BDA
DIE ARBEITGEBER

EU supply chain rules could place excessive burden on German companies

Position regarding Commission proposal on corporate sustainability due diligence of 23 February 2022 (COM(2022) 71 final)

May 2022

Introduction

On 23 February 2022 the Commission published its proposal for a directive on corporate sustainability due diligence. Under its provisions, certain companies inside and beyond the European Union (EU) would be required to perform various due diligence tasks and assume civil liability with respect to infringement of a large number of international agreements along their entire supply chain.

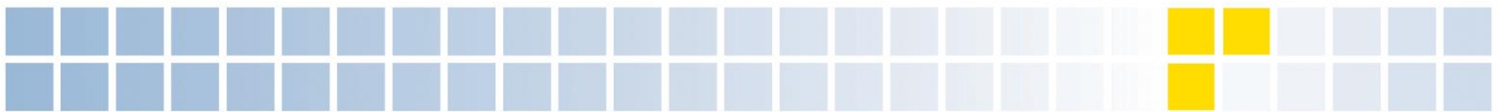
German companies regard **respect for human rights** and protection of the environment as self-evident. They already realise this ambition within their supply chains. With their above-average commitment in developing and emerging companies, many businesses contribute to higher social and environmental standards, better living and working conditions as well as better education and hence to sustainable development.

Yet the Commission's proposal for a directive does not underpin protection of human rights and the environment but rather runs the risk of overwhelming companies with **unclear due diligence requirements, excessive red tape and reporting obligations** as well as **unrestricted liability**. The draft directive overestimates the real scope for companies to exert influence and renders them responsible for situations outside their control. Even if smaller enterprises are formally excluded from the scope of the directive, they will be seriously affected in many respects as links in the supply chains of larger undertakings.

It is therefore to be feared that companies will in future feel obliged to pull out of regions with elevated human rights or environmental risks and to cut all ties with actors in these contexts ("**cut and run**" instead of "stay and improve"). A European withdrawal would do nothing to help local populations – not least where this withdrawal creates a gap or this gap is filled by foreign competitors with lower standards.

It also seems highly problematic that the EU Regulatory Scrutiny Board has twice delivered a negative vote. The independent body has deemed the Commission's proposal for a directive to be problematic at various levels and found that the Commission has inadequately assessed the impact of the proposed rules. This underlines the concerns of German business that possible **operational consequences** have not been included in the overall policy assessment and that justified reservations have been ignored.

The intended goal whereby the directive will help to create a **level playing field** within the EU will not materialise. The large number of complex and imprecise terms gives Member States a



wide berth for interpretation or additional rules ("gold-plating"). By implementing different implementing laws, each one of the Member States can choose a variant approach so that the single market is fragmented and business alliances which are active across the entire EU are potentially subject to 27 different sets of reporting obligations.

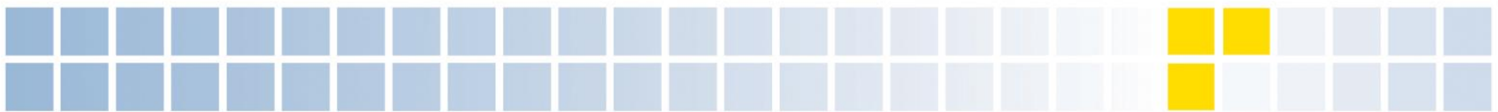
The right and balanced design of this legislative framework is of decisive importance for Germany's and the EU's attractiveness as a business location. Only in this way can Europe successfully promote its values in the world over the long term. If this fails, there is a great risk that Germany and Europe will be damaged as business locations. Unfortunately, the directive does not constitute a framework for a practical and workable approach.

Detailed comments

Scope: too many companies covered; small and medium-sized enterprises overwhelmed

Article 2 of the directive sets out the scope. Generally speaking, all companies with registered seat in the EU and an average of more than 500 employees as well as an annual turnover in excess of 150 million Euro would be covered by the directive. Furthermore, reduced threshold values of more than 250 employees and an annual turnover in excess of 40 million Euro would apply in certain sectors. Companies established outside the EU which generate an annual turnover in excess of 150 million Euro and companies with an annual turnover in excess of 40 million Euro where 50% of their annual turnover is generated in the sectors already referred to would also be covered. The financial sector is also broadly included.

This scope is too widely framed and constitutes a drastic tightening of the German act on corporate due diligence obligations in supply chains even before this German law has been fully implemented. It is right that there is a derogation for small and medium-sized enterprises (SMEs) but this does not go far enough. It is unreasonable to require companies with 500 or as few as 250 employees to monitor their entire value chain, which involves taking into consideration a long list of rules and procedures. Looking at the situation on the ground, especially for SMEs it is impossible to take into account influence on third parties in distant regions of the world. In reality, many companies which are nominally excluded will be caught indirectly in the scope of the directive because SMEs form part of the value chains of larger companies. Bearing in mind the overall situation in Europe, it would be better to choose a threshold value of 5,000 employees (similar to the French "Loi de Vigilance"). Only companies of this scale are in anything like a position to meet requirements in this area. The basically unwanted involvement of companies which ought to be excluded from the scope of the directive is encouraged by the unrestricted inclusion of the financial sector. The same danger exists if companies that are within the scope of the Directive pass on requirements via value chain relationships to companies that are actually outside the scope. The blanket identification of a range of sectors with a higher risk requiring stricter standards looks oversimplistic. The blanket negative assessment of entire sectors is disproportionate and cannot be based on transparent, objective and comprehensible reasons. It would be better to adopt a risk-based approach which enables companies to prioritise parts of their value chain for monitoring. Moreover, it would be much easier for companies to follow the approach enshrined in the German act on corporate due diligence obligations in supply chains (LkSG) whereby a distinction is made as a function of certain goods and services.



Scope: monitoring of entire value chains impossible; limit due diligence obligations to direct suppliers

Under article 1, the affected companies and their subsidiaries would have to implement range of measures (articles 6, 7 and 8) along their entire value chain (as defined in article 3 (g)) in order to comply with various due diligence requirements. The decisive element here is "established business relationships". The directive defines these as "such direct and indirect business relationships which are, or which are expected to be lasting, in view of their intensity and duration and which do not represent a negligible or ancillary part of the value chain".

Inclusion of an undertaking's entire value chain goes much too far and would lead to unmanageable obligations as well as unforeseeable risks. The introduction of liability for the actions of third parties – in other words indirect suppliers or sales intermediaries – is alien to the German legal system and cannot be required. In many cases, companies are unaware of even the identity of indirect suppliers or sales intermediaries. Indeed, the very concept of "established business relationships" newly minted by the Commission for this purpose carries its own risks. This term is inadequately defined; the point at which business relationships can be deemed "lasting, in view of their intensity and duration" will regularly be unclear. It is not evident how far an undertaking's value chain stretches. It is important to have a clearly delineated and legally certain definition of the supply chain whose extent is limited to the level of direct suppliers ("tier 1"). Only then will companies be able to implement the rules; the envisaged liability for suppliers beyond direct business partners is not realistic. Insofar as the level of an undertaking's customers is to be included, a clear definition is needed here which excludes private consumers from the category of customers to be monitored.

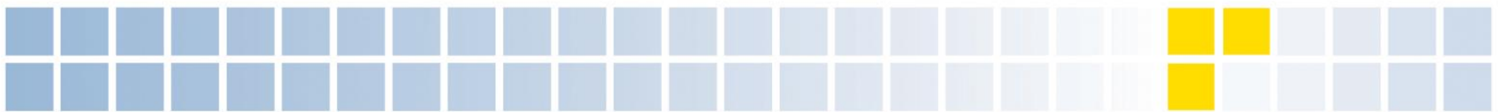
Due diligence: clear and workable definitions; UN guiding principles provide a better guide

The individual due diligence obligations which a company must meet along its value chain are articulated around a series of international agreements on human rights, fundamental freedoms and the environment. For definition of the individual elements eligible for protection, the proposal refers broadly to a wide range of different international agreements in a list of 56 points contained in a seven-page annex.

This very wide, comprehensive and sometimes very detailed reference to a large number of complex international agreements in the fields of human rights, fundamental freedoms and environmental protection goes too far – there are references to a total of more than 230 pages of complex legal texts. This framework of elements eligible for protection must be manageable and realistic. What would fit well here would be a clear and exhaustive reference to an internationally recognised standard such as the UN guiding principles on business and human rights. Otherwise, the reference points in both the German LkSG and the UN guiding principles themselves would be lost against the background of such a wide reference framework.

Civil liability: limitation to an undertaking's own actions; legal certainty based on clear definitions indispensable

Where there is an adverse impact further to infringement of the above-mentioned due diligence obligations, companies become liable for damages under civil law (article 22): inasmuch as the infringement results from the action of a company, of its subsidiary or of a direct business partner, liability always obtains. Insofar as the due diligence infringement is caused by an indirect business partner, it ought to be sufficient to have taken corresponding measures to prevent the damage.



Wide-ranging civil liability generates enormous uncertainty for the business community. Not least with regard to the numerous references in the framework of elements eligible for protection and the associated vague legal concepts, it is impossible for companies to construct even a low level of legal certainty for themselves. Yet legal certainty, especially on issues related to civil liability, is a basic condition for doing business successfully and in particular responsibly. Generally speaking, any form of liability should revolve around whether a party has caused or contributed to the damage, or is otherwise directly associated with it. Parts of the draft directive try to do justice to this principle by focusing the hitherto very widely framed definition of the value chain on the level of direct business partners. But this approach still falls short: all civil liability must end where there is involvement of a legally distinct third party. Civil liability should be limited to cases where the damage can be attributed to or is foreseeable as a consequence of a company's actions. Specifically with respect to civil liability, it is clear that responsibility can ultimately lie only with the perpetrator. A mechanism which foresees liability for the actions of third parties is rightly a rare exception in European and international legal orders and sits uncomfortably with the UN guiding principles or the OECD guidelines (Organisation for Economic Cooperation and Development). Companies can only be liable for their own activities and not for the activities of their business partners or their suppliers.

Accountability of company directors: rule out a dual structure of requirements; avoid influencing national company law

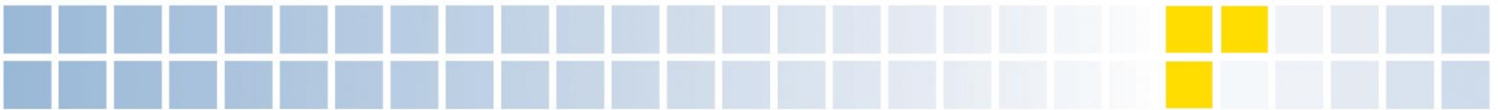
It is stipulated that company directors should orient their actions on implementation of the directive (article 25). Their decisions should take into account human rights, climate change and environmental consequences. In this connection, infringements should be punished and variable remuneration is linked to a company director's contribution to averting climate change (article 15).

Detailed policy requirements or framework conditions which encroach deep into the organisational levels of a company run the risk of permanently disrupting a company's dynamic. Imposing standards through directives runs counter to the idea of the market economy. A company's business policy is already strongly influenced by the directive and this is reflected in individual management decisions. Additional direct rules not only constitute a duplication but also pose the danger of reducing the flexibility and decision-making discretion of those affected.

Complaint mechanisms: non-bureaucratic design and protection against misuse are decisive factors

The proposal for a directive provides for the establishment of two avenues or mechanisms for complaints (article 9) where an infringement of due diligence requirements is identified or suspected. In addition, there would be a national point (article 19) to deal with "substantiated concerns". Not only those directly affected but also institutions such as trade unions and non-governmental organisations (NGOs) would have the right to lodge complaints.

In the first instance, complaint mechanisms must be effective and must not constitute a complication or impediment. To ensure legal certainty and avoid complaints from professional campaigning organisations, complaint possibilities should be restricted to those directly affected by infringements. It should also be possible to pool complaint points, e.g. inside sectoral initiatives. The complaint mechanism for "substantiated cases" as well as the term itself imply that this should cover potential infringements of some consequence. It should therefore be clarified here that article 19 relates only to potential infringements of companies' due diligence obligations but not to obligations under articles 15, 25 and 26.



Monitoring and reporting requirements: superimposition of different reporting obligations could overwhelm German companies with excessive red tape

To monitor their own actions along the value chain, companies should carry out assessments at least once a year (article 10). The directive also requires companies to report regularly (article 11). The only exceptions are companies which also fall within the scope of the Corporate Sustainability Reporting Directive (CSRD) and already have to report in this area anyway. It is intended that the Commission should draw up a list of criteria to be adopted through a delegated act.

Companies are often burdened with too much red tape as a result of the many different reporting obligations in the area of sustainability. German companies already face too many and largely redundant reporting requirements. EU initiatives are a long way from adopting a holistic approach which would bring together coherent and simultaneously workable reporting obligations for companies. In a detail, the Commission has already recognised this danger and precluded the risk of a duplication with CSRD reports. However, harmonisation and simplification of reporting requirements need to be taken further so that companies are also durably protected against excessive demands. There must be greater transparency when the individual details of a reporting obligation are being designed and companies should be given an adequate hearing. One-sided and opaque determination of requirements through a delegated act will not lead to the best possible result here.

Sanctions: proportionate, predictable and effective design

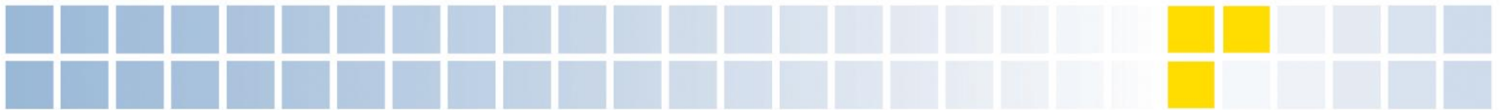
Insofar as companies infringe the national provisions of this directive, article 20 provides for turnover-oriented sanctions to be adopted. Furthermore, the Member States must ensure that companies which have been sanctioned are not eligible for public support measures (article 24).

In order to be effective, statutory provisions must also comprise legal consequences for the event of non-compliance. However, it is important here that sanctions deploy their effect first and foremost through dissuasion while respecting the principle of proportionality. It can be all too easy for small and medium-sized enterprises in particular to be driven into insolvency by unduly harsh sanctions. This is even more evident if a sanction can be triggered by the action of a third party. In addition, the call for exclusion from public support must be clearly and unambiguously defined. Insofar as this involves an exclusion from public contracts, it must be clear that even a temporary sanction can lead to the loss of a majority of orders and hence can also result in insolvency.

Transposition: German companies need uniform and above all consistent supply chain rules

The requirements under this directive would come into effect for the first group of companies (more than 500 employees and turnover in excess of 150 million Euro) two years after the directive enters into force. For companies in the special sectors mentioned above, this deadline is extended to four years (article 30).

In particular for German companies, the ambitious transposition periods are problematic and too short. The German act on corporate due diligence obligations in supply chains (LkSG), which was only adopted in July 2021, does not enter fully into force until 1 January 2024. This sequencing means that companies will have to adjust over a relatively short period first to the LkSG requirements and then to the different and more stringent requirements of the European directive. Such a rapid and strict changeover coupled with the inevitable dual structures will add to the burden on German companies and should be avoided.



Positive flanking measures: extend good initiatives; “EU Green List” a useful addition

In its proposal the Commission has rightly recognised the need for companies to receive assistance from European or national bodies in fulfilling their due diligence requirements. The model contract clauses addressed in article 12 can support companies in fulfilling the requirements of the directive and contribute to the necessary legal certainty. The guidelines envisaged in article 13 also have the potential to deliver good framework conditions for compliance. The Commission’s proposal that these guidelines be drawn up in close consultation with company representatives, among others, is important and could help to iron out transposition problems.

The diverse accompanying measures addressed in article 14 can also help companies to comply with such wide-ranging obligations. Digital arrangements such as websites, platforms or portals providing information or joint initiatives with interest representatives are a help to small and medium-sized enterprises in particular. However, the accompanying measures should be designed to have a binding effect and thus also provide the corresponding legal certainty.

A further useful accompanying measure could be the establishment of an “EU Green List”. Such a list should set out a list of States where a high level of legal standards already apply and legal enforcement is guaranteed. To avoid red tape as well as to simplify and shorten the procedure, the parts of the value chain which are performed in countries on the “Green List” should be exempted from due diligence obligations and further steps. In particular where the value chain or large parts of the value chain are located exclusively within the EU, monitoring of human rights due diligence for the EU catchment area seems excessive and obsolete. Alongside a general exemption for suppliers from the European Economic Area, the USA, Canada, the UK, Japan, Australia, New Zealand and others, the existence of free-trade agreements with the EU could be the starting point for exemption, especially if these agreements already address sustainability issues.

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