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Germany's New Supply Chain Due Diligence Act

After long and controversial discussions, on 11 June 2021, the German parliament passed the **Federal Act on Corporate Due Diligence in Supply Chains** to prevent human rights violations in Supply Chains ("*Gesetz über die unternehmerischen Sorgfaltspflichten zur Vermeidung von Menschenrechtsverletzungen in Lieferketten - Lieferkettensorgfaltspflichtengesetz"* - **LkSG**), in short the German Supply Chain Act. The LkSG obliges companies in Germany above a certain employee threshold to review their supply chain for human rights and environmental risks and to contribute to preventing, ending or minimizing such risks. Companies do not have to guarantee the compliance with human rights and environmental obligations in their supply chains. However, they must be able to demonstrate that they adequately comply with the due diligence obligations described in more detail in §§ 4 to 10 of the LkSG.

Practical impact:

Under the LkSG, companies are obliged to establish an effective **risk management with regard to** human rights and environmental risks, to conduct risk analysis on an ongoing basis, and to develop and implement appropriate and effective preventive measures with regard to the identified risks. These measures include, amongst others, the development of suitable **procurement strategies** and **purchasing practices**, the regular **implementation of training and** corresponding **audit measures**. The effectiveness of these measures has to be **reviewed once a year** and on an **ad hoc basis.**

The LkSG thus presents many companies with the challenge of having to review their existing internal compliance processes with regard to the new set of rules introduced by the LkSG and of adapting them accordingly. The same applies to the changes that must be implemented in **contracts with direct suppliers, purchasing conditions and supplier codes of conduct**. Whereas existing compliance processes were previously designed to address and identify product- and country-specific risks, the LkSG now requires that criteria be derived according to which, for the first time, specific contractual partners can be reviewed for risks.

In addition, companies must designate persons responsible for overviewing the company's compliance with the LkSG, if necessary by reinforcing the staff or by means of

external consultants, need to continuously adapt the risk management and ensure compliance with the due diligence and documentation obligations under the LkSG. Although document management systems and AI-supported tools can support these tasks, they are no substitute for the necessary pre-analysis of the requirements of the LkSG and the ongoing review to derive the criteria that need to be “fed” into the corresponding tools.

At the same time, companies must be prepared for possible changes to the LkSG if a corresponding European directive is adopted. A draft directive is expected to be published by the European Commission in fall 2021 and the draft submitted by the European Parliament already displays a tighter set of rules than the German LkSG, which the German government will have to take into account. These are in particular the much broader scope of the directive with regard to the companies covered, the broader definition of the value chain and the business relationships of the companies to be reviewed, and the fact that the European draft directive does not exclude civil liability in the same manner as the LkSG.

Core stipulations of the LkSG

I. Scope of application

The LkSG comes into force on January 1, 2023 and covers all companies, regardless of their legal form which have their registered office, principal place of business, administrative headquarters or registered office in Germany and regularly employ at least 3,000 employees in Germany; employees which are delegated abroad are included. In addition, the LkSG applies to companies that have a branch office in Germany pursuant to section 13 d of the German Commercial Code (HGB) and regularly employ at least 3,000 employees in this branch office. Temporary employees are to be taken into account if the period of employment exceeds a term of six months.

As of January 1, 2024, the above thresholds will be reduced to 1,000 employees in each case.

In affiliated companies (within the meaning of sections 15 et seq. of the German Stock Corporation Act (AktG)), the number of employees at the parent company shall be calculated on the basis of the number of employees employed in Germany by all companies belonging to the group.

II. Definition of the supply chain

According to the LkSG, the supply chain includes all products and services of a company and all production steps in Germany and abroad that are necessary to manufacture the products and provide the services. This extends to:

- the actions of a company in its own business division (*eigener Geschäftsbereich*),
- the actions of a direct supplier, and
- the actions of an indirect supplier.

Own business division: The own business division includes every action of the company to achieve the company's objective. This extends to all activities relating to the production and exploitation of products and the provision of services, regardless of whether they are carried out at a location in Germany or abroad. In affiliated companies, the parent company's own business division includes all the companies belonging to the group if the parent company exercises a **determining influence on these** (“*bestimmender Einfluss*”).

Note: The term "**decisive influence**", which is also used in the areas of antitrust and environmental law, is to be understood broadly. According to the LkSG, this requires an overall consideration of the economic, personnel, organizational and legal connections between the parent company and the affiliate. According to the explanatory memorandum to the LkSG, the decisive influence can also lie in the fact that the business areas of the affiliate and the parent company correspond to each other, for example because the affiliate produces and sells the same products or provides the same services as the parent company.

Direct supplier: A direct supplier is any contractual partner whose deliveries are necessary for the manufacture of the product or the provision of the service.

Indirect suppliers: Indirect suppliers are all contacts along the company's supply chain with whom there is no direct contractual relationship but whose supplies are necessary for the manufacture of the company's products or for the provision and use of its services.

Note: The companies' due diligence obligations described in more detail below (risk analysis/preventive/ remedial measures) only extend to their indirect suppliers if the companies have "substantiated knowledge" of specific indications that a violation or breach of a human rights or environmental obligation at indirect suppliers is possible. According to the explanatory memorandum to the LkSG, substantiated knowledge requires that the company has verifiable and concrete information about a possible human rights' or environmental violation at indirect suppliers (e.g. through reports about human rights' violations in the region or in the sector concerned). Details of the obligations towards indirect suppliers may be regulated by ordinance according to the LkSG, even though constitutional concerns have already been raised against this form of competence.

Note: The sale and distribution chain ("downstream" part of the process), i.e. the sales channel to the end customer via the distributors, is not covered by the supply chain as it is defined by the LkSG. There are in fact statements in the explanatory memorandum to the LkSG on distributors ("*Distributoren*") that suggest the inclusion of the sales chain. However, this conclusion is not supported by the wording of the law. This is one major difference to the corresponding European draft: according to its explicit wording, it includes the entire value chain, i.e. both the upstream and downstream part of the process. It is therefore to be expected that the German legislator will have to take this into account and adapt the LkSG accordingly.

III. Due diligence obligations („*Sorgfaltspflichten*")

The essential due diligence obligations that companies must observe as part of their compliance include the establishment of a risk management system, the core of which is to conduct regular risk analyses, to implement preventive measures as well as to take remedial actions, to establish a grievance mechanism and, lastly, to fulfil the documentation and reporting obligations. According to the LkSG, the respective company has to observe the due diligence obligations "*in an appropriate manner*". The appropriateness is hereby not determined by the objective standard of required care and due diligence in business transactions ("*im Verkehr erforderliche Sorgfalt*"), but individually for each company depending on the type and scope of its business activity, possibilities of influence, expected severity of the violation as well as the degree of the company's contribution to the violation. The performance of an individual risk analysis in accordance with the LkSG is therefore necessary prerequisite for a company to measure and identify the extent of the due diligence requirements it must comply with (in particular with regard to what preventive measures and, if necessary, what remedial actions must be taken).

Establishment of a risk management system: Under the LkSG, companies are required to establish an adequate and effective risk management system to comply with their due diligence obligations.

Ongoing risk analysis: Part of this risk management system is the "risk analysis", by means of which companies must continuously review their supply chain for human rights' and environmental risks. The risks identified in the risk analysis must then be weighted and prioritized appropriately. The prioritization of the risks is the basis for the companies' subsequent obligations to act and consequently specifies the order in which the violations are to be remediated, should the companies be unable to address all risks at the same time. For the order of priority, the potential severity of the violation and the company's contribution are significant factors.

The risk analysis must be carried out **once a year and on an ad hoc basis** if the company "*has to expect a significantly changed or significantly expanded risk situation in the supply chain*" (wenn das Unternehmen "*mit einer wesentlich veränderten oder wesentlich erweiterten Risikolage in der Lieferkette rechnen muss*"). The results of the risk analysis must be passed on to the relevant decision-makers in the company. These are usually the management bodies; however, the LkSG and the explanatory memorandum also include the purchasing and compliance departments.

Preventive measures: If risks have been identified, the company must respond with appropriate preventive measures ("*Präventivmaßnahmen*"). Preventive measures include in particular the implementation of the human rights' strategy which has been set out in the declaration of principles ("*Grundsatzerklärung*") to be submitted by the companies, in their relevant business processes of their own business division. Since the company's own business division includes by definition of the law also group companies over which the parent company can exercise *decisive influence*, this obligation of the parent company also extends to implementing its human rights' strategy within the relevant affiliates. Companies are furthermore obliged to **conduct training measures** in the relevant business processes. With regard to direct suppliers, examples of preventive measures listed by the LkSG are to contractually oblige the suppliers to comply with the company's human rights' and environmental expectations set by the company, as well as verifying the compliance with this obligation by conducting regular audits.

Note: Existing Codes of Conduct for suppliers and contractual regulations should be reviewed as to whether they comply with the requirements of the LkSG; furthermore, if and insofar it is necessary, corresponding compliance and audit clauses in contracts and or general terms and conditions should be revised or supplemented.

Remedial action: If violations of human rights or environmental obligations are identified (whether in the context of the risk analysis or by other means), the company must immediately take appropriate remedial action to end or at least minimize the violation. To determine what measure is to be deemed "*appropriate*" in a particular case one needs to take into account the individual company and risk situation. The more influence the company can exert, the more likely and severe the expected violation of the protected legal position is, and the greater the probable contribution to its cause, the greater are the efforts the company must make to minimize or end the violation. At the same time, a reasonable remedial action under the LkSG may also consist of making efforts to *increase* one's own ability to exert influence. In connection with the direct supplier, the LkSG explicitly mentions alliances with other companies within the framework of industry initiatives.

"Best endeavours" or specific result?

Within its own business division ("*eigener Geschäftsbereich*"), the remedial action must always end the violation as a whole (in case of companies abroad and in case of affiliated

companies only as a rule). In consequence, a parent company must also ensure that violations by the affiliated companies over which it can exercise a determining influence, are remedied through implemented appropriate measures.

Note: Under the LkSG, companies do not have to warrant that human rights' or environmental obligations' violations do not occur in their supply chains. However, they must be able to prove that they have implemented all due diligence obligations which, according to the LkSG, are feasible and appropriate considering their individual situation ("best endeavours"). At the same time, in case of violations in some divisions, the LkSG clearly requires companies to achieve a specific result, such as ending the violation or – in certain cases towards the direct supplier – terminating the business relationship. In these constellations, companies need to show a specific result and may only fail to do so if the result is impossible to achieve or if the effort by which the result could be achieved is disproportionately high. Depending on the violation, the efforts on the due diligence obligations therefore vary.

Human rights officer: Companies must designate internal responsibilities at the company's relevant interfaces (compliance department, purchasing, board of directors) to monitor compliance with the due diligence obligations under the LkSG. The appointment of a specific "human rights officer" who reports directly to the management and who is responsible for monitoring the risk management is not required by law, but is suggested and will in most cases be strongly recommendable. The management furthermore has the duty to be regularly briefed about the work of the responsible persons on an ad hoc basis, at least once a year.

Establishment of a grievance mechanism: Companies must establish an internal grievance mechanism that allows persons (including external ones, also NGOs and other) to report violations and risks to the company. Companies may as alternative also choose to participate in corresponding external grievance mechanisms. The company must via this mechanism also be able to receive information about violations and risks that have arisen through the economic activities of an **indirect supplier**. The grievance mechanism must be entrusted to persons who offer a guarantee of impartiality, who are independent and not bound by instructions. If the grievance mechanism reveals risks, the company is obliged to review its risk management accordingly and take appropriate preventive measures or remedial action. Companies are well advised to prepare themselves for the fact that they will potentially receive many such information, for example via NGOs, to which they must respond in accordance with sections 3 ff. of the LkSG.

Documentation and reporting obligations: Companies must prepare an annual report on the fulfillment of their due diligence obligations in the respective previous business year and submit it to the competent authority (the German Federal Office of Economics and Export Control - BAFA) no later than four months after the end of the business year and make it publicly accessible on the company's website free of charge for a period of seven years. The report must contain certain minimum information, in particular on the risks and violations identified and the measures taken to remedy them. The minimum information is not required if the company has not identified any risks and has plausibly explained this in its report.

Official control: The authority is entitled to summon persons and demand the handover of documents that the authority requires to fulfill its duties under the LkSG. This obligation expressly extends to information on affiliated companies, direct and indirect suppliers and the handing over of documents of these companies, insofar as the company or person obliged to provide information or hand over documents has the information at its disposal or is in a position to obtain the requested information on the basis of existing contractual relationships. Furthermore, the authority is entitled to enter the business premises.

The authority shall report once a year on the inspection and enforcement activities carried out in the previous calendar year and publish these reports on its website. The reports should list the violations found and remedial actions ordered, but not the companies involved in each case.

IV. Liability and fines

Civil liability:

The LkSG does not stipulate an own civil liability. This was explicitly clarified in the law.

Note: This does however not mean that companies and responsible persons respectively cannot be made liable at allfor violations of the LkSG. On the contrary, the LkSG made clear that any liability regulations that exist independently of the LkSG remain in force. These include, primarily, tort law (section 823 (1) of the German Civil Code (BGB)), but also internal liability regulations of the management vis-à-vis the obligated companies (section 93 of the German Stock Corporation Act (AktG), section 43 of the German Limited Liability Companies Act (GmbHG)). If the management of a company therefore culpably fails to observe the provisions of the LkSG and causes damage to the company as a result, it is generally liable to pay damages to the company.
The **liability risk** for companies is considerable, despite the last-minute inclusion of an exclusion of liability in the legislative process, because German courts regularly have jurisdiction for actions for damages and foreign law will generally apply to civil liability claims. According to Art. 4 (1) Rome II Regulation, the law of the state in which the damage occurred (place of occurence) applies; in the case of damages resulting from the violation of human rights or environmental obligations, this will rarely be Germany.

Fines and sanctions: Companies face comprehensive sanctions in the event of violations of due diligence obligations:

- **Exclusion from the award of** public contracts for up to 3 years.
- **Fines** for intentional or negligent infringement in the amount of up to:
    - EUR 800,000.00 towards natural persons or EUR 8 million towards legal persons and associations of persons in the event of failure to take preventive or remedial measures or to implement a remedial concept (vis-à-vis suppliers) or failure to establish a complaints procedure in due time;
    - EUR 500,000.00 towards natural persons or EUR 5 million towards legal persons and associations of persons in the event of failure to designate a competent body to monitor risk management, late risk analysis or updating of measures as a result of the effectiveness review to be carried out by the companies;
    - EUR 100,000.00 towards natural persons, legal entities and associations of persons in all other cases, including breaches of reporting and documentation obligations.
    - In the event of remedial measures not taken or not taken in time, in deviation from the above provisions, the fine for a legal person or association of persons with an average annual turnover of EUR 400 million may even amount to up to two percent of the average annual turnover. For this purpose, the worldwide turnover of all natural persons and legal entities as well as all associations of persons of the last three business years preceding the decision of the authorities shall be taken as a basis, insofar as these persons and associations of persons operate as an economic unit. The authority may estimate the average annual turnover.

Note: The comprehensive fine provisions continue the developments already evident in other areas of law regarding turnover-related fine limits. In view of the fact that the company's own business division has been extended to the companies belonging to the group, certain measures must also be implemented in the business processes of the affiliates. How the parent company is to ensure this (especially in the de facto group (*faktischer Konzern*) where the parent company has no authority to issue instructions) and to what extent the parent company can be held (jointly) liable or can be fined alongside the affiliate in the event of non-fulfilment of its obligations is left unanswered by the law and the explanatory memorandum to the law. Until reliable case law is available, the parent company, as a precaution, will have to make all reasonable efforts to implement the measures in the companies over which it exerts influence.

Due to the comprehensive new set of rules under the LkSG and the considerable risk of sanctions, companies should familiarize themselves with the new obligations at an early stage in order to initiate the necessary changes.

We will be happy to support you with any questions and with the implementation of the new regulations.

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