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The EU Corporate Sustainability Due Diligence Directive

Five practical steps large Japanese companies should take to prepare for the introduction of mandatory due diligence

The European Commission recently published the text of the proposed Corporate Sustainability Due Diligence Directive. Once adopted, this will require many large Japanese companies doing business in the EU to take extensive steps to identify and address human rights and environmental impacts in their operations, supply chains and downstream value chains (i.e. associated with the use or disposal of their products or services). The issue has also caught the attention of the Japanese Government which, in February this year, established a working group focused on the corporate responsibility to respect human rights in global supply chains.

This client alert looks at what these developments mean for large Japanese companies doing business in the EU. It concludes with five practical steps that can be taken to prepare for the introduction of mandatory human rights due diligence and reduce the likelihood of future legal liability and reputational harm.

TO WHICH COMPANIES WILL THE DIRECTIVE APPLY?

Initially, the proposed Directive will apply to all:

- companies domiciled in the EU with more than 500 employees and €150 million global annual net turnover; and
- non-EU domiciled companies active in the EU with a net turnover of €150 million generated in the EU.

Two years after implementation, the threshold will be reduced for companies operating in certain “high impact sectors” so as to apply to EU companies with 250 employees and €40 million annual net turnover, and to non-EU companies with €40 million annual net turnover generated in the EU.

In practice, this means that the Directive will apply both to:



- Japanese domiciled companies with net turnover generated in the EU in excess of the applicable threshold (for example through direct sales of their products into the European market); and
- any EU domiciled subsidiary of a Japanese company with global net turnover and an employee headcount in excess of the applicable thresholds.

Even if the Directive does not apply directly to a Japanese company, foreign companies caught by the Directive may nevertheless require their Japanese business partners to demonstrate compliance with the substantive provisions of the Directive as a condition of doing business.

WHAT WILL QUALIFYING COMPANIES BE REQUIRED TO DO?

Qualifying companies would be required to carry out due diligence on human rights and environmental impacts in their operations and value chain. This includes:

- “upstream” impacts, i.e. human rights impacts which occur in their operations or supply chains. This will include issues in its supply chain, including in the extraction of raw materials in a foreign country by an entity with which the qualifying company has no direct business relationship; and
- “downstream” impacts, i.e. human rights impacts associated with the use and disposal of a product or service by a third party. For example, a company manufacturing technology for a government client will be required to anticipate and address potential human rights impacts associated with the end-use of its products by the government. Similarly, companies in the financial services sector will be required to carry out due diligence on the use of their products and services by clients.

“Due diligence” has a specific meaning in the context of human rights and environmental impacts. Unlike conventional forms of legal due diligence, the primary focus must be on the risk to affected rightsholders, not to the company. Further, the identification and assessment of a risk is only the first step in human rights due diligence. In keeping with the OECD Guidance for Responsible Business Conduct and UN Guiding Principles on Business and Human Rights, under the Directive, companies are also required to:

- integrate due diligence into policies and management systems;
- prevent or (where prevention cannot be done) adequately mitigate potential adverse impacts;
- cease or (where cessation cannot be done) minimize actual adverse impacts;
- periodically assess the effectiveness of the due diligence policy and measures;
- publicly communicate on due diligence; and
- provide for remediation, including appropriate procedures for complaints by affected persons, trade unions and civil society organizations.

The Directive also imposes requirements on qualifying companies to put in place a plan to ensure that the business model and strategy of the company are compatible with the transition to a sustainable economy and the limiting of global warming to 1.5 degrees in line with the Paris Agreement. Where a company identifies (or should identify) climate as a principal risk or impact of their operations, they will also be required to include specific emission reduction objectives in their plans.



HOW WILL THE RULES BE ENFORCED?

The Directive requires that Member States designate a domestic authority to ensure effective enforcement of administrative sanctions for non-compliance. The Directive specifies that pecuniary sanctions will be proportionate to a company's turnover.

It also provides for a civil liability regime, enabling victims of adverse human rights impacts to obtain compensation for damage in the domestic courts of EU Member States where such an impact could have been identified and prevented (or mitigated) with appropriate due diligence measures. The civil liability regime does not extend to provide a cause of action in relation to the climate change and emission reduction plans required under the Directive.

The Directive also imposes duties on directors of qualifying EU domiciled companies (including the directors of any EU domiciled subsidiary of a Japanese company which meets the relevant turnover and headcount thresholds) to: adopt a due diligence policy; set up and oversee the implementation of due diligence processes; and integrate due diligence into their corporate strategy. In addition, when directors act in the interest of the company, they must take into account the human rights, climate and environmental consequences of their decisions and the likely short, medium and long-term consequences. When remuneration is linked to a director's contribution to business strategy and long-term interests and sustainability, companies must take due account of the fulfilment of the corporate climate change plan. Breach of these duties will be enforced through existing Member State law on directors' duties.

THE WIDER MOVE TOWARDS MANDATORY HUMAN RIGHTS DUE DILIGENCE

The Directive is part of a range of measures being introduced in Europe which require large multinational businesses to implement effective human rights and environmental due diligence. Such legislation has been in force in France since 2017, although it applies only to a small number of large French companies. Germany has recently adopted mandatory human rights due diligence legislation which is broader in scope and due to come into force in 2023 and due diligence reporting regimes recently came into force in Norway and Switzerland. There are parallel developments in the common law which may enable claims in negligence against companies in the UK where they fail adequately to implement a public commitment to due diligence resulting in a human rights or environmental harm.

WHAT SHOULD QUALIFYING JAPANESE COMPANIES DO TO PREPARE FOR MANDATORY HUMAN RIGHTS DUE DILIGENCE?

Although the Directive will not come into force for at least two years (and still needs formally to be adopted by the Parliament and Council), companies should act now to prepare for the arrival of mandatory due diligence and minimize legal risk. For companies with complex global supply chains, it will take a considerable amount of time and investment to map their supply chains, prioritise areas for action and take the necessary steps to prevent, mitigate and bring to an end adverse impacts with which they are associated. Where this is not possible and they need to bring a business relationship with a supplier to an end, companies will need to allow the time to find an alternative supplier before the Directive comes into force. And, where companies are considering new, commercial opportunities, they should take steps to identify and address the associated human rights impacts now so as not to be tied into a long-term contractual arrangement with a business partner which could give rise to liability (not to mention adverse publicity) when the Directive comes into force.

To prepare, we recommend that qualifying Japanese companies prioritise the following **five practical steps**:

1. **Engage the senior leadership in your company.** The measures required to comply with the Directive are extensive and cross-functional. To be effective, they will require significant investment and buy-in from your company's senior leadership, including the board of directors. One way of demonstrating their engagement is to



develop and adopt a public human rights policy commitment, endorsed by the CEO and Chair of the company. Another is to appoint a board member with designated responsibility for human rights.

2. **Map and stress test the company’s existing approach.** Identify the policies, systems and processes already in place to assess and manage human rights impacts. This will include documents such as the company’s code of conduct, modern slavery policy, data privacy policy and responsible sourcing or procurement policy. Then, stress-test the existing approach to ensure that it corresponds with the relevant international standards and will enable the company to comply with the Directive. Where you identify gaps, prioritise these for action.
3. **Develop and implement a stand-alone “due diligence policy.”** This will set out the steps the company will take to identify and address human rights issues in the company’s supply chain, operations and downstream value chain. This may draw on the company’s existing approach. However, it is likely that most companies will need to add new systems and processes to ensure compliance. As part of this process, the company should seek to identify its “salient” human rights issues (i.e. those human rights at risk of the most severe negative impact through the company’s activities and business relationships) and prioritise these for action.
4. **Begin drafting a human rights adjusted code of conduct and accompanying contractual provisions** and incorporate these into commercial contracts. The Directive anticipates that the responsibility for due diligence is “cascaded” down the supply chain, including through the adoption of appropriate codes of conduct and commercial contractual provisions. However, it is not enough to impose unilateral obligations on suppliers. In order to use these contractual provisions as a defence against liability under the Directive and to comply with international standards, they must be accompanied by the appropriate measures to verify compliance and it must be reasonable to expect that the measures will be adequate to actually address the adverse impact. There will be circumstances in which a company must adapt its own purchasing practices in order effectively to address a human rights risk in its supply chain and cannot simply flow the obligation down to a supplier.
5. Design and introduce an internal **complaints procedure** (or operational grievance mechanism) which enables affected persons, trade unions and relevant civil society organisations to raise a legitimate concern about an actual or potential adverse impact.

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