

Considering Supply Chain Due Diligence

Businesses should be alert to the growing importance of supply chain due diligence. This is driven by recent case law and legislative developments, as detailed below, but also shifting societal attitudes and stakeholder (including investor and customer) concerns. However, supply chain due diligence is also a challenging and multi-faceted exercise, with companies having to consider a broad range of interlinked factors including, for the focus of this article, human rights and environmental concerns manifesting on multiple fronts. The result is that many companies are facing heightened legal and reputational risks if they fail to adequately investigate and manage the human rights and environmental risks embedded in their supply chains. In this post, we take stock of recent legal developments and provide some practical tips on how businesses can comply with their legal obligations.

ENGLISH CASE LAW DEVELOPMENTS

A significant example of the heightened risks businesses are facing is demonstrated by the recent decision handed down by the UK Court of Appeal on 27 June 2024 in [World Uyghur Congress v National Crime Agency \[2024\] EWCA Civ 715](#). The Court ruled that the National Crime Agency (NCA) had misinterpreted the law by refusing to investigate whether imported cotton goods from the Xinjiang Uyghur Autonomous Region were produced using forced labour. The Court found that the NCA was wrong to determine that the belief on the part of the business that adequate consideration (i.e. fair market price) anywhere in the supply chain would "cleanse" the relevant goods of their criminal status, and that therefore any onward dealing with these goods could not be a money laundering offence under the [Proceeds of Crime Act 2002 \(POCA\)](#).

The potential repercussions for businesses of this decision are vast, especially for those which have supply chains linked to high-risk industries or countries from a human rights perspective. Even if those businesses pay a fair value for such goods (or believe that others earlier in the supply chain paid a fair value for such goods) they may still be exposed to criminal liability under POCA for trading criminal property, if they do so knowing or suspecting that such goods may be tainted by human rights abuses.

It would therefore theoretically follow that businesses now have a legal obligation to ensure that they know that their products remain untainted from such abuses and to undertake the necessary supply chain due diligence to satisfy themselves that this is the case. However, one potential unintended consequence of the judgment is that it might create an incentive for businesses to actually limit the scope of their supply chain due diligence, in order to avoid gaining knowledge or sufficient suspicion that the relevant goods are tainted by human rights abuses.

EU LEGISLATIVE DEVELOPMENTS

Such a loophole is likely to be closed for certain companies and partnerships which are caught by the [European Union's Corporate Sustainability Due Diligence Directive \(CS3D\)](#), which entered into force on 25 July 2024 and must be transposed into national law by EU Member States within the next two years. The CS3D's aim is to end or mitigate the adverse impact of businesses on human rights and the environment. It aims to do so by, among other things, establishing mandatory human rights and environmental due diligence obligations on companies and partnerships of a certain size (determined by thresholds relating to turnover and number of employees) operating in the EU (even, in the case of companies, if not incorporated there).

In-scope businesses will be required to adopt and implement due diligence policies to prevent, mitigate and end potential and actual "adverse impacts" on human rights and environmental matters within companies' own operations, those of their subsidiaries and across their "chain of activities". To that end:

- "Upstream" business partners include those relating to the production of goods or the provision of services. The CS3D includes a non-exhaustive list of examples, being the design, extraction, sourcing, manufacture, transport, storage or supply of raw materials, products or parts of products and the development of the product or the service.
- "Downstream" business partners include those related to the distribution, transport and storage of a product of that company, where the business partner carries out those activities for the company or on behalf of the company.
- "Business partners" may be either direct (where a commercial agreement is in place) or indirect (where there is no commercial agreement in place, but the business partner nonetheless performs activities related to the operations, products or services of the company).

"Adverse impacts" means adverse impacts on both specific rights as listed in the CS3D (which are wide ranging and, in relation to human rights, include adverse impacts on the right to life, the right to liberty and security, the right to enjoy just and favourable conditions of work, including a fair wage and rights of a child to the highest attainable standard of health) as well as

impacts on the legal interests protected in a number of international human rights instruments and treaties listed in the CS3D.

If a company breaches its obligations under the CS3D and fails to adequately manage its supply chain risk, consequences can include: (i) fines of at least 5% of the company's worldwide turnover (such penalties to be calculated taking into account the consolidated turnover at the level of the ultimate parent company); (ii) reputational damage via a public "name and shame" statement for companies that fail to pay fines within the prescribed time period, which could impact consumer confidence and/or lead to boycotts; and (iii) civil liability, with injured parties having the ability under certain circumstances to bring a claim for damages before a national court.

Crucially, the CS3D is just one piece of regulation amongst a number of evolving legislative requirements depending on the nature of your business. For example, the [EU Deforestation Regulation](#), which will apply from 30 December 2024, further requires companies doing business in the EU which trade in seven certain products (cattle, cocoa, coffee, oil palm, rubber, soya and wood) and products derived from these goods, to conduct diligence on their value chain to ensure the goods do not contribute to deforestation or forest degradation. The products impacted – which will be wide ranging from beef to furniture – must also be produced in accordance with local social and environmental legislation and in-scope businesses will be required to produce due diligence statements relating to the same.

CONCLUDING THOUGHTS

This growing area of exposure will no doubt appear daunting to many businesses which do not currently mandate due diligence of the standard now required throughout their supply chains. Such organisations will need to become rapidly adept at understanding their supply chains to know where human rights and environmental adverse impacts may exist take steps to root out any such issues, and develop appropriate tools to help identify and mitigate future risks. This may include, for example, rejecting goods that may be tainted by criminality and terminating certain commercial relationships. However, businesses should bear in mind that these courses of action may also carry their own legal risks, such as potential breach of contract or

wrongful termination claims, and will therefore require careful thought. Reviewing and amending the contractual terms they have in place with their business partners to afford them greater flexibility may help with this.

Furthermore, businesses should consider carefully which regulatory regime(s) may apply to them, including the CS3D in due course, and take all appropriate steps (including seeking legal advice where necessary) to ensure their compliance. With regards to conducting the diligence itself, whilst there is no 'one size fits all' solution, particularly given the nuanced regimes that are in place depending on sectors and jurisdictions, businesses should consider:

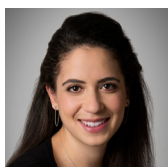
- Gathering data on who their suppliers are, such as implementing 'chain of custody' systems and processes;
- Putting together a risk assessment to be able to understand which business partners to focus on;
- Ensuring that their business partners have relevant codes of conducts in place that reach minimum requirements expected of them;
- Putting controls, procedures and audits in place to be able to monitor compliance by their business partners of their own codes of conduct;

- Maintaining strong business relationships to encourage transparency; and
- Updating standard terms and conditions to ensure that their business partners are required to be transparent and share relevant information with them in a timely manner.

If you would like more information or further background on other aspects to the CS3D, including the relevant thresholds for being in scope and its extra-territorial reach, the requirement for a climate transition plan or the modified rules for regulated financial undertakings, please speak to your regular contact at Weil. We are able to advise on these issues or any other topic mentioned in this briefing, as well as draw in leading ESG consultants to provide support with practical implementation.

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