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The German Supply Chain Due Diligence Act – outline and applicability

An overview of the Supply Chain Due Diligence Act (Lieferkettensorgfaltspflichtengesetz, LkSG) which the German Federal Parliament passed on 11 June 2021.

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On 11 June 2021, the German Federal Parliament (***Bundestag***) passed the so-called Supply Chain Due Diligence Act (***Lieferkettensorgfaltspflichtengesetz, LkSG***) by the votes of the parties CDU/CSU, SPD and Bündnis 90/Grüne. The Act requires businesses to undergo significant efforts in order to achieve compliance. In this article, we will provide a first outline of the material contents of the Act and already provide an in-depth analysis on the applicability of the Act to various corporate structures. This article is the first of a series of articles in which we will take a closer look at further key issues, especially addressing the question as to what you can do in order to adequately prepare yourself at this early stage. We would be happy to provide you with individual advice, as well. Please do not hesitate to contact us.

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I. Overview

What goals does the Act pursue?

Its goal is to bind undertakings with footage in Germany to comply with due diligence obligations in order to improve or to ensure compliance with human rights and material standards of environmental protection in supply chains. In terms of content of the protected human rights and environmental legal positions, the Act refers to an enumerative list of international treaties, e.g. concerning child labor, modern slavery or deprivation of land serving as livelihood.

The Act uses the German term "Unternehmen" as the relevant subject for the applicability of the Act. The term may best be translated as undertaking and can either refer to a legal entity or an economically active business unit in which all group companies form an undertaking.

When will the Act enter into force?

The Act will enter into force on 1 January 2023.

Who will be affected?

The Act will bind undertakings, regardless of their legal form (including foreign),

> which have their head office, main establishment, administrative headquarters or statutory seat or a branch office in Germany ***and***
>
> which, from 1 January 2024 onward, regularly employ more than 1,000 employees in Germany (until 31 December 2023, the Act will already apply to undertakings employing more than 3,000 employees).

Temporary workers must be taken into account if they have been assigned to the undertaking for more than six months. Employees dispatched to another country will be included. Among affiliated companies (within the meaning of section 15 of the German Stock Corporation Act (***Aktiengesetz, AktG***)), employees employed in Germany will be allocated or attributed to the parent company (***Obergesellschaft***).

What are the due diligence obligations?

Undertakings must make an effort to prevent human rights and environmental legal positions from being violated by fulfilling due diligence obligations (duty of effort, no duty to succeed). They must carry out the due diligence obligations in their own sphere of business as well as vis-à-vis their direct suppliers. An indirect supplier will be deemed a direct supplier if the direct supplier has been involved by an improper act of evasion. Only in the case of substantiated knowledge, i.e. actual indications that suggest a violation of an

obligation relating to human rights or the environment by an indirect supplier, will the undertaking be required to carry out certain due diligence obligations also with regard to such indirect supplier.

Not all due diligence obligations are immediately applicable; instead, besides general due diligence obligations that apply regardless of the specific situation (stage 1), there are such obligations that will not take effect until a certain risk (stage 2) or a(n imminent) violation (stage 3) of human rights or environmental legal positions is determined. Stage 2 and 3 due diligence obligations will not affect the undertaking in general, but only in relation to the relevant risk and/or violation.

Stage 1 due diligence obligations

- Establishing a risk management system
- Defining internal responsibilities (e.g. human rights officer)
- Carrying out regular risk assessments
- Putting an internal complaints procedure into place or participating in an external complaints procedure and monitoring the effectiveness of the procedure
- Documenting the fulfillment of the due diligence obligations
- Annual reporting on the fulfillment of the due diligence obligations

Stage 2 due diligence obligations

- Issuing a human rights policy statement
- Implementing appropriate preventative measures in one's own sphere of business and vis-à-vis direct suppliers; in the case of substantiated knowledge, also vis-à-vis indirect suppliers
- Monitoring the effectiveness of the preventative measures

Stage 3 due diligence obligations

- Implementing appropriate remedial measures in one's own sphere of business and vis-à-vis direct suppliers; in the case of substantiated knowledge, also vis-à-vis indirect suppliers
- Monitoring the effectiveness of the remedial measures

Monitoring by the authorities

Compliance with the due diligence obligations will be monitored by the Federal Office of Economics and Export Control (***Bundesamt für Wirtschaft und Ausfuhrkontrolle, BAFA***). The office will examine the reports to be issued by the undertakings on an annual basis and

monitor their compliance with the due diligence obligations ex officio or upon request. Undertakings will have a duty to furnish the office with information, and the office may define specific actions to be taken by the undertaking in order to fulfill its duties and enforce such actions by imposing fines (*Zwangsgeld*) in the amount of up to EUR 50,000.

What are the consequences of violating due diligence obligations?

The intentional or negligent violation of a due diligence obligation constitutes an offense and is punishable by a fine (*Bußgeld*). An intentional violation will result in a fine in the amount of up to EUR 800,000 against natural persons; and up to EUR 8 million against legal entities. However, in the case of legal entities or partnerships with an average global (consolidated) annual turnover of more than EUR 400 million, a fine can be levied in the amount of up to 2% of the average (consolidated) annual turnover. Fines resulting from negligent violations will amount to half of the maximum fine stated above (section 17(2) of the Administrative Offense Act (*Gesetz über Ordnungswidrigkeiten, OwiG*)).

Also, an undertaking may be excluded from public invitations to tender for up to three years if a violation has been confirmed to be punished by a fine in a certain amount in a final non-appealable judgment.

The Act further reads: "*A breach of the obligations under this Act will not give rise to civil liability. Any civil liability substantiated regardless of this Act will not be affected.*" According to the explanatory memorandum relating to the committee version of the Act that has been enacted, the due diligence obligations will "*instead be enforced and sanctioned in administrative proceedings and by means of the offense law. This must be clarified in particular with regard to section 823(2) of the German Civil Code (BGB).*". Thus, the legislator seems to have decided that the Supply Chain Due Diligence Act is not a protective law within the meaning of section 823(2) BGB and that a tortious liability of the undertaking resulting from corresponding violations of the due diligence obligations on this basis is out of the question. Even if, based on existing legal principles and considering the new rule on the capacity to sue in one's own name without being directly involved in the subject matter of the action (*Prozessstandschaft*) incorporated into the Act, this outcome seems questionable, it is still supported by the clear wording and the explanatory memorandum. However, it cannot be ruled out that a liability pursuant to section 823(1) BGB can be substantiated and that the courts will refer to the due diligence obligations in order to determine whether and to what extent companies are liable for damages.

Capacity to sue in one's own name without being directly involved in the subject matter of the action (*Prozessstandschaft*)

In order to facilitate the enforcement of the law, a person concerned can authorize a domestic trade union or nongovernmental organization to conduct a case provided that

he/she invokes being violated in any of the legal positions codified in the existing international treaties and, in addition, such legal position being of paramount importance. The Act merely achieves a facilitation of process. It is still the general rules that govern the question as to when a violation of such a legal position will substantiate a specific claim (for damages) and which procedural and substantive law will be applicable.

II. Particular questions as to the scope of application

The term of "undertaking" and the rules of allocation or attribution with regard to employees raise questions as to the scope of the Act:

Is it the undertaking as a legal person or the economically active business unit in which e.g. all group companies can establish an undertaking that the applicability of the Act is connected to?

According to the explanatory memorandum, the "***addressee of the Act and the connecting factor for the employee threshold is the relevant natural or legal person or other partnership with legal capacity as the legal entity operating the business***". Thus, it is the individual company within a group of companies that is relevant.

Are employees employed in Germany included in the allocation if they are employed by a foreign group company?

This is suggested by the wording, as it is not limited to German companies, but talks about "***all group companies' employees employed in Germany".***

Can a foreign parent company not having its seat or a branch office in Germany fall within the scope of the Act just because it is allocated the employees employed by its subsidiaries being the parent company?

There is no clear cut answer to this. Although, in this case, the first two requirements of the applicability are not met (seat or branch office in Germany), the explanatory memorandum talks about ensuring by way of the rule of allocation "***that parent companies fall under the Due Diligence Act, regardless of whether the employees are employed by the parent company or the subsidiary/subsidiaries***". This could indicate that foreign parent companies may also be bound by the Act. This remains unclear.

Can a German subsidiary be attributed (a) fellow group company's/companies' employees employed in Germany?

The statutory rule of allocation reads "*Among affiliated companies (section 15 of the Stock Corporation Act), all group companies' employees employed in Germany shall be taken into account in the calculation of the parent company's employee count (subsection 1 sentence 1 number 2) [...].*" The German federal government's draft version previously read "parent company of the group (*Konzernmutter*)" instead of "parent company (*Obergesellschaft*)". According to the explanatory memorandum relating to the committee version which was enacted, the replacement of the term "parent company of the group" by "parent company" is, and we quote, "*of a merely stylistic nature*". On the one hand, the wording could yield that employees may only be allocated starting from subsidiaries in the direction of a parent company within the meaning of an ultimate parent company of a group, but not sideways between affiliates or even downwards from a parent to the subsidiary. On the other hand, the purpose of the Act could yield that, *"[a]mong affiliated companies [...], all group companies' employees employed in Germany shall be taken into account"*, regardless of their hierarchical level within the group. This question remains open, too.

Will the due diligence obligations apply to a German subsidiary/company even if the management of the group has its head office abroad?

Besides the number of employees, the Act connects the due diligence obligations to the factor that the head office, main establishment or administrative headquarters are based in the Federal Republic of Germany. On this issue, the explanatory memorandum states that this is where "*decisions relevant to the risk management of the supply chains are made*". On this basis, one might argue that a centralized approach is taken and that the Act will not be applicable as long as the "head office" and/or the management of the group of companies are based abroad. This means that, in this approach, the "undertaking" would be relevant in the meaning of an economic unit regardless of the individual legally independent companies. However, as already discussed above, this could also be interpreted to the effect that the term undertaking applies to the individual companies: A German subsidiary has its head office in Germany and the Act can only apply to the German subsidiaries if it employs a number of employees exceeding the relevant thresholds (taking into account the rules of allocation, as well). The German subsidiary could be obligated to exercise its due diligence obligations also vis-à-vis its foreign parent company if such parent company is the direct supplier. At present, it is still open which interpretation will take effect.

Please note: This article was last updated on the date of publication and, therefore, does not include any developments that may have arisen after such date.

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