Supply Chain Due Diligence: Location, Location, Location

by Tom Hayes, BEERG Executive Director

On 23 February 2022, the European Commission issued its much-delayed *Proposal for a Directive on Corporate Sustainability Due Diligence* (available here), covering human rights and environmental impacts across global value chains.

In this *BEERG Perspective* we examine one crucial issue: do non-EU headquartered companies have a choice over the EU jurisdiction whose supervisory authority will oversee their due diligence compliance? Do such companies have the option of locating their "authorised representative" in the country of their choosing?

We believe that it is important that non-EU companies have this choice. Legislation should not be such as to instruct a company where to locate a management function. As currently drafted, the Directive is unclear on the matter.

The Directive

The proposed Directive would impose a corporate due diligence duty on large EU and third-country companies, and smaller companies in certain "high-risk" sectors, to identify and take steps to remedy actual, and prevent or mitigate potential, adverse impacts on human rights and the environment in the companies' own operations, and their subsidiaries and value chains.

The Commission estimates that 13,000 EU companies and 4,000 third-country companies would be within the scope of the Proposed Directive.

The Directive would apply to both EU-based companies and companies incorporated in third countries. Whether a company would be subject to the provisions of the directive would depend on its size, sector, and source of revenue:

- Companies based in the EU with more than 500 employees and a net worldwide turnover of more than €150 million during the last financial year.
- Companies based in the EU with more than 250 employees and a net worldwide turnover of more than €40 million in the last financial year, if at least half of that net turnover was generated in specific high-risk sectors:
    - (i) the manufacture of textiles, leather, and related products (including footwear) and the wholesale trade of textiles, clothing, and footwear;
    - (ii) agriculture, forestry, fisheries, the manufacture of food products and the wholesale trade of agricultural raw materials, live animals, wood, food, and beverages; and

(iii) the extraction of mineral resources regardless of where extracted, including crude petroleum, gas, coal, metals and metal ores, the manufacture of basic metal products, other non-metallic mineral products and fabricated metal products, and the wholesale trade of mineral resources and basic and intermediate mineral products, including metals and metal ores, construction materials, fuels, and chemicals.

- Companies established outside the EU with either (i) a net turnover in the EU of more than €150 million during the financial year preceding the last financial year, or (ii) a net worldwide turnover of more than €40 million, but a net turnover in the EU of less than €150 million, if at least 50% of the net worldwide turnover was generated in the high-risk sectors listed above. Note, there is no employee threshold for companies based outside the EU.

Companies in scope would have to:

1) *integrate due diligence into their policies,*
2) *conduct due diligence to identify actual or potential adverse impacts from their operations on human rights and the environment,*
3) *prevent, mitigate, and end such adverse impacts,*
4) *put in place a complaints procedure,*
5) *monitor effectiveness of their due diligence policies, and*
6) *publicly communicate on their due diligence.*

Enforcement

The Directive provides for enforcement by Member State administrative authorities, with fines for non-compliance. Fines would have to be proportionate and dissuasive and related to the company's turnover. Victims would also be able to sue companies in the civil courts for damages for alleged harm which could have been avoided by proper due diligence measures.

Further, companies in scope would have to create a procedure to allow affected persons, trade unions, and relevant civil society organisations to submit complaints to them about real, perceived, or manufactured human rights or environmental problems anywhere in the company's entire value chain. Complainants would be entitled to request appropriate follow-up on a complaint and to meet with the company's representatives.

On reading the last paragraph, labour relations executives will roll their eyes to heaven. We know what's coming. Unions will see this as an excellent opportunity to get in front of senior executives to complain about "anti-union" activity.

For example, if the UAW or the IAM were trying to organise a European-based company in the US and the company rolled out the usual "positive employee relations" response, the unions would immediately lodge a complaint of "union busting" with the company, and probably also with the relevant supervisory authority.

Or if a US company that was part of a European supply chain was resisting union demands in the US that resulted in a collective bargaining deadlock and a strike, the union could lodge a complaint with the customer company in Europe as well as with the relevant supervisory authority.

There is no point in anyone saying, "But this is not the point of the legislation." It is like the "Field of Dreams." Build a complaints mechanism and the complaints will come. What rational trade union would not use leverage freely presented to it?

It is also what the unions tried to do with the OECD Contact Points, turn them into a form of "labour court," without any great success, because the Contact Points had no "teeth" and no ability to impose sanctions.

Which is why the unions have been so strident in the demands for this legislation. It will be a complaint process *sans frontiers,* a European-based mechanism with a global reach. For them, what's not to like?

Could we see a situation where, for instance, a supervisory authority in Sweden is asked to pass judgement on the labour relations policies of an American supplier to a Swedish multinational because of a complaint from US unions? And impose a penalty on the Swedish company over these policies of its US supplier?

There is obviously a great deal more to the Directive than the brief summary above. More detailed comments can be found from law firms and thinktanks. here; here; and here.

Two points

Two points seem to me to be very unclear.

The first is how deep into supply chains does due diligence obligation run? Is it only tier one suppliers to the "controlling undertaking" – a term I am borrowing from the EWC Directive to refer to the lead company at the top of the supply chain? The proposal assigns companies responsibility for both direct and indirect relationships in their supply chain. That seems very broad and potentially very deep.

Do obligations imposed on the controlling undertaking stretch to the entirety of the supply chain? Which clearly raises the question how any company can have sight of the entirety of a supply chain that involves multiple contract and sub-contract relationships. How many parents know all the friends of their children? Never mind knowing who the friends of the friends are?

We will come back to this first point in a future paper.

Which brings me to the second point: location. This point concerns non-EU headquartered companies within scope as provided for in Article 2(2). Who supervises these companies? To which national jurisdiction are they subject? There seems to us to be some confusion around this in the current text.

Location

Article 16:1 of the proposed Directive reads:

> *Member States shall ensure that each company referred to in Article 2(2) designates a legal or natural person as its authorised representative, established or domiciled in one of the Member States where it operates. The designation shall be valid when confirmed as accepted by the authorised representative.*

This seems fairly straightforward. A non-EU headquartered company must appoint an "authorised representative" in one of the EU Member States in which it operates for the purposes of this legislation. The concept of a "representative agent" will be familiar to any American company, for example, which has a European Works Council.

If this is the case, then companies will look carefully at their jurisdictional options. Given the complexity of this legislation and the likelihood of complaints from individuals, trade unions, or NGO, as well as the possibility of investigations by supervisory authorities, and claims for damages in the civil courts, then for

non-EU headquartered companies an English-language jurisdiction would seem to be the jurisdiction of choice.

Which points to Ireland. Who wants to add language complications to what could already be difficult legal proceedings?

But Article 16:3 adds a further wrinkle which seems to complicate matter: Article 16:3 reads:

> *Member States shall ensure that a supervisory authority in the Member State where the authorised representative is domiciled or established and, where it is different, a supervisory authority in the Member State in which the company generated most of its net turnover in the Union in the financial year preceding the last financial year are informed that the company is a company within the meaning of Article 2(2).*

So, who is the "authorised representative" answerable to? The supervisory authority in the Member State is which he/she is located or the supervisory authority in the Member State in which it generates most of its net turnover? Or both?

Do the same rules apply to companies that are headquartered in the EU? There must be EU headquartered companies that are registered in one country but generate most of their turnover in others. Will such companies be subject to two supervisory authorities? If not, could 16:3 be seen as discrimination against non-EU companies on the basis of nationality?

The matter is even further complicated by Article 17:3 which appears to contradict 16:3.

> *As regards companies referred to in Article 2(2), the competent supervisory authority shall be that of the Member State in which the company has a branch. If the company does not have a branch in any Member State, or has branches located in different Member States, the competent supervisory authority shall be the supervisory authority of the Member State in which the company generated most of its net turnover in the Union in the financial year preceding the last financial year before the date indicated in Article 30 or the date on which the company first fulfils the criteria laid down in Article 2(2), whichever comes last.*
>
> *Companies referred to in Article 2(2) may, on the basis of a change in circumstances leading to it generating most of its turnover in the Union in a different Member State, make a duly reasoned request to change the supervisory authority that is competent to regulate matters covered in this Directive in respect of that company.*

What is a "branch"? It does not appear to be defined in Article 3 of the Directive which deals with "definitions". How can something that is not defined play a critical role in such a matter?

If the "competent supervisory authority" is the authority in the Member State in which a non-EU company generates most of its net turnover, then what purpose does nominating an "authorised representative" in another Member State serve? Is the "authorised representative" expected to serve two supervisory masters?

Further, does the EU actually have the authority to instruct a company where it must base a particular management function for regulatory purposes, which is what 17:3 appears to do, in conflict with 16:3? As noted above, non-EU companies have a free choice where to base their "representative agent" for European Works Councils. Non-EU companies can also decide where to locate their "data controller" who is answerable for compliance with the General Data Protection Regulation. Why should this Directive take a very different approach?

Could such an instruction be seen as counter to the principle of freedom of movement as set out in the Lisbon Treaty and comprehensively interpreted by the CJEU in *Polbud?*

Need to clarify

Why should the “authorised representative” for the purposes of due diligence be based in the EU country with the highest net turnover?

As we commented above, when a major, non-EU headquartered company needs to assess significant, long-term litigation risks, and how best to position itself against such risks, then surely it should have the right to determine where in the EU to locate itself for such purposes?

Turnover is an arbitrary metric. What happens if turnover changes from year-to-year? This could easily happen not just as a result of organic growth, but also as a result of mergers, acquisitions, and disposals. Could a non-EU company be required to change supervisory authority every time there is a change in its turnover?

These are questions we think will need to be clarified during the legislative process and clarified in a way that does not discriminate against non-EU headquartered companies.

We think it is important that non-EU companies retain freedom of movement and establishment when it comes to deciding on the location of critical functions.

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