
Publications & Events

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Dr. Alexander Kiefner | Christian M. Theissen | Prof. Dr. Norbert Wimmer | Anna Burghardt-Kaufmann |
Dr. Julia Sitter (née Kersjes) | Sabine Kueper

The German Parliament passed the "Act on Corporate Due Diligence in Supply Chains" on 11 June 2021

After several months of discussion, the German Parliament ("Bundestag") adopted the "Act on Corporate Due Diligence in Supply Chains" (Supply Chain Due Diligence Act – "Act" or "LkSG") on 11 June 2021.¹ The Act imposes, for the first time, a binding obligation on companies to establish, implement and update due diligence procedures to improve compliance with specified core human rights and, to a limited extent, environmental protection in supply chains.

This Act applies not only to companies with their registered office or principal place of business in Germany, but also to foreign companies that have a branch office in Germany. The new obligations for supply chain due diligence will inevitably impact foreign companies doing business with German companies.

The Act will come into force on 1 January 2023, giving companies a transitional period to prepare for their new supply chain due diligence obligations by revising their existing compliance management systems, establishing new processes, and training their employees accordingly.

Background

With the LkSG, the German government aims at implementing the 2016 "National Action Plan for Business and Human Rights in the Federal Republic of Germany", which envisages companies to appropriately identify, address and report on human rights risks in their supply and value chains, with reference to their size, sector and role within the supply chain, and enable persons to notify relevant risks and infringements by means of a complaints procedure or grievance mechanism. The basis of the Action Plan and the new national requirements is the due diligence standard of the 2011 UN Guiding Principles on Business and Human Rights.

Below is a short summary of the due diligence obligations, highlighting recent key amendments to the initial governmental draft dated 19 April 2021 (BT-Drucksache 19/28649).

Scope of application

As of 1 January 2023, the LkSG applies to companies (irrespective of their legal structure) that have their central administration, headquarters or registered office in Germany, provided they have more than 3,000 employees in Germany. Employees seconded (**entsandt**) to a foreign country by such company will also be taken into account. In addition, the LkSG now also includes in its scope foreign companies that have a branch office in Germany and, in general, at least 3,000 employees in Germany (not taking into account employees seconded to a foreign country). On 1 January 2024, the threshold of 3,000 employees will be reduced to 1,000 employees for both German and foreign companies, which is expected to increase the number of companies exposed to the LkSG from around 700 in 2023 to 2,900 in 2024.

When calculating the relevant number of employees of a company, employees of subsidiaries of such companies shall be taken into account, if working in Germany for a subsidiary or seconded by a subsidiary to a foreign country. Please note that German companies that serve as German "hub" or holding company for the German or European activities of a foreign parent are not exempt from the application of the LkSG.

Protected legal positions

Legal positions protected by the LkSG are defined by reference to the human rights conventions listed in the Annex to the Act and three selected environmental agreements. The purpose of the statutory due diligence obligations is to improve compliance with certain enumerated core prohibitions set out in these international agreements, such as prohibitions of child labor, forced labor and slavery, unequal treatment on the grounds of national, social or ethnic origin, health status, disability, sexual orientation, age, gender, political opinion, religion or belief, the withholding of an appropriate wage and forced eviction or unlawful seizure of land; and the prohibition of hiring or using private or public security forces involving torture or injury to life or limb. These obligations also strive for the protection of workers' safety and freedom of association at places of employment.

The LkSG does not pursue comprehensive environmental protection, but extends due diligence obligations to certain environmental risks required for the protection of human health. Specifically to the prohibition of causing harmful impacts on the soil, water pollution, air pollution, harmful noise emissions and excessive water consumption, provided these are likely to adversely affect natural resources on which people depend, deny people access to safe drinking water, impede or destroy access to sanitation or impact human health. In addition, companies must comply with certain key prohibitions stipulated by three international conventions (namely the Minamata Convention on Mercury, the Stockholm Convention on Persistent Organic Pollutants and the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal).

New risk management and reporting duties for companies

With newly imposed due diligence obligations on human rights and environmental protection, companies must introduce iterative and ongoing, or in certain circumstances ad hoc, due diligence processes on the human rights and environmental protections specified by the LkSG. Identification and management of a company's supply chain and its respective risks lie at the heart of the required due diligence processes. The term "supply chain" refers to all products and services of a company, including all manufacturing and service steps in Germany and abroad, from the extraction of raw materials to the delivery to the end customer. The entire supply chain in Germany and abroad is covered, however, required the due diligence processes differ according to, first, a company's "own business", the business of any "direct supplier" and – to a limited extent – the business of any "indirect supplier", and, secondly, the following criteria:

- type and scope of the business activities of the company subject to the due diligence obligations,
- ability of the company subject to the due diligence obligations to exert influence (so-called leverage),
- typically expected severity of the violation, and
- type of contribution by the company subject to the due diligence obligations to causing a violation.

The company's "own business" covers any activity undertaken by it to achieve its objectives. Compared to the initial governmental draft legislation, the adopted version of the LkSG clarifies that subsidiaries of a company are included in a parent company's own business area if the parent company exercises determinative influence over the subsidiary. This means that human rights or environmental risks caused, for example, by subsidiaries domiciled or operating abroad, but effectively controlled by the parent company, will be included in such company's own business for purposes of responsibility for the statutory due diligence requirements. Assessing whether the necessary determining influence exists requires an overall assessment of all legal and factual aspects governing the relationship between parent company and subsidiary. This result sits well with more recent foreign case law on responsibility for, e.g. human rights violations in the context of group companies. In practice, however, it may be difficult for the competent authority to gain a sufficient understanding of the factual and legal relationships existing within the group.

Insofar as risks result from the business of an effectively controlled subsidiary, the parent company must take remedial action that generally leads to the termination of violations; just as with respect to risks arising from its own business area in Germany and abroad. The legislator thus assumes the parent company to be unable to stop violations by its respective subsidiaries or foreign business units for legal or factual reasons only in atypical cases.

As part of their due diligence duties, companies must establish an appropriate and effective risk management in relation to both their own business, as well as that of any direct suppliers, and conduct an appropriate risk analysis. Where a component risk analysis reveals indications of abusive supply chain arrangements, the company must also subject its indirect suppliers in the risk analysis as appropriate in a specific case. Appropriate preventive measures, specifically in respect of selection of suppliers, supply agreements and implementation of control mechanisms, must

immediately be adopted upon identifying a risk. In addition, companies must implement an internal complaints procedure or grievance mechanism that enables persons to notify potential risks or violations of protected human rights or environmental obligations arising from the company's economic activities in its own business and/or those of any of its direct or indirect suppliers. All notifications must be followed up, and companies must also establish written rules of procedure and make them publicly available.

As part of its preventive management, companies must issue a statement on their human rights strategy. Responsibility for this statement rests with the company's management. In addition, companies must prepare an annual report on their compliance with their due diligence obligations during the previous fiscal year. This report must be made publicly available at no charge on the company's website for at least seven years. Uncertainty remains about the role this additional reporting duty will play in the context of the other duties, especially non-financial reporting duties. It is to be expected, however, that satisfying the reporting duties under the LkSG will require more than non-financial reporting, since the latter "only" requires material risks to be identified (with companies in practice supposedly often not identifying risks within the meaning of the LkSG by referring to the materiality requirement), while the LkSG imposes a comprehensive reporting duty irrespective of materiality thresholds.

The now adopted version of the LkSG introduces a duty to inform the company's economic committee about issues relating to the statutory due diligence obligations. By amending the Works Constitution Act, the legislator has complied with a demand made by the German Trade Union Federation during the expert hearings. The rationale for this additional duty to provide information is the significance that human rights and environmental risks in supply chains may have for the economic activities of the company and associated reputational and performance risks, which can have a direct impact on the economic situation of the company.

No new civil law liability

A major point of discussion during the legislative process was the implicit expansion of civil law liability for companies subject to the due diligence obligations with or without the introduction of a new statutory ground of liability. To avoid creating **any additional** civil law liability risks for companies, the Bundestag has now adopted the Act with the express proviso that a violation of the obligations arising under the LkSG shall not give rise to civil law liability. However, any liability arising independently from the LkSG remains unaffected. In addition, the legislative explanation clarifies that the new statutory due diligence obligations created for the purpose of improving the human rights situation in international supply chains are to be enforced through administrative proceedings and by means of administrative offense law. In the event of serious violations, companies can also be excluded from public procurement for up to three years.

The Act does, however, allow domestic trade unions and non-governmental organizations to sue in one's own name on another's behalf, thereby allowing them to take legal action if a violation of an "eminently important legal position" is to be asserted in court. In addition to bringing an action,

potential victims of violations of protected legal positions resulting from a non-compliance with the due diligence duties can file a complaint with the German Federal Office of Economics and Export Control (BAFA).

Review of obligations by a regulatory authority and sanctions

BAFA has been given responsibility for reviewing compliance with the obligations arising from the Act and has to review the annual reports on the fulfillment of due diligence obligations to be submitted by companies. BAFA will take action in order to monitor the due diligence obligations and respond to substantiated complaints received by it. If BAFA determines that any violation has occurred, a penalty payment of up to EUR 50,000 or a fine can be imposed by it. In the case of companies with average annual sales of more than EUR 400 million, the fine for certain violations may be fixed by BAFA at an amount equal up to two percent of the average annual sales of the company.

Conclusion

The Act imposes, for the first time, a binding obligation on companies to establish, implement and update procedures to improve compliance with core human rights and certain environmental provisions in supply chains. This result follows and responds to an increasingly perceivable international trend. However, as far as the due diligence obligations with respect to the business activities of indirect suppliers are concerned, the German legislator falls short of the wording of the UN Guiding Principles. Although the supply chain generally encompasses all of a company's indirect suppliers, principal due diligence obligations, such as conducting risk analysis and implementing further risk management including preventive and remedial measures as well as public reporting, per se, apply only in relation to the company's own business and its direct suppliers. Only where the company has substantiated knowledge of a possible infringement of a protected legal position by, or in the business context of, any of its indirect suppliers, do the aforementioned due diligence obligations also apply towards indirect suppliers' business.

In its explanatory memorandum to the Act, the legislator states that the legal requirements for performing a supply chain due diligence are not rigid and that no company can be required to do what would be legally and factually impossible. Apparently, the legislator deems due diligence procedures to be primarily individual in nature, and that industry initiatives are taken into account only to a very limited extent. Despite demands made during the legislative process, the LkSG also contains no explicit exculpation or safe harbor regulations.

To the extent that the legislator has not specified the details, best practices will develop for designing the now required supply chain due diligence. The LkSG also provides for BAFA to issue official guidance, cross-sector or industry-specific information, assistance and recommendations on compliance with the Act.

In March of this year, the EU Parliament presented a draft Directive on Mandatory Human Rights, Environmental and Good Governance Due Diligence ("**MHRDD**") that shall require companies to get to know their supply chains in detail. This step by the EU Parliament puts pressure on the European Commission to move forward and propose a formal Proposal, which once adopted by the EU Parliament and the Council (representing the 27 Member States) will ensure that EU rules on MHRDD will be in place. However, it is not expected to be adopted in the short term. From the perspective of the German legislator, the LkSG could be a blueprint for a uniform European regulation.

¹ As amended by the Bundestag Committee on Labor and Social Affairs (BT-Drucksache **19/30505**).

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