

DEFORESTATION REGULATION: NEW OBLIGATIONS FOR BUSINESSES AND A MAJOR CHALLENGE FOR GLOBAL TRADE

Last year, the European Union enacted a new regulation aimed at combating global deforestation. The regulation focuses on enhancing environmental protection and introduces fundamental changes for businesses operating within the EU market to achieve this goal. The new obligations will affect not only European entities but also, indirectly, foreign companies trading with them. Consequently, this regulation is set to have a significant impact on international trade and global supply chains.

OBJECTIVES OF THE REGULATION AND RELEVANT COMMODITIES

Regulation (EU) 2023/1115 of the European Parliament and of the Council on the making available on the Union market and the export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010 was adopted on 31 May 2023 (the "**Regulation**"). Its primary aim is to contribute to a reduction in global deforestation and reduce the EU's contribution to greenhouse gas emissions and biodiversity loss.

To achieve these objectives, the Regulation imposes new obligations on obliged entities regarding trade in relevant commodities within the Union market. These commodities include **cattle, cocoa, coffee, oil palm, rubber, soya, and wood**. However, the obligations extend not only to these commodities but also to the relevant products listed in Annex I of the Regulation, which contain these commodities, have been fed with them, or have been produced using them. Consequently, the Regulation is expected to significantly impact the EU market, affecting a broad range of everyday products such as meat products, chocolates, tyres, wooden products, and books. The European Commission anticipates expanding the list of commodities in the future.

Initially, the Regulation was scheduled to take effect for large and medium-sized enterprises¹ on 30 December 2024. However, following appeals from global partners, Member States, and the public, a one-year postponement has been proposed. As a result, the Regulation is likely to take effect for large and medium-sized enterprises on 30 December 2025, and for micro and small enterprises on 30 June 2026. The postponement is partly due to businesses' lack of preparedness for the new rules, which may necessitate complex adaptations, such as implementing new processes to trace the origin of raw materials and revising supply contracts. It is therefore advisable for businesses to utilise this additional time effectively and not stall their preparations.

Key Points

- The regulation covers cattle, cocoa, coffee, oil palm, rubber, soya, wood and products derived from these commodities.
- It introduces a number of new obligations for businesses, particularly the requirement to conduct due diligence.
- Businesses must demonstrate that their products have not contributed to deforestation, which includes performing the necessary supply chain due diligence.
- Breaches of the regulation will incur substantial penalties.

¹ The Regulation classifies enterprises by size according to Article 3 of Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.

The Regulation forms part of the EU's long-term strategy aimed at sustainable development and mitigation of the negative environmental and social impacts of Member States' business activities, known as ESG. In recent years, the EU has enacted a number of legislative acts to support these objectives. Notable examples include the CS3D Directive², concerning companies' responsibility for the supply chain, which is expected to take effect in 2027, and the CSRD Directive³ on non-financial reporting, which mandates certain companies to prepare a sustainability report already for 2024. Some EU Member States, such as Germany⁴, France⁵, and the Netherlands⁶, have already established varying degrees of ESG obligations. In the Czech Republic, a legal framework is in place concerning public procurement, requiring contracting authorities to consider sustainability principles in their purchasing decisions.⁷

OBLIGED ENTITIES

The Regulation will affect a significant number of Czech companies, particularly those operating in the wood processing and food industries, but the obligations will also extend to entities such as publishing houses and shoe manufacturers. The Regulation distinguishes between two types of obliged entities: (i) **operator** and (ii) **trader**. An **operator** is an undertaking that **imports** relevant commodities and products into the EU market for the first time or **exports** them. This category also includes entities that alter a product on the European market by changing its code according to the table in Annex I of the Regulation. A **trader** is defined as someone who **participates in the supply chain but is not an operator**, typically encompassing distributors or end sellers. The scope of obligations under the Regulation is also influenced by the size of the obliged entity. Traders who are not classified as small or medium-sized enterprises will have obligations similar to those of operators. Conversely, simplified obligations will apply to small and medium-sized traders.

OBLIGATIONS IMPOSED BY THE REGULATION

Only relevant commodities and products that meet the following criteria can be placed, supplied, or exported within the EU market:

- They did not cause deforestation or forest degradation after 30 December 2020.
- They have been produced in accordance with the legislation of the country of production.
- They are covered by a due diligence statement.

Obliged entities must therefore perform due diligence when placing relevant commodities and products on the market, or supplying or exporting them, to demonstrate compliance with these criteria.

DUE DILIGENCE AND DUE DILIGENCE STATEMENT

Performing due diligence involves gathering information, data, and documents that demonstrate the compliance of relevant commodities and products with the specified criteria. This information, which will include, among other things, the geolocation of all plots of land used for production, must be retained by obliged entities for a period of 5 years. Additionally, due diligence encompasses a comprehensive risk assessment that considers various criteria such as the presence of forests and indigenous peoples in the country, the risk level assigned to the country of production, and the reliability of the information collected. If risks are identified, the obliged entity must implement measures to mitigate them. For low-risk countries, a simplified due diligence process will be applied. The European Commission will determine the categorisation of countries by risk level through an implementing act.

Obliged entities must not place relevant commodities on the market or export them without a due diligence statement confirming that due diligence has been performed and that no non-negligible risks have been identified. The statement is uploaded to the European Commission's information system and assigned a reference number. A specimen statement is included in Annex II of the Regulation.

If a due diligence statement has already been uploaded to the system for a relevant product or part thereof, the next obliged entity further down the supply chain does not need to perform due diligence to that extent. Such entity can simply

² Directive (EU) 2024/1760 of the European Parliament and of the Council of 13 June 2024 on corporate sustainability due diligence and amending Directive (EU) 2019/1937 and Regulation (EU) 2023/2859.

³ Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

⁴ Supply Chain Due Diligence Act (in German: *Lieferkettensorgfaltspflichtengesetz* (LkSG)) of 16. July 2021, BGBl. I 2021, p.2959.

⁵ Particularly the Law on "Duty of Vigilance" (in French: *Loi de Vigilance*) No. 2017-399 of 27 March 2017.

⁶ Child Labour Due Diligence Act (in Dutch: *Wet Zorgplicht Kinderarbeid*) No. 2019/401 of 13 November 2019.

⁷ Cf. Section 6(4) of Act No. 134/2016 Coll., on Public Procurement.

refer to the relevant statement using the assigned reference number. In practice, this provision will simplify compliance with the Regulation for distributors and end sellers. However, the due diligence obligation remains for those parts of the relevant product for which it has not yet been fulfilled. Large companies are required by the Regulation to verify that due diligence has indeed been conducted in accordance with its requirements, which may necessitate additional checks and verifications throughout the supply chain. It is therefore crucial for all businesses to thoroughly establish their internal processes and select reliable partners to minimise the risk of non-compliance and potential sanctions.

INCORPORATION OF SPECIFIC CONTRACTUAL CLAUSES

Given the scope of obligations, it is imperative to pay close attention to contracts within the supply chain. Effective compliance with the Regulation will be difficult to achieve without adequate cooperation. We recommend incorporating specific obligations of the parties into supply contracts, particularly regarding the provision of information and audit rights. It is also advisable to address potential liability for sanctions imposed by regulators and the possibility of withdrawing from the contract in the event of a breach of the obligations laid down in the Regulation. Additionally, businesses in the supply chain might consider developing a corrective action plan outlining steps to take if deficiencies are identified. This could involve defining specific actions and providing support from other companies in the supply chain. Incorporating contractual clauses and preparing corrective action plans can help businesses avoid substantial financial penalties and protracted litigation. In our practice, we have encountered companies that attempted to address compliance with ESG rules, including supply chain compliance, merely by referencing adherence to individual companies' codes of conduct. However, this approach is often inadequate due to the vagueness and generality of these codes, which frequently lack specific benchmarks or commitments on essential aspects. For an ESG strategy to be truly effective, it is necessary to implement specific measures, regularly collect relevant data, evaluate impacts, and clearly define goals that reflect genuine sustainability and social responsibility efforts.

SANCTIONS AND IMPLEMENTING REGULATIONS

The Regulation lays down penalties, the specific form of which is to be determined by the Member States. These may include, for example, a fine with an upper limit not lower than 4% of the obliged entity's total annual turnover in the EU, confiscation of relevant commodities and products and income derived from them, a ban on participating in public tenders, or a ban on importing or exporting relevant commodities and products. The specific form of sanctions will be clarified once the final text of the adaptation regulation in the Czech Republic is available. This regulation is expected to be the government's draft amendment to Act No. 226/2013 Coll., on the marketing of wood and timber products, and other related acts, which is currently proceeding to the Chamber of Deputies.

The Deforestation Regulation introduces new obligations for businesses, raising many questions. We will address the Regulation and other topics at our upcoming **Compliance Seminar**, scheduled for **the first quarter of 2025**. Please feel free to contact us with any questions or suggestions you would like us to cover during the seminar. You can reach us at prabusinessdevelopment@cliffordchance.com, and please include "Compliance Seminar" in the subject line.

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