German Supply Chain Act

(Lieferkettensorgfaltspflichtengesetz)

NEW STANDARD FOR HUMAN RIGHTS AND ENVIRONMENTAL DUE DILIGENCE FOR GLOBAL SUPPLY CHAINS

DLA PIPER

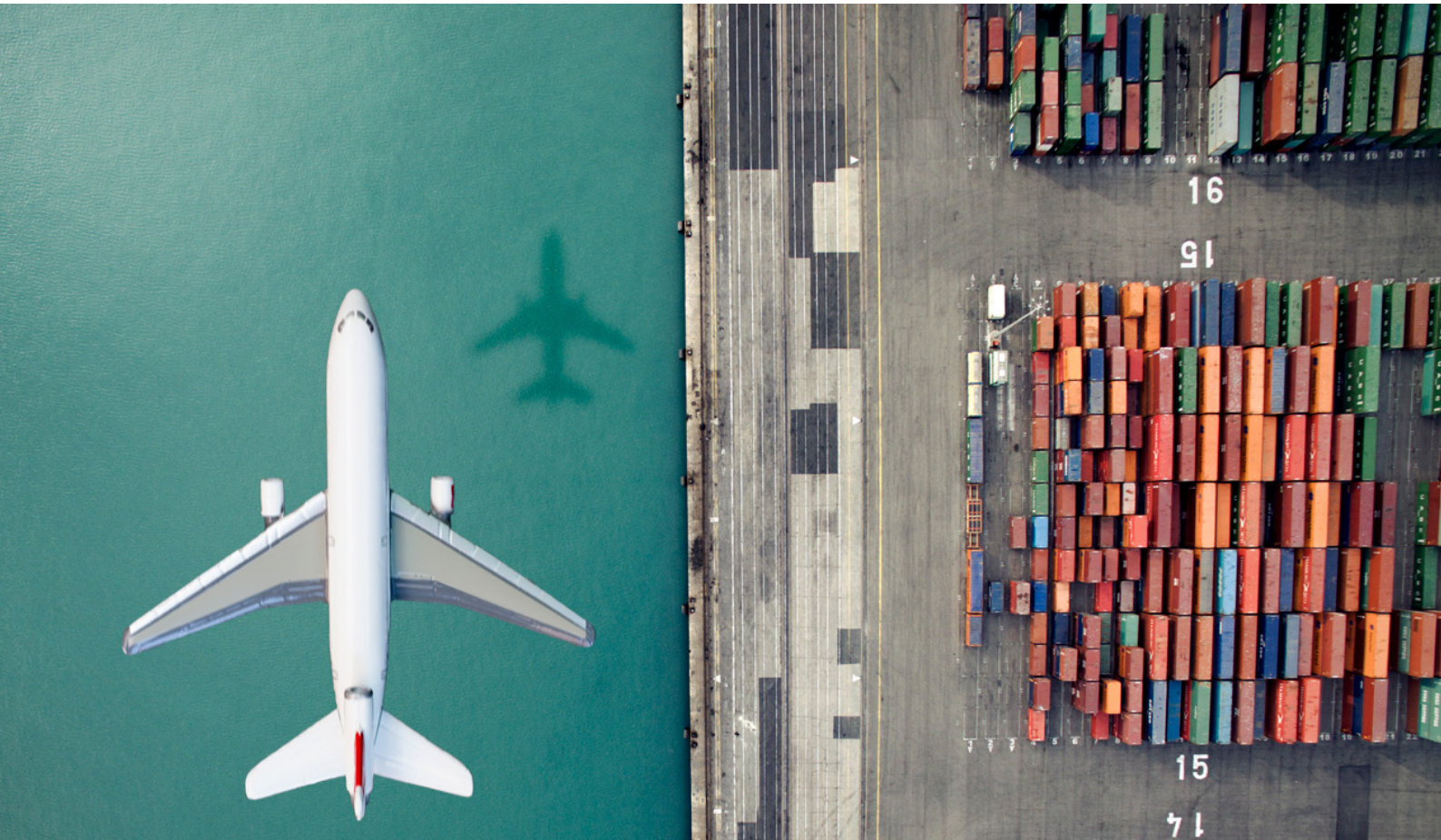
In the context of globalized trade, value and supply chains extend across the entire world. International corporations that do not voluntarily comply with human rights and environmental standards along their supply chains (83-87% of German companies) have been criticized for several decades for profiting from weak and poorly enforced national regulations in emerging and developing countries, especially in the Global South. The call for companies to comply with these standards is emphasized by the fact that the International Labor Organization estimates that 25 million people worldwide are victims of forced labor, and that global environmental damage is also steadily increasing, according to the UN. Against this backdrop, and as a result of the tragic collapse of the Rana Plaza textile factory in Bangladesh in 2013 that claimed the lives of over 1,000 people, the necessity for German lawmakers to adopt a legally binding and stricter liability regime for corporate supply chains was confirmed. In June 2021, the German legislature passed the "*Gesetz über die unternehmerischen "Sorgfaltspflichten zur Vermeidung von Menschenrechtsverletzungen in Lieferketten"* (Supply Chain Act). The Supply Chain Act imposes significant obligations on companies that source their products and services through supply chains from developing and emerging countries and sell them in Germany to comply with human rights and environmental standards, and exposes them to potentially serious liability in the event of violations.

This article highlights the most important aspects of the new German Supply Chain Act.

Scope

The Act will come into force on 1 January 2023. The scope of the Supply Chain Act will initially be limited to partnerships and corporations that have their headquarters, principal place of business, administrative headquarters, registered office or a domestic branch in Germany and employ more than 3,000 employees across the entire group (*Konzern*). From 2024, the Supply Chain Act will also apply to smaller companies with more than 1,000 employees.

Under the Supply Chain Act, a supply chain comprises all the steps in Germany and abroad (companies' own business operations; direct and indirect suppliers) that are required to manufacture a company's products and to provide its services – starting with the extraction of raw materials and ending with delivery to the end customer. According to the explanatory memorandum of the Act, financial services are also covered by the Supply Chain Act, because by investing a large sum or granting a large loan, further production processes are triggered.



Requirements and implications for companies

Under the Supply Chain Act, companies' responsibilities extend to the entire supply chain, scaled according to the degree of their influence. The Supply Chain Act obligations must be fully implemented by companies in their own business operations as well as vis-à-vis their direct suppliers. These requirements of the Supply Chain Act only extend to indirect suppliers if a company gains "substantiated knowledge" of human rights violations or environmental violations at this level.

The centerpiece of the new Supply Chain Act is the obligation for companies to conduct human rights and environmental due diligence. The new due diligence requirements include:

Risk management

As a first step, companies have to analyze and assess their risks within their supply chains to be able to take appropriate measures to manage these risks. The German Supply Chain Act identifies inter alia the following Environmental, Social, and [Corporate] Governance (ESG) criteria as relevant risk areas:

- child labor
- forced labor
- occupational health and safety
- problematic employment and working conditions
- freedom of association
- discrimination
- minimum wage
- life
- health
- unlawful seizure of land and waters
- torture
- environmental damage

The risk analysis must be carried out by companies at least once a year and on an ad hoc basis (e.g. when introducing a new product/service). As part of their risk management, companies must first conduct an analysis of their own human rights and environmental risks and the identical risks of their direct suppliers. In cases where an unjustified contractual arrangement has been concluded with the direct supplier or a circumvention transaction has been undertaken, an indirect supplier is considered to be a direct supplier.

In addition, if companies obtain substantiated knowledge of a possible violation of human rights or environmental standards by one of their indirect suppliers, they must immediately conduct a risk analysis for these violations. The results of the risk analysis must be communicated internally to the relevant decision-makers – such as directors, senior management or the purchasing department – and given due consideration by the decision-makers. Finally, companies are required to appoint a "human rights officer" who is responsible for monitoring the risk management within the company.

Obligation to remedy human rights and environmental violations

As a consequence of the risk analysis, companies must take measures to prevent, minimize and remedy any identified negative impacts on human rights and the environment. Accordingly, if a company identifies a risk as part of such an analysis, its directors or senior management must issue a policy statement on its "human rights strategy" to prevent negative impacts on human rights and the environment in the future through preventive measures. The statement ensures that company directors and management commit themselves clearly to the human rights strategy. These preventive measures include, in particular, implementing an appropriate procurement strategy, considering the supplier's compliance with human rights and environmental standards when selecting a supplier, the assurance of a supplier's compliance with human rights and environmental requirements, agreeing on appropriate contractual control mechanisms with the supplier, and implementing risk-based control measures. Further, if a company determines that a violation of a protected legal position has occurred or is imminent, it must immediately take appropriate remedial action to prevent, stop or minimize the violation. The closer a company is linked to the violation that was threatened or already happened, and the more it contributes to it, the greater its efforts must be to end the violation. A company's own business operations are so closely linked to the risk that it can be expected to immediately end the violation that was threatened or already happened. If, however, in the event of a violation by a supplier, a company is not in the position to end the supplier's human rights and environmental violations in the foreseeable future, it must immediately

draw up and implement a concept to minimize them: either the company must create and implement a plan to remedy the violation in cooperation with the supplier causing the violation, or solutions must be developed within the framework of industry initiatives and industry standards to increase the company's ability to exert influence on the supplier causing the violation. Alternatively, the company may temporarily suspend the business relationship with the supplier while efforts are made to mitigate the risk (including contractual penalties, delisting). Termination of business relationships is only required as a last resort in the event of serious human rights violations by suppliers that cannot be remedied in any other way. The effectiveness of the preventive and remedial measures must be reviewed annually and on an ad hoc basis in the event of a significant change in the risk exposure profile – e.g. through the introduction of new products, projects or a new field of business.

Grievance mechanism

Companies also need to establish a grievance mechanism for misconduct regarding human rights and environmental standards caused by the economic activities of the company or its direct or indirect suppliers. Grievance procedures must be designed in a way that persons whose rights may be infringed by such economic activities, and persons aware of such infringement (e.g. non-governmental organizations), can bring these risks or violations to the attention of the company. Companies must review the effectiveness of the grievance mechanism at least once a year and on an ad hoc basis (see above).

Mandatory documentation and reporting

Companies must continuously document their compliance with the due diligence requirements under the Supply Chain Act and retain the relevant records for at least seven years.

Companies concerned are also legally bound to prepare an annual report on the actual and potential negative impacts of their business activities on human rights and the environment and submit it to the Federal Office for Economic Affairs and Export Control *(Bundesamt für Wirtschaft und Ausfuhrkontrolle)*. The report must also outline which measures the company has taken to fulfill its due diligence obligations. Companies are required to publicly disclose the report on their website for a period of seven years.

Best-effort obligation and proportionality

Both the duty to analyze risks and the duty to undertake follow-up measures are not designed as a duty to succeed, but as a duty to use one's best efforts. In other words, companies are not obliged to prevent all human rights and environmental infringements in their own business operations and those of their suppliers under all circumstances. Rather, the required risk management is based on the principle of proportionality.
The measures that are proportionate and reasonable for the individual company depend in particular on the actual influence that the company can exert within its supply chain, the causal contributions to the human rights and environmental risk, and the countries to which the supply chain extends. However, termination of the business relationship with a supplier is only required if the violation of human rights or the environment is classified as very serious, no remedy is feasible, and no other mitigating measures are available to the company. This means the required measures a company must adopt depend on its proximity to, and ability to influence, human rights and environmental violations.

Monitoring, fines and sanctions

The Supply Chain Act requires the Federal Office for Economic Affairs and Export Control to monitor compliance with due diligence obligations, to review companies' reports, to issue the necessary orders and/or measures, and to conduct onsite inspections at companies. It acts at its own discretion or upon application to monitor compliance with the obligations under the Supply Chain Act and to detect, remedy and prevent violations of the Act. However, the Federal Office for Economic Affairs and Export Control will only impose measures upon application if the person filing the application asserts in a substantiated manner that a protected right has been violated or that a violation is imminent due to the company's failure to comply with an obligation under the Supply Chain Act.

If a company fails to comply with the due diligence obligations pursuant to the Supply Chain Act, the Act provides for sanctions in the form of periodic penalty payments of up to EUR 50,000 in administrative enforcement proceedings and/or fines. The fines can amount to up to EUR 8 million. If the company has an annual revenue of more than EUR 400 million, a regulatory offence may even be punished with an administrative fine of up to 2% of a company's global revenue. The amount of the fine is determined

by the significance of the violation, the economic circumstances of the company and the circumstances that militate in favor of and against the company.

Companies that have been fined substantially can also be excluded from public contracts for up to three years.

Civil liability

Under German law, companies are generally not liable for any damage caused abroad by other companies in their global supply chains. However, the Supply Chain Act grants German trade unions and non-governmental organizations the right to represent aggrieved parties before German courts in the event of violations of human rights and environmental standards in the supply chains of German companies (legal standing; *Prozessstandschaft*).

Conclusion

The German Supply Chain Act is the first legislative step to oblige German companies to protect people and the environment adversely affected by their global supply chains. In other countries, especially in the EU (such as the Netherlands or France), comparable liability regimes already exist. Due to the EU Supply Chain Directive scheduled for fall 2021, further – probably wider-reaching – regulations of supply chains are to be expected.

On the one hand, according to a study by the Handelsblatt Research Institute (HRI), compliance with the standards stipulated in the German Supply Chain Act comes at a cost to companies of 0.005-0.6% of their annual revenue. On the other hand, compliance with human rights and environmental standards along their supply chains also increases the value and reputation of companies, their brands and trademarks, and of the products and services they sell. This additional burden on businesses is to be compensated for by the relief provided by the Third Bureaucracy Relief Act *(Dritte Bürokratieentlastungsgesetz)*. By complying with due diligence under the Supply Chain Act, it is expected that prices for goods and services will increase only moderately, if at all.

To avoid liability (fines and sanctions) under the Supply Chain Act, board members, senior managers, supervisory board members, compliance and human rights officers now have the daunting task of incorporating the Supply Chain Act's canon of due diligence into existing compliance and governance systems in the spirit of responsible corporate governance. This means that contracts with suppliers must be aligned with the standards of the Supply Chain Act. The annual and ad hoc monitoring obligations required as part of risk management must also be implemented in the companies' compliance programs. In addition, onsite inspections should be carried out on a spot-check basis. The key prerequisite for effective risk management is the knowledge of the effects of one's own entrepreneurial activities on people and the environment that are connected with the company's business sectors, products or services. Finally, companies must create a grievance mechanism and should establish processes to address human rights and environmental violations and prevent or minimize future violations.

Dr Daniel H. Sharma, LL.M.
Partner
T +49 69 271 33 220
daniel.sharma@dlapiper.com

Franz D. Kaps
Associate
T +49 69 271 33 256
franz.kaps@dlapiper.com

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