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## COMPLIANCE & INVESTIGATIONS

### INTRODUCTION OF A DIGITAL SUPPLY CHAIN REGISTER: NEW COMPLIANCE OBLIGATIONS FOR COMPANIES WITH REGARD TO HUMAN RIGHTS VIOLATIONS IN GLOBAL VALUE CHAINS?

In 2011, the UN Guiding Principles on Business and Human Rights were adopted. Since then, countries such as France, the Netherlands and the United Kingdom have enshrined in law their own compliance standards for companies with international supply chains. Since the beginning of the current legislative period in Germany, various approaches to an effective enforcement of human rights in international supply chains have been under discussion. The focus of the draft bill that was discussed in the middle of last year was linked to the introduction of material compliance requirements for domestic companies. Currently, the draft of a "Supply Chain Register Act" (*Lieferkettenregistergesetz*, "LKG") is being discussed which has as its subject the certification of importing companies that receive goods from outside the EU. In the future, the compliance and legal departments of German companies will have to prepare to reflect compliance standards in the organisation of their supply chain structure. Such a certification will also most likely become increasingly significant for supply relationships and public tenders.

#### Background

Germany is still considered to be the "export champion" of the world, even if has meanwhile lost this title to China. It also profits from international supply chains and the import of finished goods, raw materials, components and subproducts from all over the world. The more the public becomes aware of this fact, the more evident it also becomes that no uniform human rights standards are being complied with by all of the international companies involved in the value chain.

Many companies are already making a serious commitment to Corporate Social Responsibility ("CSR"): A large number of certificates and quality seals exist today. Such certificates are issued for compliance with self-imposed minimum standards that have been set within the industry and are intended to make the CSR commitment visible. Many companies undertake in code(s) of conduct independently of certificates to maintain minimum ethical standards in their dealings with employees, customers and suppliers. In some cases, international companies pass their own CSR standards on to their contracting partners by agreeing on respective CSR clauses.

#### Objective of a supply chain register

However, all of this must not obscure the fact that the various certificates do not define uniform CSR standards, nor are they widely disseminated or verifiable. Therefore, it is not always possible for either entrepreneurs or consumers to ascertain whether a potential contracting partner, according to these standards, is meeting its human rights responsibility along the entire supply chain in a "trustworthy" and reliable manner.

This is where the LKG comes in. The introduction of an accessible digital supply chain register is meant to enable companies to publicly document their implemented standards. This also means on the other hand that companies, for their part, are to be taken more strongly to task by the market with regard to their safeguarding of human rights. Ultimately, the intention of the LKG is not to have the persons involved lose their work or their orders ("**cut and run**"); rather, German undertakings are supposed to exert their influence to drive forward changes in foreign workplaces ("**stay and change**"). The commitment to human rights standards, as well as the commitment to environmental standards, should become an element of competition.

At the same time, the LKG is to be a first step in the direction of harmonising international human rights standards. The grievances which are taken into consideration are many and varied, for example compulsory and child labour, discrimination, violations of the freedom of association, violations of occupational safety requirements, problematic hiring and working conditions, violations of land rights, damage to health, to shelter, or to assets needed for subsistence, and corruption. The long list of targeted grievances shows that the German Federal Government has set itself an ambitious goal.

Its efforts must be seen in the context of the broader discussion about CSR in the supply chain. The coalition agreement had provided for a supply chain act which was meant to achieve this objective. However, as yet no political agreement has been reached on this. The issue is also being discussed intensively on the European level. On 27 January 2021, the Committee on Legal Affairs of the European Parliament resolved an own-initiative report on the regulation of the supply chain of companies active in the EU. In the future, they are supposed to examine their entire supply chain to ascertain whether any violations of human rights, governance or protection of the environment are being committed in the course of the production. This should also apply for small and medium-sized undertakings if they are listed or active in high-risk sectors. The report will be passed on to the Commission once the Parliament has voted on it. It is therefore to be expected that the European legislature will be dealing with this issue very soon.

### What is the content of the LKG?

The key provision of the new statute pertains to the establishment of a register and a certification system for foreign workplaces. A certificate would indicate that recognised human rights standards are being complied with in the workplace. In this regard, the German Federal Ministry for Economic Cooperation and Development (*Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung*, "BMZ") is to task a committee with determining the specifics for recognition of certificates which already exist, as well as for the development of new certificates. Additionally, this committee should decide on the certification of individual companies and the accreditation of the certifying body. Where or not a certification should be awarded to a given company should be governed by the applicable law of the state in which that company is domiciled. Furthermore, international agreements which have been ratified by the country – such as the social and labour standards of the ILO and the UN Human Rights Agreement – will apply.

The register would record one of three certification statuses:

- › positive status (products can be received without any problem),
- › open status (for a maximum two-year period if it is determined that a proper certification is not yet possible; receiving the respective products does not violate the LGK), and
- › negative status (if companies fail to obtain certification despite the possibility of doing so or do not meet the necessary standards; receiving the respective products will then be in violation of the LKG).

The entry of a certificate into the digital register would generate a standardised token containing various items of information regarding the certified company (such as the certifying body, the period of validity of the certificate, content and scope of the certificate, location of the undertaking in the supply chain and the status of the most important upstream suppliers). The ordering party should be able to access this information.

So that certificates can be taken into account in making an entrepreneurial decision, it should be easy to ascertain the status of the certificates of foreign undertakings from the register. This corresponds to the obligation of German undertakings to check the certification status of the participating undertakings along the supply chain before placing an order ("**requirement to check**"). The certification status thus ascertained will be digitally reported, evaluated and documented in a status report. After a certain transition period, companies are to be obliged to place orders only if a supplier is certified or its status is at least open, but not negative.

Along with this core duty, undertakings are additionally obliged to implement a process that would make it possible to determine and assess human rights risks, take measures for reducing the risks and verify their effectiveness. This involves the following obligations, among others:

- › The obligation to establish a complaint system, whereby substantiated suspected violations are to be notified to the body managing the register.
- › The obligation to publish a status report showing the measures by which the company is striving to achieve improvements of the shortcomings in human rights along the supply chain.
- › The obligation to include other regions and sectors which are not yet covered by the certification system, for example by making donations to aid agencies or sector initiatives.

- ’ The obligation to train and further educate employees about the supply chain register and human rights risks along the supply chain.

### Who are subject to the obligations under the LKG?

According to the key points in the draft, the envisaged statute will only oblige companies which generate at least a EUR 20 million net turnover in Germany and have purchased goods or intermediate products with an import volume of more than EUR 10 million net from non-EU countries in at least two of the last three years. This obligation is also to apply for companies which “indirectly” purchase goods or intermediate products from intermediaries within the EU which originate from non-EU countries.

At the same time, the register would initially apply only to certain sectors (such as the textile sector) and regions and be expanded successively by way of legal ordinances.

### What will be the consequences of non-compliance with the LKG?

Compliance with the requirements set out under the LKG can be checked by way of audits at the end of the financial year. Even an auditor’s report that is not unqualified can constitute a sanction (in terms of reputational damage). In addition, the law will enable **finances** to be imposed on companies should they intentionally and repeatedly breach their corporate duties. Furthermore, companies may already be **excluded from the award of public contracts** in the event of serious misconduct on their part that casts doubt on their integrity. Unlike predecessor drafts discussed hitherto, however, the draft currently under discussion sees no necessity for an independent compensation regime. This issue was and remains the subject of particularly controversial discussion and it is not certain whether the current draft version will be the only one.

It will therefore be essential for the companies concerned to check their existing supply relationships to see whether they comply with the standards in the regulations yet to be introduced. Should this not be the case, the contractual and supply relationships would then need to be adapted. This may raise difficult questions under contractual law, for example where long-term supply contracts are non-compliant, negotiations on the adaptation of contracts fail and the contracts do not provide for corresponding termination options.

### What will happen after the LKG?

Given the considerable differences of opinion among politicians, it is not certain whether the LKG will in fact be resolved in the current version of the draft or whether this will in fact be the last word on the subject of “compliance in supply chains”. Frequently, doubts are even raised as to whether politicians will at all succeed in bringing the legislative procedure to an end during this legislative period. In parallel to the legislative procedure at national level, the European Parliament has drawn up a resolution relating to sustainable corporate governance. While resolutions are not legally binding, they are, an important tool for reaching a political consensus before taking legislative decisions. Ultimately, there is agreement between the EU Member States that EU legal frameworks must be created for corporate duties of care along supply chains. A respective draft directive is planned for the spring of 2021. This has prompted some German members of the German Federal and European Parliaments to approach Mr Reynders, the EU Commissioner for Justice, with the idea of a supply chain register so that it could also be included in the European legislative procedure.

The German legislator agrees that a national supply chain register can only be a first step and, consequently, it follows that the rules of the LKG should cease to be effective as soon as and to the extent that relevant European regulations have been issued.

### Conclusion

Regardless of how the forthcoming law on supply chain registers will be configured in detail and what developments are still likely in this area at the level of the European Union, CSR will continue to take on an (even) more important role for compliance officers and in-house legal departments. What was hitherto a purely voluntary decision, will now become a legal obligation of gradually increasing “severity” for companies. The risk of mere reputational damage will evolve into the substantial risk of a fine. There will also be the aforementioned (formal) legal obligations, for example to publish a status report. Companies of relevant industries should now start to prepare accordingly. **Such certifications will in future most likely play a role similar to that of certified environmental standards and environmental management systems that are becoming increasingly significant for supply relationships with internationally operating corporate groups as well as regarding public tenders.**

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## EXPERTS

**Dr. Marc Ruttloff**

**Dr. Eric Wagner**

**Dr. Simon Wagner**

**Matthias Hahn**