Lessons for the EU Directive on Corporate Sustainability Due Diligence from the German Supply Chain Act

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On February 23, 2022, the European Commission published its proposal for a directive on corporate sustainability due diligence (EC Draft). While the document presented by the Commission is only a draft, it officially initiates the EU's legislative procedure [Art. 294 Treaty on the Functioning of the European Union (TFEU)] and is therefore a decisive step on the path forward towards the regulation of corporate due diligence obligations at the European level. The Commission based its competence on Art. 50 and Art. 114 TFEU, as several member states have already enacted national corporate due diligence laws. France's and the Netherlands' laws both predate any initiative at the European level.

On the other hand, Germany, the latest EU member state to enact national legislation in the field of business and human rights, rushed its Supply Chain Act (LkSG) through parliament at the end of the last legislative period in full awareness of the ongoing regulatory efforts at the European level (while e.g. Austria deferred its legislative process to await EU proposals). The result of the German legislative process was a rather business-friendly law that clearly fell short of the then already publicly available European Parliament Draft (EP Draft). It is of course difficult to determine the motivating factors behind the timing and final contents of the LkSG as an outsider with no access to confidential legislative consultations. Yet, the legislative process that led to the LkSG can serve as a cautionary tale for preserving the EC Draft's advantages regarding an effective regulation of corporate due diligence duties in the further European regulatory process.

Advantages of the EC Draft Compared to the German Supply Chain Act

From the viewpoint of an effective protection of human rights and the environment from corporate misconduct, the EC Draft contains several advantages compared to the LkSG. The most important ones relate to its scope, the extent of its obligations and its enforcement mechanism which are crucial elements of any business and human rights law.

Whereas the LkSG and its obligations only apply to companies with more than 3000 employees in Germany (the law provides for extending the personal scope to companies with more than 1000 employees in Germany from 2024 on), the EC Draft has a broader scope. Not only does it apply to all European companies with more than 500 employees on average and a net worldwide turnover of more than EUR 150 million [Art. 2(1) (a)], it also applies (with certain modifications) to smaller companies operating in business sectors with a particularly high risk of human rights and environmental violations, such as textile manufacturing or mineral extraction

[Art. 2(1)(b)]. Consequently, the EC Draft would create obligations for a far larger number of companies. It is, however, noteworthy that the EC Draft dropped the inclusion of publicly listed and high-risk SMEs that was contained in Art. 2(2) of the preceding European Parliament Draft (EP Draft).

In terms of the obligations imposed on companies, the difference between the German and European approaches lies less in the design and more in the extent of the obligations. Both the LkSG and the EC Draft pursue a due diligence approach (see Art. 5-9 EC Draft and §§ 4-8 LkSG). However, the EC Draft seems more ambitious regarding the "depth" of the imposed obligations. Both the LkSG and the EC Draft introduce a distinction between the company's own sphere, direct contractual partners and indirect partners/suppliers (the latter being entities with whom no direct contractual relationship exists). Yet, the LkSG only imposes duties on the company when there is a factual indication of potential violations regarding indirect suppliers (§ 9 LkSG). Under the EC Draft most obligations apply to the entire supply chain [upstream and downstream, see e.g. Art. 6(1) EC Draft] and are (if at all) slightly modified when it comes to indirect partners [see e.g. Art. 7(3) EC Draft].

Regarding the crucial aspect of enforcement there are further differences between the LkSG and the EC Draft. While some enforcement mechanisms (complaint mechanism, administrative supervision) are common to both approaches, the EC Draft establishes civil liability for violations of the obligations to prevent and mitigate an adverse impact (Art. 22). The EC Draft also prescribes that member states shall ensure the applicability of the substantive liability provisions under international private law. This is perhaps the biggest difference between the Draft Directive and the LkSG, which contains a specific exclusion of civil liability on the basis of the Act (§ 3 (3) LkSG).

Overall, the LkSG sets a lower standard than the proposed EU measures in the aforementioned key areas.

The German Legislative Process as a Cautionary Tale

At the same time, there are certain striking similarities between the LkSG and the EC Draft. In terms of the obligations imposed on corporations, the EC Draft departed from the EP Draft (which proposed i.a. the establishment and implementation of a "due diligence strategy" involving trade union and workers' representatives) and instead mirrors the LkSG model of specific corporate obligations (Arts. 5-9 EC Draft; §§ 4-8 LkSG). The LkSG can therefore be said to have served as a reference point for the EC Draft, yet not in the way some may have hoped. Predictions that a German law would show a strong commitment by the leading European economic power to the protection of human rights in corporate supply chains, thereby advancing further European efforts, seem to have been overly optimistic. Instead, the LkSG ended up being a rather business-friendly law.

There is of course not just one right way to regulate business and human rights given the wide variety of interests at play. On the one hand, there exist legitimate economic concerns on the side of corporations relating to substantial additional costs and practical difficulties of addressing violations throughout their extensive supply

chains. On the other hand, potential victims have a legitimate interest in effective prevention of violations and access to legal remedies. It is the task of the legislature to strike a fair balance between these interests.

Upon examining the process which led to the LkSG, it is doubtful that such a balance was struck. The LkSG already started out as a business-friendly draft (e.g. rejecting broader responsibility for indirect suppliers' conduct in deviation from the UN Guiding Principles). As a result of significant lobbying efforts, it experienced further watering-down in the legislative process. A prominent example is the matter of civil liability, a critical component of a functioning enforcement mechanism. Any civil liability for violations of the due diligence obligations was explicitly excluded in an amendment after corporate interest groups had expressed demands to that end. At the same time, the demands expressed by trade associations and the German National Human Rights Institution (e.g. asking for an alignment of the LkSG to the UN Guiding Principles regarding its scope and the conduct of indirect suppliers) remained unheard.

It would be regrettable if lobbying efforts led to a watering down of the EC Draft in a similar manner as it occurred with the LkSG. The EC Draft has already been subject to efforts to make it more business-friendly than the EP Draft. Judging by the response to the final EC Draft from various interest groups (see e.g. here and here), it seems likely that corporate interest groups will continue lobbying efforts to further align the final directive with the German model. Given their success at the national level, they may find an ally in the German representative on the Council. Under the applicable European legislative procedure, the Council will need to approve of the Directive for it to become law. The newly renamed Federal Ministry of Economic Affairs and Climate Action may be less receptive to the industry's lobbying efforts under its new Green Party leadership, but it would not be the first time that initially ambitious EU regulatory action ended up as a paper tiger.

Outlook

European harmonisation efforts in the field of business and human rights are a positive development. Only a common international approach has any realistic chance of setting effective standards and successfully regulating multinational corporations' conduct and duties in their international supply chains. Considering the economic weight of Germany within the EU and the "precedent" set by the Supply Chain Act, there is, however, a real danger of low-scale harmonisation following the model of the Supply Chain Act. Particularly the EC Draft's provision on civil liability is likely to meet fierce resistance by corporate interest groups. The path towards a definitive European Directive is still long and rocky. For those who wish to see meaningful regulation at the end of this path, it remains important to keep the process in the public eye to mitigate attempts at further down-scaling of a common European approach to corporate due diligence duties.