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DUE DILIGENCE AND THE RISK OF DISENGAGEMENT:
Experiences from the mineral sector and a way forward for the CSDDD

INTRODUCTION

The Corporate Sustainability Due Diligence Directive (CSDDD) is currently being negotiated by the European institutions. This long-awaited piece of legislation is expected to be finalised by early 2024. With the aim of holding companies operating in the EU accountable for the adverse human rights and environmental impacts of their operations and the impacts across their value chains, the Directive will require companies to identify, prevent, mitigate, and account for these adverse impacts. In other words, to conduct due diligence.

This isn't the first piece of legislation that makes it mandatory for companies to conduct due diligence on human rights violations in their supply chains. In force since January 2021, the "Conflict Minerals" Regulation obliges companies sourcing specific minerals – tin, tungsten, tantalum and gold (3TG) – to conduct due diligence in an effort to avoid the financing of conflict in their supply chain. Similarly, and already in force since 2010, the US Dodd Frank Act imposes legal obligations with regard to due diligence measures by companies that trade on US Exchanges and are implicated in the supply chains of 3TGs from the Democratic Republic of the Congo and its neighbouring countries.

In this paper we explore the lessons learnt from these two pieces of legislation and discuss how they can inform a better CSDDD, with a focus on the need to clarify issues around disengagement.

PART 1:
DISENGAGEMENT AND DE-RISKING

What is disengagement?

In the context of human rights and environmental due diligence, disengagement is understood to be the process of terminating a business relationship based on the risks identified in the due diligence process.

The concept is described by the two international standards on due diligence, the OECD Guidelines for Multinational Enterprises and the United Nations Guiding Principles on Business and Human Rights.

Disengagement according to: The OECD Guidelines for Multinational Enterprises

"Appropriate responses with regard to the business relationship may include continuation of the relationship with a supplier throughout the course of risk mitigation efforts; temporary suspension of the relationship while pursuing ongoing risk mitigation; **or, as a last resort, disengagement with the supplier either after failed attempts at mitigation, or where the enterprise deems mitigation not feasible, or because of the severity of the adverse impact.** The enterprise should also take into account potential social and economic adverse impacts related to the decision to disengage."

Disengagement according to: The UNGPs

"If the business enterprise has leverage to prevent or mitigate the adverse impact, it should exercise it. And if it lacks leverage there may be ways for the enterprise to increase it. Leverage may be increased by, for example, offering capacity-building or other incentives to the related entity, or collaborating with other actors. There are situations in which the enterprise lacks the leverage to prevent or mitigate adverse impacts and is unable to increase its leverage. Here, **the enterprise should consider ending the relationship, taking into account credible assessments of potential adverse human rights impacts of doing so."**

This raises the notion of **responsible disengagement,** which takes place when:

- it is used as a last resort, either because
    - it follows failed attempts at mitigation
    - it happens where mitigation is not feasible
    - it happens due to the severity of the adverse impact
- it is conducted taking into account potential new adverse impacts related to the decision to disengage.

What is de-risking?

When disengagement is wider than one single business relationship, we can speak of de-risking. In this context, de-risking is when a company chooses to avoid current or future sourcing altogether from a high-risk area, sector, or type of supplier, including for example small-scale producers, rather than considering engagement in due diligence and adopting nuanced risk assessment measures.

PART 2:
IRRESPONSIBLE DISENGAGEMENT: LESSONS FROM THE MINERALS SECTOR

The Dodd-Frank Act (USA)

In 2010, the US passed a provision on conflict minerals (3TG minerals) from the Democratic Republic of the Congo (DRC) and adjoining countries as part of a larger law that became known as the Dodd-Frank Act. This law encouraged increased scrutiny on conflict financing from mineral trade in the DRC region, and as a direct consequence, most international mineral traders abstained from sourcing minerals from the DRC in 2010. This was the so-called de facto embargo. Consequently, an estimated 2 million people indirectly experienced difficult socio-economic consequences, including decreased revenues, increased thefts, the decline of local/retail trade, a rise in the number of school drop-outs, etc.

As this example illustrates, well-intentioned regulations can have far-reaching negative effects for the most vulnerable communities. In the mineral sector, this is the artisanal and small-scale mining (ASM) sector. The ASM sector is estimated to produce 26% of tantalum, 25% of tin, 6% of tungsten, and 25% of primary gold worldwide.[1] Moreover, it provides a livelihood to people in many producing countries: the World Bank estimates that 44,670,000 people are employed in ASM globally,[2] while the number of people who depend on the sector is much higher. However, at the same time, due diligence costs may be higher when sourcing from ASM, due to the relatively low quantities and potential risks. The ASM sector also has a bad reputation as smaller upstream actors, often working informally in a fragile environment, are more vulnerable to the risks listed in the OECD Guidance's Annex II.[3] In addition, most responsible sourcing requirements required by international downstream companies are beyond the means of ASM actors. The consequence is an effort at de-risking by mineral traders and their clients, which in turn pushes the ASM sector into a downward spiral. De facto embargoes exacerbate the stigma associated with ASM, and drive it toward informal or secondary markets with less rigorous sourcing practices.[4]

It is important to stress a significant difference here between the US Dodd Frank Act and the CSDDD which is relevant for the likelihood for disengagement. The US Dodd Frank Act sets additional requirements for companies sourcing minerals from the DRC and neighbouring countries. This limited geographic focus created an incentive for companies to avoid sourcing from the region, in particular the DRC. Sourcing outside the region became a low-cost and low-risk business decision whereas remaining engaged entails significant due diligence, audit and organisational costs.[5] The CSDDD does not set any additional requirements for specific geographic zones, which decreases the likelihood of blacklisting a region.

1 Occupational Knowledge International, see: http://www.okinternational.org/mining.
2 Delve Platform, https://delvedatabase.org/data, visited on 28 September 2023.
3 OECD (2021), Cost and Value of Due Diligence in Mineral Supply Chains, OECD Position Paper.
4 For example, the LBMA concluded in its 2021 annual report that artisanally mined gold currently accounts for less than 1% of the throughput of LBMA refiners, and has dropped 16% since 2019 (LBMA, Responsible Sourcing Report 2021).
5 Impact assessment of the EU Conflict Minerals Regulation, SWD(2014) 53 final.

The Conflict Minerals Regulation (EU)

The Conflict Minerals Regulation aims to break the link between conflict financing and the mineral trade and exploitation of 3TG minerals. The Regulation hence focuses on producing countries that are in a state of armed conflict or fragile post-conflict.[6] In order to support importing companies, the EU compiled a public list of conflict-affected and high-risk areas (CAHRAs). The CAHRA list is non-exhaustive and indicative in the sense that, under the Regulation, EU importers are not relieved from due diligence obligations when sourcing from countries that are not included.[7] This nuanced approach is however not used by the majority of companies and Member States' Competent Authorities.[8]

Despite the broader geographical focus of the EU Regulation compared to the US Dodd Frank Act, the risk of disengagement from the 28 countries on the list[9] is still a concern as it will often entail higher due diligence, audit and organizational costs compared to sourcing outside a conflict affected area. On top of this, there is a fear of reputational risk when doing business in CAHRAs and/ or with the ASM sector. In short, there are few incentives for companies to actually engage with ASM/CAHRAs and the trend to raise the bar in terms of sourcing standards has exacerbated this reluctance. Companies tend to look for a binary answer to the question: is this supplier clean or is it not? Yet, this lack of nuance in supplier risk scores, ratings and certifications stimulates de-risking and contravenes the spirit of the OECD Guidance on which most of these standards are built. The Guidance indeed is conceived to stimulate a process of continuous and progressive improvement through engagement with suppliers, which so far has been overshadowed by a prioritisation of (simplified) compliance.

Disengagement and de-risking has had many far-reaching implications; risk-aversive business decisions can lead to trade going further underground. At best, disengagement is at odds with the premise of the CSDDD that responsible behaviour by companies can stimulate positive socio-economic development. At worst, regulating due diligence could encourage informal and/or illegal trade.

Again, it is important to stress here a difference in scope between the Conflict Minerals Regulation (CMR) and the CSDDD, relevant for the likelihood of disengagement: the focus on conflict-related risks in the EU CMR. Although the number of countries is bigger compared to the US Dodd Frank Act, there is still a limitation in the number of cases where a company would need to do enhanced due diligence: only where there can be a possible link to conflict. This again stimulates companies to source elsewhere, outside problematic areas and the ASM sector.

PART 3: DISENGAGEMENT IN THE CSDDD

The previous examples illustrate that in order to be effective in its goal of minimising adverse human rights and environmental impacts caused by companies operating in Europe, and to avoid unintended negative consequences for vulnerable people in value chains, the EU must carefully design the CSDDD and clearly communicate this expectation to companies and implementing authorities. This includes finding the balance needed when it comes to the role of disengagement in due diligence.

Not too much

The law must include elements designed to prevent de-risking, where companies simply shift their sourcing to lower risk areas or lower risk suppliers, potentially leaving the rightsholders in their value chains even more exposed to human rights adverse impacts. To achieve this, it should make clear that when adverse impacts are found with a supplier, the company is expected to engage with them in mitigation and prevention efforts, and terminate the relationship only as a last resort. This is particularly relevant in cases where human rights issues are systemic and cannot be solved in the short term, but where long-term commitment and support from companies can be impactful, like we see for instance in the case of child labour.

6 https://www.cahraslist.net/glossary. Also included are areas witnessing weak or non-existent governance and security, such as failed states, and widespread and systematic violations of international law, including human rights abuses.
7 See: https://www.cahraslist.net
8 See IPIS/PAX report Oct 2023
9 At time of writing, Nov 2023

Not too little

At the same time, we should avoid a situation in which companies are able to systematically cause, contribute or be linked to adverse impacts without ever having to take action to prevent or mitigate them or disengage from the business relationship.

In this sense, we strongly advise against the Council General Approach, which gives companies the possibility to not disengage when a) no alternative business relationships exist and termination would cause substantial prejudice to the lead company; or b) the business relationship was established before the transposition of the directive.

A good balance

» Avoid de-risking through a wide scope and a risk-based approach

Companies under the CSDDD will not be expected to conduct due diligence only on certain sectors or products, or have a higher administrative burden if they opt for certain higher risk regions, as they do under the Minerals Regulation.

Instead, they will need to conduct due diligence across all of their business operations and value chains, which should follow a risk-based approach for prioritisation. We see this as a very positive choice, because it prevents companies from "cleaning up" their value chains of entire areas to avoid due diligence.

The scope of environmental issues and human rights covered by due diligence obligations should also be wide enough to account for the various issues that are present in the value chain, and not be restricted or highly targeted to one narrow issue, like conflict-related risks in the EU Minerals Regulation. The extraction of minerals is frequently linked to human rights abuses that do not necessarily occur in the framework of violent conflict only. In fact, in many top producing countries of 3TGs serious human rights violations such as child labour occur, while they are not affected by (post-) conflict, weak or non-existing governance or systematic violations of international law and hence not included in the EU CAHRA list.

» Specify when and how disengagement should occur

When faced with adverse impacts, companies should, in accordance with the OECD Guidelines and the UNGPs, engage with their business partners in mitigation efforts. If they lack leverage, businesses must attempt to increase it to effectively address, mitigate, or prevent the impacts they have found in their value chains.

In case of failed attempts at mitigation, and when further increasing leverage is not possible - or in other words, as a last resort – companies should then opt for responsible disengagement, which must be conducted taking into account potential new adverse impacts related to the decision to disengage.

In order to be clear and binding, these references should be brought directly under the articles that stipulate the due diligence duty, rather than only being mentioned in the recitals of the CSDDD. The position adopted by the European Parliament does exactly this, by mentioning responsible disengagement as a last resort on articles 7 and 8.

» Mandate stakeholder engagement when terminating a business relationship

The disengagement of a company from a business relationship may engender new kinds of rights violations. Companies should therefore be required to meaningfully engage with their stakeholders, including rightsholders, in a timely manner when considering disengagment. This will allow them to identify and address the negative impacts of their disengagement in an effective way.

» Make companies assess the role of their own purchasing practices and business models when considering adverse impacts

Part of the mitigation efforts that should take place before disengagement is necessary should also include reviewing if and how the company's purchasing practices and business models impact the supplier and their ability to respect human rights or the environment. Unfair trading practices like paying prices below production cost, long payment terms or one-sided contractual demands that benefit the buying company can seriously undermine supplier's ability to adopt or maintain production systems that are in line with the environment and human rights.

» Require transparency about disengagement

In order to drive transparency, reporting obligations under the CSDDD should include an obligation for companies to disclose information on disengagement. For example, companies should be expected to share information on all instances where they opted for terminating business relationships as a result of their due diligence processes, the reason for the disengagement, the geographical location of the concerned stakeholders (without directly disclosing their identity), and whether adverse impacts of the decision to disengage have been addressed, whether and how prevention and remediation of past adverse impacts has been pursued, and whether meaningful stakeholder engagement has been undertaken accordingly.

» Provide guidance to companies

Companies should be supported in understanding and practising responsible disengagement. This process should be guided by existing international standards from the UN and OECD. Moreover, the European Commission should be prepared to support companies by issuing information on responsible disengagement, as proposed by the Parliament position under article 13.

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The International Peace Information Service (IPIS) is an independent research institute providing tailored information, analysis, capacity enhancement and policy advice to support those actors who want to realize a vision of durable peace, sustainable development and the fulfillment of human rights.

ABOUT SOLIDARIDAD

Solidaridad is a civil society organization that makes international supply chains more sustainable. It is our mission to create a better perspective for farmers and workers in developing countries, while reducing impact on the environment. We envision a world in which all we produce and consume can sustain us, while respecting the planet, each other and the next generations. For more information, please refer to www.solidaridad.nl or www.solidaridadnetwork.org.

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