

February 8, 2023

New German Law on ESG Due Diligence Obligations in Supply Chains

Introduction of New Due Diligence Obligations on ESG Matters That May Affect German Companies and International Organizations Based on Their Business Activities in Germany

SUMMARY

On January 1, 2023, the German Act on Corporate Due Diligence Obligations in Supply Chains (*Lieferkettensorgfaltspflichtengesetz* – the “Act”) came into effect. The Act requires certain German companies and foreign companies with business activities in Germany to implement, observe and disclose due diligence procedures to ensure compliance with fundamental human rights and certain environmental standards.

The Act extends to the business activities and supply chains of in-scope companies and their global subsidiaries. It has implications for German companies and international organizations, whether because they are within the scope of the Act or in their capacities as suppliers of companies that are in-scope.

The Act introduces general due diligence requirements that require in-scope companies to use their “reasonable efforts” to comply with. It also mandates specific due diligence processes that in-scope companies are required to implement, including the introduction of risk management systems and processes for dealing with identified violations.

In-scope companies that have not yet implemented the new law or that fall within its scope in the future are required to take, *inter alia*, the following steps without undue delay:

- conduct a risk assessment and issue a policy statement for any identified risks;
- establish or amend the existing risk management and compliance system to include monitoring of relevant violations;

SULLIVAN & CROMWELL LLP

- assign the internal responsibility for compliance, e.g., by appointing a human rights officer;
- implement a whistleblowing policy for violations under the Act;
- implement and document sufficient preventive measures, such as procurement policies, training of staff and contractual information rights towards direct suppliers; and
- prepare for annual compliance reports.

Non-compliance with the Act can carry a number of consequences for in-scope companies, including a maximum fine of up to two percent of annual turnover and/or exclusion from the award of public contracts within a period of up to three years.

BACKGROUND

The Act was passed and promulgated by the German legislature on July 16, 2021 and became effective on January 1, 2023. It is the first law in Germany of its kind and is primarily intended to enhance human rights and environmental protections in Germany.

The Act predates the implementation of the latest EU directives and initiatives regarding ESG and corporate sustainability, in particular the Corporate Sustainability Reporting Directive (“CSRD”), which entered into force on January 5, 2023, and the draft Corporate Sustainability Due Diligence Directive (“CSDD”), which is being considered by the EU’s institutions. With a view to the implementation of the CSRD and CSDD, the German legislature has committed itself to review the Act by June 30, 2026, or earlier if the European Union passes any regulation or directive concerning supply chain due diligence. For more information on the CSRD and CSDD, see S&C’s client memos [here](#) and [here](#).

SCOPE OF THE ACT

The Act applies to all companies – irrespective of their legal form and jurisdiction – that:

- have either their head office, principal place of business, administrative headquarters, registered office or a domestic branch in Germany; and
- employ in the regular course of their business at least 3,000 employees in Germany, although this threshold will be reduced to 1,000 employees from January 1, 2024.

The Act equally applies to privately held and stock exchange-listed companies.

For calculating the number of employees in Germany, the Act looks at the average figures, disregarding short-term fluctuations of the workforce. Leased personnel (*Leiharbeitnehmer*) will only be attributed to the lessee if such personnel is employed for more than six months. Employees seconded abroad (*ins Ausland entsandte Arbeitnehmer*) must always be included in the calculation.

Employees in Germany of any direct or indirect subsidiaries (the Act does not differentiate between German and foreign subsidiaries) are, as a rule, attributed to a parent company if such parent company has its head

office, principal place of business, administrative headquarters, registered office or a domestic branch in Germany.

The Act can therefore directly apply to international organizations in a number of different scenarios. For instance, any entity in the group structure that is registered abroad but has its head office, principal place of business, administrative headquarters or a domestic branch in Germany will be within the scope of the Act if it meets the threshold for employees in Germany. Moreover, the presence anywhere in the group structure of a German registered intermediate holding entity would trigger the Act in respect of that entity if it meets the threshold for employees in Germany.

In addition, the Act is likely to affect German or international organizations indirectly in their role as suppliers to companies that fall within the scope of the Act. As discussed below, in-scope companies will need to carry out due diligence on their direct and indirect suppliers and obtain contractual assurances from their direct suppliers in order to fulfill their obligations under the Act.

GENERAL DUE DILIGENCE REQUIREMENTS

In-scope companies must undertake “reasonable efforts” to prevent violations of human rights and certain environmental protection rights from occurring in their own business operations and across their supply chains.

1. Violations of Human Rights and Certain Environmental Protection Rights

With regard to the prevention of human rights violations, the Act defines relevant violations, such as child labor, slavery, work-related health hazards, unequal treatment in employment, withholding adequate living wage, inhibitions of the freedom of association and unlawful evictions. Furthermore, the Act refers to violations of specific human rights stipulated in international treaties, in particular conventions of the International Labor Organization.

With regard to environmental protection rights, the Act refers to the Minamata Convention on Mercury, Stockholm Convention on Persistent Organic Pollutants and the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal.

2. Own Business Operations and Supply Chain

Relevant own business operations of an in-scope company comprise in principle all of its business activities irrespective of whether they are carried out in Germany or abroad. As a rule, operations of direct or indirect subsidiaries globally will in most cases be attributed to in-scope parent companies. This means that if a parent company is within the scope of the Act, it must use its reasonable efforts to prevent violations from occurring within subsidiaries that may not themselves fall within the scope of the Act, i.e., including non-German subsidiaries or German subsidiaries not reaching the employee threshold.

The relevant supply chain comprises all suppliers that supply goods or provide services (including financial services) necessary for the business operations of a company. The chain starts at the extraction of raw materials and ends at the delivery to the customer. It comprises direct and indirect suppliers, i.e., suppliers with a direct contractual relationship with the company and any further suppliers across the supply chain. In principle, an in-scope company must – to some extent – also consider the supply chains of its direct or indirect subsidiaries globally.

3. Reasonable Efforts

The Act generally requires the use of “reasonable efforts” to prevent relevant violations. What exactly is required by this standard is determined on a case-by-case basis in accordance with, *inter alia*:

- the nature and extent of the company’s business activities;
- the company’s ability to influence the party responsible for any relevant violations;
- the probability of any violation occurring and the magnitude of any violation; and
- the company’s role in creating the relevant risk or causing the violation.

SPECIFIC DUE DILIGENCE PROCEDURES

The Act requires in-scope companies to implement the following specific due diligence procedures. In-scope companies needed to first implement such procedures prior to January 1, 2023 and are required to regularly review and update them (at least annually or on an ad-hoc basis in case of changes to the specific risk environment of the company).

1. Establishment of a Risk Management System

In line with common risk management and compliance systems mandatory for listed German stock corporations, a company in-scope of the Act has to implement an appropriate and effective risk management system to prevent or minimize the risk of relevant violations and has to regularly conduct a risk analysis. The company must identify and weigh its potential risks and prioritize them.

In-scope companies must also designate one or more persons to monitor its risk management (e.g., a human rights officer), who must report to the company’s senior management on a regular basis.

2. Implementation of Preventive Policies

If an in-scope company identifies a risk in the course of its risk analysis, it must take appropriate preventive measures provided for under the Act without undue delay. The company must implement adequate preventive measures in its own operations, including, *inter alia*, the implementation of procurement strategies, training of staff and risk monitoring. With regard to direct suppliers, the company must consider its human rights-related and environment-related expectations when selecting a direct supplier. It must further obtain contractual assurances from a direct supplier on compliance with the expectations, implement

SULLIVAN & CROMWELL LLP

initial and further training measures and agree on appropriate contractual control mechanisms for the verification of compliance.

The management of the company must issue and communicate to employees, direct suppliers and the public a policy statement on its human rights strategy (*Grundsatzklärung*). This must contain at least a description of the procedures it has implemented to comply with the Act, the primary risks it has identified and its expectations towards its employees and suppliers.

These preventative measures must be reviewed and updated regularly.

3. Identified Violations

If an in-scope company determines that a relevant violation has occurred or is imminent, it must take appropriate remedial actions without undue delay. The required actions depend on the location of the violation and the circumstances of the individual case. If the violation occurs or is imminent within:

- Its own operations in Germany, the company must terminate the violation; in this case, reasonable efforts are not sufficient;
- Its own operations outside Germany or at a subsidiary, the violation must in general be terminated but the company will not automatically be held responsible if the violation continues;
- A direct supplier and the violation cannot be terminated in the near term, the company is obligated to implement a strategy to end or minimize it, which may include actions such as (i) jointly developing a steps plan with the supplier, (ii) involving other companies to effect a change, or (iii) suspending the business relationship with the supplier;
 - Termination of a business relationship with a supplier is only required in aggravated circumstances if the violation is considered to be very severe, the measures implemented based on the joint strategy have not been successful and no more lenient means are available;
 - The mere fact that a state has not ratified or implemented one of the international treaties listed in the Act does not by itself result in an obligation to terminate a business relationship in this context;
- An indirect supplier and the company has substantiated knowledge of the violation, the company is obligated to implement a strategy to end or minimize it, which may in particular include providing support to the indirect supplier to implement preventive measures.

The effectiveness of remedial actions has to be reviewed on a regular basis.

4. Complaints Procedure

In-scope companies must implement and publish a complaints procedure guaranteeing impartial and confidential handling of notifications of relevant risks and violations in the area of human rights and the environment by employees and third parties. The procedure must ensure protection of any whistleblower.

5. Documentation and Annual Reporting

Compliance with the Act must be consistently documented by the in-scope company, with relevant documentation being kept for at least seven years. Furthermore, the company must prepare and publish

on its website an annual report within four months after the end of its business year on how it has fulfilled its due diligence obligations during the relevant financial year. Such reports must be available for a period of seven years. Reports must be submitted electronically and in the German language to the Federal Office for Economic Affairs and Export Control (*Bundesamt für Wirtschaft und Ausfuhrkontrolle*).

CONSEQUENCES OF NON-COMPLIANCE

The Federal Office for Economic Affairs and Export Control (*Bundesamt für Wirtschaft und Ausfuhrkontrolle*) is responsible for enforcing the Act and can, for example, conduct on-site inspections, summon individuals for inquiries or order a company to take specific actions, including remedial measures against a relevant violation.

Penalties for non-compliance include fines of up to EUR 8 million or, if the company's annual turnover exceeds EUR 400 million, up to two percent of the company's annual turnover. In addition, any proceeds from the conduct causing the administrative offence can be levied. Companies that violate the Act can also be excluded from the award of public contracts for a period of up to three years if fined an amount above a certain threshold, which depends on the severity of the violation.

To a certain extent, the Act can also be enforced in civil law proceedings. German trade unions and non-governmental organizations have been granted a special authority to sue for compliance on behalf of persons claiming to have suffered a violation in-scope of the Act. However, the Act itself does not give rise to any additional civil liability and does not expand the application of German law to alleged tortuous acts in foreign jurisdictions.

RELEVANCE TO M&A AND CAPITAL MARKETS TRANSACTIONS

The acquisition of another company will regularly result in a potential change of the buyer's risk environment and may therefore trigger an obligation to review and, if needed, update existing policies under the Act. A buyer will also factor in the Act into its ESG and compliance due diligence, which may include scrutiny of a target's suppliers. In capital markets transactions, compliance with the Act will need to be taken into account and appropriately disclosed in the prospectus or offering memorandum.

* * *

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.