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Germany's New Supply Chain Act – Part 4 of 4 – FAQs

2 July 2021

On 11 June 2021, the German parliament approved the Federal Act on Corporate Due Diligence Obligations in Supply Chains ("*Gesetz über die unternehmerischen Sorgfaltspflichten zur Vermeidung von Menschenrechtsverletzungen in Lieferketten – Lieferkettensorgfaltspflichtengesetz – LkSG*") – **German Supply Chain Due Diligence Act**.

Part 4 of our series of briefings highlights a couple of practical relevant questions including (i) the method to calculate the number of employees of a company, (ii) the risk of receiving cease and desist letters in cases of non-compliance, (iii) supply chain related disclosure obligations in capital market transactions, (iv) the interlink between the specific reporting obligations under the new Act and the "usual" non-financial disclosure obligations under the German Commercial Code, (v) enforcement risks and (vi) the risk of fines and the risk that regulators siphon off financial benefits. Finally, we consider what steps should be taken next to ensure compliance with the new regulations entering into force on 1 January 2023.

Further questions on how to deal with the new rules will certainly arise in the next days, weeks and months. Our dedicated teams in Germany and around the world will be there to assist to comply with applicable supply chain regulations.

The German Supply Chain Due Diligence Act will apply to companies that generally employ at least 3,000 (as of 1 January 2024 also to smaller companies with at least 1,000) employees.

How is this threshold to be determined?

Soeren Seidel:

The term "generally employed employees" is an unspecified legal term used in numerous labour law provisions. Its interpretation is basically subject to case, although the official reasoning of the Act itself provides some guidance on the interpretation.

The regular number of employees is determined neither by the head count on a given date nor by the average number of employees in a given period. Instead, the number of employees that is characteristic of the company in general, meaning in the regular course of business, is decisive as opposed to the number of temporarily employed employees.

This requires both a view back into the past and a forecast of the future number of employees. The period considered both retrospectively and prospectively is to be measured sufficiently long so that short-term fluctuations in the workforce do not have any influence on the applicability or non-applicability of the Act, e.g. periods of exceptionally high or low workload (e.g. Christmas business, year-end work, closing sales, off-season) and the associated fluctuations in the number of employees are not to be taken into account.

Thus, the length of the reference period depends on the individual case, but should in principle be based on the business year.

When assessing the future development of the number of employees, the circumstances that characterise the development of the business in the individual case must be determined. This includes, in particular, concrete decisions on change by the employer, for example, whether a continuous reduction of the workforce to a certain level is planned for the future. It is required, that this decision has been taken by the competent body of the company and that nothing significant prevents the implementation of the decision. Therefore, the mere expectation of a change in workload is not sufficient.

If employees are not permanently but only temporarily employed, the question of regular employment depends on whether they are usually employed for most of the year. Pursuant to the Act, temporary agency workers with an assignment term of more than six months are explicitly to be taken into account when calculating the relevant number of employees. A workplace-related consideration is decisive, i.e. whether the company fills workplaces with temporary agency workers for a period of more than six months a year, irrespective of whether this involves the deployment of specific or changing temporary staff and whether the temporary agency workers are assigned to the same or different workplaces. In this case, the workplaces concerned must be included in the determination of the threshold. Employees posted to work abroad are also to be included in the threshold.

Within affiliated companies (section 15 of the German Stock Corporation Act), the employees of all group companies are to be taken into account when calculating the number of employees of the parent company.

Will non-compliance with the German Supply Chain Due Diligence Act trigger the risk of receiving cease and desist letters

and being taken to court by competitors or consumer and industry associations, including interlocutory injunctions?

Dr Jens Matthes:

Germany is well-known for its very effective and quite claimant-friendly system of interlocutory in-junctive relief. Based on unfair competition, competitors as well as consumer and industry associations can take every market participant to court who is not in compliance with obligations under statutory law – if such obligations aim at steering behaviour in the market.

There is no clear definition as regards which legal obligations (outside the core law against unfair competition) qualify as aiming into this direction. German courts have handed down numerous decisions that however do not provide general guidance, either. Unsurprisingly, it is therefore quite uncertain whether a German court will hold that obligations stipulated in the German Supply Chain Due Diligence Act will be held to aim at steering behaviour in the market.

German courts require that the relevant legal obligation has the purpose, among others, of guiding the behaviour in the market in the interest of all market participants. Market behaviour in this sense means any activity in a market that objectively aims at fostering sales or procurement and by which a market participant influences competitors, consumers or other market participants.

Most obligations set out in the Act relate to internal processes and decision-making within a company and not to an activity “in the market” that would influence other market participants. However, the reporting and publication obligation in section 10(4) of the Act describes an activity that is visible to other market participants. There is a good argument, however, that this obligation is not in the interest of other market participants. The Federal Court of Justice (BGH) held, slightly simplified, that this is the case only where a legal obligation aims at protecting the other market participants’ freedom of decision-making and their legal rights or legitimate interests. This is not the case where such protection is a mere reflex of prevailing other purposes of the legal obligation at issue. The reporting and publication obligation in section 10(4) of the Act mainly is for the purpose of publishing a report for the supervisory authority to check.

On the other hand, consumers and also B2B customers and suppliers might well take a look at such a report, or take note if a certain company does not comply with its obligation to publish such a report, and consider whether or not to do business with or to buy products from such a company.

Inevitably the German courts will have to decide whether the nuanced definition of an obligation that steers at behaviour in the market applies to the reporting and publication obligation laid down in the Act.

What are the implications of the new Supply Chain Act on capital markets transactions?

Dr Knut Sauer:

The obligations and risks for German IPO candidates or listed companies seeking to raise additional equity or debt capital resulting from the new Supply Chain Act will need to be taken into account and appropriately disclosed to investors in prospectuses or offering memoranda prepared for such offerings. We expect that compliance with the new rules will become an integral part of the due diligence process for any such capital markets transactions.

Will reporting obligations under the German Supply Chain Due Diligence Act and non-financial disclosure obligations under German Commercial Code (*"Handelsgesetzbuch, HGB"*) apply simultaneously?

Dr Michael Weiss:

The disclosure regimes pursuant to the German Supply Chain Due Diligence Act and pursuant to sec. 289b, 289c HGB for large capital market oriented companies will apply in parallel and thus will require the respective companies to draw up two distinct reports.

Under the German Supply Chain Due Diligence Act, in-scope companies are obligated to publish a yearly report setting out their compliance with the due diligence obligations, referring to at least (i) any identification of human rights related or environmental risks, (ii) any measures undertaken for the fulfillment of their due diligence obligations under the German Supply Chain Due Diligence Act, (iii) the evaluation of effectiveness and impact of such measures and (iv) conclusions derived for future measures.

Yet, under sec. 289b, 289c HGB, large capital market oriented companies are already required to non-financial reporting on a yearly basis, including, any environmental issues and their compliance with human rights, in particular the description of the companies' concepts pursued in this regards and any material risks for human rights or environmental issues arising from their business activities or business relationships, products or services, hence including the companies' supply chains.

However, while the content of both disclosure obligations overlap with regard to human rights and environmental issues, the German Supply Chain Due Diligence Act overall applies broader reporting obligations due to extensive references to treaties under international law and the lack of a materiality threshold. German legislators have also not given any indication for an exemption from disclosure obligations for companies subject to both reporting obligations.

What are the main enforcement risks for companies and their employees?

Dr Tim Mueller:

Failures to comply with obligations stipulated in the German Supply Chain Due Diligence Act constitute administrative offences.

Administrative offences differ from criminal offences in that they can be sanctioned with fines but not with imprisonment. Under German law, administrative offences can only be committed by individual persons, not by legal entities. Therefore, administrative fines under the German Supply Chain Due Diligence Act may be imposed, in the first instance, against a company's management and other employees responsible for ensuring compliance with the relevant legal obligations. In addition, however, administrative fines may be imposed against corporate legal entities if their legal representatives or managerial employees have committed an administrative offence under the German Supply Chain Due Diligence Act. The authorities have a wide margin of discretion as to whether to prosecute administrative offences. This includes the discretion to sanction both the individual person and the legal entity, sanction only either of them or dispense with the prosecution altogether. When being confronted with regulatory enforcement proceedings, a sound defence strategy is key to mitigating the enforcement risks for both individuals and legal entities.

What fines can be imposed against companies and their employees in case of infringements?

Dr Tim Mueller:

As an example, the intentional or negligent failure to remediate discerned human rights violations in the supply chain constitutes an administrative offence.

This failure may be sanctioned with an administrative fine of up to EUR 800,000 in the case of an intentional infringement and up to EUR 400,000 in the case of a negligent infringement. As noted, these administrative fines may be imposed against the company's management and other employees responsible for ensuring compliance with the German Supply Chain Due Diligence Act.

At the same time, the statutory maximum of a corresponding administrative fine against the relevant corporate legal entity is increased tenfold, i.e. amounts to EUR 8 million for intentional infringements and EUR 4 million for negligent infringements. In addition, for companies with an average annual global turnover of more than EUR 400 million, the corporate administrative fine for such a violation may amount up to 2% of the annual global turnover (i.e. EUR 20 million for a company with an annual global turnover of EUR 1 billion).

These amounts can be exceeded if needed to siphon off financial benefits obtained from the commission of the alleged offences in excess of the statutory maximums.

The German Supply Chain Due Diligence Act requires prosecuting authorities to take into account a company's efforts to investigate past infringements as well as measures taken to ensure future compliance with the law when determining the amount of a fine. Having a compliance management system in place or improving it after the fact thus reduces the risk of further infringements but also helps to manage sanctioning risks.

What should be done to be well prepared for 1 January 2023?

Dr Udo Olgemoeller:

The German Supply Chain Due Diligence Act triggers the need to thoroughly review existing compliance management systems and to adopt them, if necessary, in view of the extensive new compliance requirements relating to the supply chain. This process should be kicked-off rather sooner than later.

Procurement departments and management will have to collaborate closely with technical supply chain advisors to identify and to assess relevant risks whilst legal counsel will may help to construe the complex legal environment stipulated by the German Supply Chain Due Diligence Act. Potential risks identified within this process will have an impact on sourcing, supply chains, future products and services – and on the overall Environmental Social Governance profile.

In parallel, political and legal developments should be monitored closely: After the German federal elections in September, the newly formed German government may amend the German Supply Chain Due Diligence Act and new supply chain regulations on the EU level may also have an impact on the German legal framework as well as on the legal framework in other EU Member States.

Our briefings on the German Supply Chain Due Diligence Act

This briefing is Part 4 of a series of briefings aiming at providing an overview of the key elements of the new German Supply Chain Due Diligence Act.

Our series consists of the following briefings:

Part 1: Introduction (updated 22 June 2021)[1]

Part 2: Compliance[2]

Part 3: Litigation[3]

Part 4: FAQs

Key points/15 seconds read/summary

The German Supply Chain Due Diligence Act will enter into force on 1 January 2023. Companies should carefully consider what needs to be done to ensure compliance from day 1 given that it is a complex challenge to identify the relevant risks and to take appropriate counter-measures needed to comply with the new set of rules.

1 Part 1 can be found **here**
2 Part 2 can be found **here**
3 Part 3 can be found **here**

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