Corporate Sustainability Due Diligence Directive: Final Sprint to the Finish Line

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The EU legislature has finally reached an agreement on the text of the Corporate Sustainability Due Diligence Directive (CS3D) (see here our previous client alert). The CS3D profoundly affects the ways companies active in Europe will manage their supply relationships and supply chains worldwide. The CS3D also establishes legal liability for companies regarding both environmental and human rights harm within their supply chain. EU and non-EU companies should be aware that violations of the CS3D may result in fines of up to 5% of their net worldwide turnover, harming the company's reputation by naming and shaming, and potential private enforcement. Its global impact may be compared to that of the General Data Protection Regulation (GDPR).

Reaching an agreement was challenging; several EU countries objected at the last minute to the proposal that had been provisionally agreed on by the EU Council and the European Parliament in December 2023, unless the CS3D was sharply toned down compared to the initial proposal made by the European Commission. To reach a deal before the June European Parliament elections, the Belgian Presidency of the EU Council proposed a watered-down text, which garnered enough support. Following EU Council approval on March 15, the European Parliament's Committee on Legal Affairs approved the compromise text on March 19, with 20 votes in favor and 4 against. The CS3D is now set for final approval with a vote during the European Parliament's Plenary Session scheduled for April 22–25, 2024. Typically, wordsmithing takes some months before the definitive text will be published. The polished text may necessitate another vote by the newly elected Parliament later this year, followed by a final vote in the EU Council before eventual publication.

Scope of Application: Fewer Companies Covered

Of the many changes at the hands of the Belgian Presidency, the significantly **reduced scope of application** as laid down in Article 2 is probably the most striking. Fewer EU and non-EU companies now fall within the scope of the CS3D, as there is a clear focus on larger companies rather than SMEs.

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- **EU Companies.**
  - The thresholds have been raised to apply to companies with **1,000 employees** and a net worldwide turnover of **more than €450 million**, from 500 employees and €150 million in the previous proposal.
  - Ultimate parent companies of a group that reaches these thresholds are also subject to the provisions of the CS3D.
  - Another category now caught by the rules is companies linked by **licensing or franchising agreements** with independent third-party companies in return for royalties if:
    - these agreements provide a shared identity and business concept and the application of uniform business methods;
    - the royalties amounted to more than €22.5 million in the past financial year; and
    - the licensing/franchising company had or is the ultimate parent company of a group that had a net worldwide turnover of more than €80 million in the past financial year.

The original proposal foresaw that companies not reaching the original employee and turnover thresholds but with more than 250 employees and a net worldwide turnover of more than €40 million with half of that generated in specified "high-impact" sectors would still need to comply with the CS3D. This **high-impact sector approach has been scrapped.**

- **Non-EU Companies.** The rules applicable to third-country companies mainly mirror the rules applicable to EU companies. Non-EU companies are caught if they meet the same turnover threshold as EU companies but only in the EU, i.e**., €450 million**. However, there is **no employee-related threshold**.

  The European Network of Supervisory Authorities, composed of representatives of the supervisory authorities (see Art. 21(1)), will publish an **indicative list of third-country companies** subject to the CS3D (Art. 21(9)). While this list provides some guidance for third-country companies, it can be quite problematic if a company is listed due to an error or not listed despite fulfilling the criteria. The details and in particular the timeline for the publication of the list are still open. Companies must keep an eye on the list and may also want to consider taking legal action against an indicative listing they would disagree with.

  The CS3D now includes an **exemption clause** for ultimate parent companies engaged in **holding** shares in operational subsidiaries and not involved in management, operational or financial decisions affecting the group or its subsidiaries. For this exemption to apply, a subsidiary established in the EU must be designated to fulfill the CS3D obligations on behalf of the ultimate parent company. The exemption is not automatic but must be

applied for with the competent supervisory authority under Article 17 of the CS3D, and it does **not free the ultimate parent company from liability**. Joint liability will arise if the designated subsidiary fails to comply with its CS3D obligations.

Due Diligence Obligations

Overall, the current due diligence obligations in Articles 5–11 look very similar to those in the December 2023 text. However, the March Council text contains a few new provisions (Art. 6a, 8c, 8d and 11a), as well as significant changes to the previous text.

- **Integrating due diligence into policies and risk management systems (Art. 5).** Companies should integrate due diligence into their policies and risk management systems, ensuring a risk-based approach.

  The due diligence policy should be updated after significant changes and at least annually. It should include:

  - The company's approach to due diligence;
  - A code of conduct for the company, its subsidiaries and its (in)direct business partners, including the measures taken to verify compliance; and
  - A description of how due diligence will be integrated and implemented.

- **Identifying and assessing actual and potential adverse impacts (Art. 6).** Companies will have to take appropriate measures to identify and assess actual and potential adverse impacts caused by their own, their subsidiaries' and—where related to their chains of activities—their business partners' operations. This notably includes a mapping exercise of such operations.
- **Prioritization of identified actual and potential adverse impacts (Art. 6a).** When it is not feasible to prevent, mitigate, end or minimize all the identified adverse impacts, companies must prioritize and address adverse impacts based on their perceived severity and likelihood.
- **Preventing potential adverse impacts (Art. 7).** In determining the "appropriate measures" to prevent potential adverse impacts, the following factors should be cumulatively considered:

  - Whose conduct caused the potential adverse impact (only the company or business partner or the company and subsidiary/business partner jointly).
  - Whether the potential adverse impact could occur in the subsidiary's or direct/indirect business partner's operations.

- The company's ability to influence the business partner (jointly) causing the potential adverse impact.

Appropriate measures include:

- Developing and implementing a prevention action plan;
- Seeking contractual assurances from a direct business partner;
- Making necessary financial or nonfinancial investments, adjustments or upgrades;
- Making necessary modifications or improvements to the company's business plan, overall strategies and operations;
- Providing support for a SME that is a business partner of the company and whose viability may be threatened by compliance with the company's code of conduct or action plan;
- Collaborating with other companies in compliance with EU law to prevent or mitigate the adverse impact;
- Engaging with a business partner about the company's expectations that potential adverse impacts be prevented and mitigated; and
- Providing or enabling access to capacity-building, guidance, administrative and financial support.

If these measures fail, contractual assurances can be established with indirect business partners.

As a last resort, the company may have to refrain from entering into or extending relations with a business partner and do the following:

- Adapt and implement an enhanced prevention action plan.
- Consider termination if the potential adverse impact is severe and other measures fail, with consideration of the impacts of such termination.

- **Bringing actual adverse impacts to an end (Art. 8).** Companies have to take appropriate measures (as prescribed under Art. 7) to stop actual adverse impacts or minimize their extent when they cannot be ended.

  Appropriate measures include, in addition to those listed under Art. 7, the following:

  - Developing and implementing a corrective action plan. This might be created in cooperation with industry or multi-stakeholder initiatives.
  - Providing remediation pursuant to Article 8c.

  - Engaging with a business partner about the company's expectations regarding the termination or minimization of adverse impacts or providing or enabling access to capacity-building, guidance, administrative and financial support.

  The last two paragraphs included under Article 7 (on contractual assurances and last resort measures) are applicable *mutatis mutandis*.

- **Remediation of actual adverse impact (Art. 8c).** Any company that has (jointly) caused an actual adverse impact must provide remediation.
- **Carrying out meaningful engagement with stakeholders (Art. 8d).** Companies have to provide relevant and comprehensive information to stakeholders in order to carry out effective and transparent consultations. The consultation of stakeholders will take place in specified steps of the due diligence process. If needed, experts can assist companies.
- **Notification mechanism and complaints procedure (Art. 9).** Companies must establish a complaint mechanism for legitimate concerns regarding actual or potential adverse impacts in relation to their operations and those of their business partners and subsidiaries. This procedure should be fair, publicly available, accessible, transparent and anonymous.

  Complaints may be submitted by:

  - Natural or legal persons and their legitimate representatives who are affected/have reasonable grounds to believe they might be affected by an adverse impact;
  - Trade unions; and
  - Civil society organizations.

  Complainants should be entitled to:

  - Request appropriate follow-up;
  - Discuss the potential or actual severe adverse impacts and remediation with the company's representatives; and
  - Receive the reasoning as to why a complaint was considered founded or unfounded.
- **Monitoring (Art. 10).** Companies must assess their due diligence measures yearly. They must monitor the adequacy and effectiveness of the identification, prevention, mitigation, termination and minimization of the extent of adverse impacts.
- **Communicating (Arts. 11 and 11a).** Companies that are not yet subject to sustainability reporting under Directive 2013/34/EU (the Accounting Directive) have to report on the matters that are covered in the CS3D by publishing on their website an annual statement in accordance with the requirements of Article 11(1) of the CS3D. The Commission has an

obligation to adopt delegated acts by March 31, 2027, on the content and criteria for this reporting obligation.

As of January 1, 2029, when publishing their annual statement, companies must also simultaneously submit it to the collection body—a Union body, office or agency, or a national body, authority or register designated as such that collects information submitted by companies—to ensure that it is accessible via the European Single Access Point (Art. 11a). Member states must designate at least one collection body by December 31, 2028.

Enforcement (Arts. 20–22)

The CS3D lays down an extensive public and private enforcement framework that includes both pecuniary and nonpecuniary penalties. Member states will have to ensure that penalties are effective, proportionate and dissuasive.

Such penalties should take into account (i) the nature, gravity and duration of the infringement and the severity of the consequences; (ii) the extent to which prioritization decisions were made (Art. 6a); (iii) previous infringements by the company; (iv) financial benefits gained from or losses avoided by the company due to the infringement; and (v) other aggravating or mitigating circumstances.

– **Fines.**

The CS3D introduces a minimum floor, meaning that the maximum of pecuniary penalties cannot be less than 5% of the net worldwide turnover of the company in the financial year preceding the fining decision.

– **"Naming and shaming": reputational damage.**

The CS3D presents significant challenges to reputation management, with mandatory publication of penalties related to the infringements ("naming and shaming"). Member states must ensure that any infringement decision of the supervisory authorities is published, publicly available for at least five years and sent to the European Network of Supervisory Authorities (Art. 20(4)), which will also publish the penalties (Art. 21(9)). This public denunciation of violations and the ensuing damage to reputation can exceed the damage caused by fines. It also fuels private enforcement, as the violations come to the attention of the general public.

The CS3D is unusually strict as regards naming and shaming. Unlike, for example, Article 68 of the Capital Requirements Directive (Directive 2013/36/EU), it does not contain any proportionality requirements (e.g., in the case of disproportionate damage). Although personal data within the meaning of Article 4(1) of Regulation (EU) 2016/679 (GDPR) may not be included in the publication, this does not preclude naming and shaming of companies. Recital

54 explicitly states that the publication of the company's name is allowed even if it contains the name of a natural person. Whether this is in line with the GDPR remains to be seen.

- **Reduced civil liability?**

The CS3D requires Member states to allow third-party claims against the infringing companies. The March compromise text introduces a number of significant limitations.

- **Scope of civil liability.** Already the Commission proposal foresaw that a company can incur civil liability when it, intentionally or negligently, fails to comply with the obligations of Articles 7 and 8 only. The March Council text adds that an infringer is only liable if the labor or environmental provision in question aims to protect the claimant.
- **Exclusion.** A company is not responsible if the damage was caused solely by its business partners in the supply chain.
- **No overcompensation.** The CS3D provides that any liability cannot lead to overcompensation by means of punitive, multiple or other types of damages.

On the other hand, the March compromise text expanded liability risks from a procedural standpoint.

- **Trade unions and NGOs** can enforce the rights of victims.
- When additional evidence supporting the claimant's claim lies in the control of the company, Member states must make sure that national courts can order the **disclosure** of that evidence on the basis of a reasoned justification in accordance with national procedural law and the principle of proportionality.
- Companies that have participated in industry or **multi-stakeholder initiatives**, or used third-party verification or contractual clauses to support the implementation of due diligence obligations, can still be held liable.

- **Indirect enforcement: CS3D and interaction with public procurement.**

Qualifying as an environmental or social aspect, compliance with the obligations resulting from the national measures transposing the CS3D, or their voluntary implementation, may be taken into account by contracting authorities as part of the award criteria for public and concession contracts (Art. 24). Moreover, contracting authorities may lay down compliance with the CS3D as an environmental or social condition for public and concession contracts.

No Director's Duty of Care

The previous versions of the CS3D included a duty of care for directors of EU companies to consider the impact of their decisions for sustainability matters. This duty has been removed.

Financial Sector

Recital 19 now provides that, regarding regulated financial undertakings, the “chain of activities” does not include downstream business partners that are receiving the company’s services and products. Therefore, only the upstream part of the chain of activities is covered by the CS3D.

Gradual Application (Art. 30) and Next Steps

Member states must transpose the CS3D within two years from its entry into force. As regards further compliance, the CS3D provides a gradual phase-in approach depending on the size of the company:

- **For EU companies:**
  - More than 5,000 employees and €1,500 million turnover: three years after entry into force.
  - More than 3,000 employees and €900 million turnover: four years after entry into force.
  - More than 1,000 employees and €450 million turnover: five years after entry into force.
- **For third-country companies:**
  - More than €1,500 million turnover (EU only): three years after entry into force.
  - More than €900 million turnover (EU only): four years after entry into force.
  - More than €450 million turnover (EU only): five years after entry into force.

How Can WilmerHale Help You?

Companies doing business in the EU and falling within the scope of the CS3D will need to understand how it applies to them, which obligations should be complied with, and how they need to put in place the required procedures or policies or adjust existing ones. Given that the current final text is a patchwork compromise, it risks being vague and ambiguous in terms of specific obligations. WilmerHale has extensive experience advising clients on ESG—for example, on the German Supply Chain Due Diligence Act (LkSG) and on the French Law n°2017-399 establishing a duty of care, which share similarities in various aspects. We can assist and provide advice on the

substantive issues raised by the CS3D and other EU ESG-related regulations. In addition, our transatlantic ESG team is a cross-disciplinary group that helps clients navigate the rapidly evolving legal, policy and corporate governance responses to climate change and social justice issues both in the US and in Europe. It works for many multinational companies and has all the necessary resources to help with complex ESG challenges.

For further information, please contact a member of our team in this area:

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