



## The EU Approach to Supply Chains

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*February 2022*

After the German legislature passed the "Law on Corporate Due Diligence in Supply Chains" (LkSG) in June 2021, the EU Commission is now also presenting a draft directive on corporate due diligence. In the future, companies will be obliged at the EU level to identify, prevent, eliminate, or reduce the negative impact of their activities on human rights and the environment. The draft directive goes beyond the German Supply Chain Act in terms of both scope and content of the due diligence requirements and places greater obligations on companies.

### Scope

According to the draft directive, the new due diligence obligations apply to all corporations based in the EU with more than 500 employees and a global net turnover of more than 150 million euros (Group 1). Companies that do not meet both thresholds will still be required to comply if they are primarily active in certain resource-intensive industries and have more than 250 employees and global net sales of more than EUR 40 million (Group 2). According to the final catalog, resource-intensive industries comprehend the textile industry, agriculture and forestry (including fisheries, food production, wholesale trade in agricultural raw materials, live animals, timber, foodstuffs and beverages), and the extraction of and trade in mineral

resources and raw materials. However, the regulations will not apply to Group 2 companies until two years later. Regardless of the number of employees, companies from third countries will also be addressed if they generate sales of either EUR 150 million in any industry or EUR 40 million in one of the resource-intensive industries within the EU.

According to estimates by the EU Commission, the directive would affect around 13,000 European companies and 4,000 companies from third countries operating in the EU. This means that 99 percent of the European economy, in particular small and medium-sized enterprises (SMEs), would not fall within the direct scope of the new due diligence requirements. Indirectly, however, they may be affected, for example as suppliers to large companies, if these in turn are obliged to provide a proper supply chain.

From a factual point of view, the due diligence obligations basically cover the entire value chain. The business activities of the companies concerned, and their subsidiaries are covered. The supply chains must be monitored in both directions for possible violations of the provisions of the directive: this applies to suppliers and customers. According to the wording of the draft directive, however, the obligation to monitor within the supply chain is limited to those companies with which there is an established business relationship.



The draft directive defines such an established business relationship as a direct or indirect business relationship which, due to its intensity or duration, is or is expected to be permanent and does not merely represent an insignificant or incidental part of the value chain. What exactly is meant by this remains unclear and is likely to be a point of discussion in the further legislative process.

## Extension of due diligence obligations

The legislative goal of the EU Commission is to ensure that companies respect human rights and comply with environmental standards within their global value chain. This includes, for example, the prevention of child and forced labor, the creation of safe and healthy working conditions, and fair wages. A practical example of a violation of environmental standards is the sometimes excessive water pollution caused by mining for the extraction of raw materials.

To achieve this goal, companies must make due diligence an integral part of their corporate policy, identify actual or potential negative impacts on human rights and the environment, prevent or mitigate potential impacts, eliminate or minimize actual impacts, establish a grievance mechanism, monitor the effectiveness of due diligence policies and measures, and communicate publicly about their due diligence performance.

If companies have identified violations of human rights or environmental standards in their value chain, they must take appropriate measures depending on the severity of the violation in each individual case. In the case of minor violations or suspected violations, it may be sufficient to enter into contractual agreements within the supply chain, whereby the draft directive explicitly requires that contractual agreements must always be accompanied by appropriate measures for verification and compliance. In the event of serious violations, a company may also be obliged to terminate the business relationship completely. This could present companies with the difficult practical task of finding new suitable suppliers, as supply chains worldwide are already under strain.

Direct due diligence obligations with regard to negative consequences for the climate have not yet been stipulated in the draft directive. However, companies in Group 1 must have a plan to ensure that their business strategy sufficiently takes into account the goals of the Paris Climate Agreement (limiting global warming to 1.5° C).

The draft directive also does not contain any provisions on the import of products manufactured using forced labor. However, the EU Commission is already working on a separate legal instrument. This should prevent such products from entering the European market in the future.

## Sanctions

The draft directive contains various sanction mechanisms for breaches of the due diligence. On the one hand, it obliges the member states to create suitable and appropriate sanctions when transposing the directive into national law. In particular, fines are to be imposed on the companies concerned. The amount of the fine is to be based on the company's turnover. Companies that are required to draw up a climate plan (especially Group 1) are also to make the payment of bonuses to management dependent on compliance with the climate plan.

According to the draft directive, companies that have violated their due diligence obligations should, under certain circumstances, be liable under civil law for damage that has occurred along their value chain. Those affected by human rights violations or environmental damage could thus claim compensation from companies in the EU. However, the draft directive does not provide for any easing of the burden of proof in favor of the affected parties. Potential plaintiffs would still have to present and prove all the requirements for a claim for damages. On the other hand, a genuine exclusion of liability for companies is only envisaged in cases where the obligated company has already obtained contractual assurances along the supply chain, additional protective measures were not



initiated and the damage that occurred was caused by an (indirect) supplier.

### **Comparison with German supply chain law**

The structure of the draft directive is based on the German Supply Chain Act, but its content goes beyond it in many respects. First, the scope of the directive is broader. For example, from 2023 the German regulations will only apply to companies with more than 3,000 employees, with the limit being lowered to 1,000 employees from 2024. Nevertheless, this is still twice as many employees as in the draft directive. According to the will of the EU Commission, significantly more companies would therefore be directly affected by the due diligence obligations. Also, the control obligations for companies under the German Supply Chain Act generally only apply to the direct supplier, while the draft directive establishes control obligations for the entire value chain.

It is also striking that the German Supply Chain Act does not contain any provisions relating to climate protection, bonus payments or liability. In particular, the issue of civil liability for damage along the value chain, which has been intensively debated in this country, is likely to become an issue again in the wake of the EU directive.

### **Next steps**

The draft directive will now be submitted to the European Parliament and the Council. There, the draft will be discussed and voted on, and if necessary, amendments will be proposed. Once the final version of the directive has been adopted, the member states will have two years to transpose it into national law. In this case, for example, the German Supply Chain Act would have to be adapted to the then applicable European requirements. Only then will the directive take legal effect for German companies in the form of the German implementation.

### **Practical implications**

The EU Directive is expected - irrespective of its final version - to stipulate higher due diligence requirements for the companies addressed. On the one hand, more companies than before could be obliged to monitor their supply chain. Secondly, the control obligations are then likely to extend further than just to the direct supplier. Above all, contractual agreements to fulfill due diligence obligations will probably increase. This will not only affect companies within the scope of the directive, but also SMEs as part of the value chain. To this end, the draft directive explicitly urges member states to support SMEs in fulfilling their due diligence obligations. The member states are to set up and operate appropriate websites, platforms, and portals for this purpose.

The trend toward certification is also likely to increase. By obtaining certificates (EMAS, Green Button, SMETA, etc.), companies can more easily prove that they meet certain human rights or environmental standards. Certificates make the supply chain more transparent and increase the reputation and attractiveness of a company, especially in the face of increasing due diligence requirements. It is also possible that the EU directive will lead to a concentration of suppliers. From a market economy perspective, the directive is intended to ensure a fairer playing field. Companies should not enjoy any advantage by violating human rights or environmental due diligence obligations. The extension of the scope of application to companies from third countries is also intended to contribute to this.

However, one thing can already be said with certainty: For companies, especially in the so-called high-risk industries, the monitoring and control of their own value chain will become increasingly important in legal terms. Because of the threat of sanctions and the potential risk of civil liability, companies should be required to examine their business relationships and supply chains for any violations and remedy them as soon as possible.



Regardless of the fate of the draft directive, the German Supply Chain Act will already come into force in large part on January 1, 2023.

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