no/no/dokumenter/prop.-150-l-20202021/id2843171/.

2. Transitional arrangements

The CS3D compromise includes a phased implementation process depending on the size of the company. The new EU directive should apply

- to all companies with more than 5,000 employees and turnover of EUR 1,500 million no later than *three* years after its introduction;
- to companies with at least 3,000 employees and turnover of EUR 900 million after *four* years;
- and to companies with more than 1,000 employees and turnover of EUR 450 million after *five* years.

3. Chain of activities covered

The EU compromise still addresses both the "*upstream*" and "*downstream*" value chain. However, the concept of the "chain of activities" is now defined more narrowly; the disposal of end-of-life products is no longer covered, while business partners are only included in the material scope of the corporate due diligence obligations subject to monitoring if they have been expressly contractually commissioned to carry out their activities ("on behalf" and "direct business partner"). Although this restricts the indirect scope of the directive, the focus remains on a bi-directional value chain rather than a purely one-dimensional supply chain.

4. Climate change mitigation

To combat the harmful effects of climate change, companies are still obliged to take the maximum warming target of 1.5 degrees under the Paris Climate Agreement into account in their business models and corporate strategies. This is to be achieved by way of "transition plans" mapping out a path to a climate-neutral economy. However, under the current compromise, these transition plans do not have to be reflected in the variable remuneration structures for managers in large companies. In addition, companies that are already subject to the reporting obligations of the EU Corporate Sustainability Reporting Directive (CSRD) are expressly not required to prepare separate transition plans in accordance with CS3D in order to avoid unnecessary additional work[12].

5. Civil liability

The previous concept of "genuine" civil liability for companies has also been adjusted. According to the current CS3D compromise[13], companies are obliged to pay compensation for damages under certain conditions. Unlike in the previous version, however, this liability for damages expressly does not apply if only a business partner along the chain of activities was responsible for causing the damage.

6. Next steps

The agreement just reached must now be approved by the EU Parliament. This is scheduled for the plenary session on 24 April 2024 before the EU parliamentary elections on 9 May 2024.

Recommendations for companies

Despite fierce controversy and repeated criticism that the directive is just another "bureaucratic monster" that will not help to improve human rights or environmental protection, or accusations that it represents a further setback to Europe's competitiveness, especially in times of crisis, we can once again expect supranational legislation from Brussels on top of decades-old international supply chain compliance legislative intiatives. Even if the EU CS3D had ultimately failed, this would not have affected the applicability of the German LkSG – and in this respect, the harmonisation at the EU level may also ensure more uniform competitive conditions to the benefit of German companies. Progressively stricter new corporate due diligence obligations, such as the EU Packaging Regulation[14] and

[12] Cf. CS3D Art. 15 as amended "*Combating climate change*"

[13] Cf. CS3D Art. 22 as amended "*Civil liability of companies and a right to full compensation*"

[14] To address the issue of disposable packaging, the EU Packaging Regulation (2022/0396 COD) stipulates that all packaging must soon be recyclable. Available at eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52022PC0677

the EU Forced Labour Regulation[15], which were adopted just last week, or the still "young" EU Deforestation Regulation[16] – which contain sometimes surprising excursions into global corruption prevention or human rights protection – are perhaps even more complex for companies to implement internally than an "EU Supply Chain Act" with significantly higher application thresholds (double the number of employees and triple the turnover). The direct legal application thresholds will have an impact irrespective of this and ensure the continued proliferation of obligations via contractual clauses from dominant market players, an effect that was already clearly visible following the introduction of the German LkSG over a year ago.

Given the abundance of new corporate due diligence obligations, companies would be well advised to start examining the new risk analysis and management obligations as soon as possible, or to expand their existing compliance management systems (CMS), risk management systems (RMS) and internal control systems (ICS) to include the new compliance risk categories or protected rights in the area of human rights and environmental protection law. In particular, companies should consider adapting their risk-based business partner due diligence processes (business partner compliance due diligence) as well as their whistleblower and complaints procedures.

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[15] The EU Forced Labour Regulation (2022/0396 COD) was adopted by the Council of Ministers shortly before the CS3D and prohibits the import and export of products manufactured using forced labour. Available at https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52022PC0453. In the USA, the Uyghur Forced Labour Prevention Act (UFLPA) enacted last year imposes strict nationwide import regulations, including the customs detention of goods in US bonded warehouses based solely on the suspicion of the involvement of forced labour of Uyghurs in the western Chinese province of Xinjiang. Available at https://www.congress.gov/bill/117th-congress/house-bill/1155/text

[16] The EU Deforestation Regulation 2023/1115 of 31 May 2023 prohibits the import and export to the single market of products and raw materials that have been produced or extracted on forest areas that have been illegally deforested for commercial agricultural purposes. Available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32023R1115

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