

Due Diligence in Supply Chains Act and the operation in Brazil: New Challenges and Liability Risks for Companies

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After a long tug-of-war, the German legislator passed the draft of a law on corporate due diligence in supply chains ("Due Diligence in Supply Chains Act"; "Lieferkettensorgfaltspflichtengesetz" - LkSG) on 11 June 2021. The highly controversial draft law was adopted with a clear majority of the members of the German parliament.

According to the explanatory memorandum of the government draft, companies are to do more justice to their responsibility for internationally recognised human rights:

"Through this Act, companies having a business seat in the Federal Republic of Germany above a certain size will be obliged to better fulfill their responsibility in the supply chain with regard to respect for internationally recognised human rights by implementing the core elements of human rights due diligence. This is intended, on the one hand, to strengthen the rights of people affected by corporate activities in supply chains and, on the other hand, to take into account the legitimate interests of companies in legal certainty and fair competitive conditions."

1. Scope of Application

The Due Diligence in Supply Chains Act applies to all companies, regardless of their legal form. The prerequisite is that the company has its head office, main branch, administrative headquarters, or statutory seat in Germany. But according to a last-minute change to the Act it also covers foreign companies that have been established abroad and whose branch with more than 3,000 employees is in Germany.

As of 01 January 2023, the Due Diligence in Supply Chains Act applies to companies with a staff size of generally at least 3,000 persons, whereby temporary workers are

also included, provided they are employed for at least 6 months. As of 01 January 2024, the threshold is reduced to 1,000 employees. In the case of group companies (within the meaning of sections 15 et seq. German Stock Corporation Act (AktG)), all employees belonging to the group are taken into account, including employees seconded abroad.

2. Duties of Care Along the Supply Chain

The Due Diligence in Supply Chains Act defines the supply chain comprehensively as all steps required in Germany and abroad to manufacture products and provide services. From the extraction of raw materials to delivery to the end customer, the entire value creation process is to be covered. The supply chain covers:

- The actions of a company in its own business sector,
- The actions of a direct supplier
- The actions of an indirect supplier.

The Act obliges companies to observe human rights and environmental due diligence obligations along the supply chain in an "appropriate manner".

The due diligence obligations establish a duty of effort and not a duty to succeed. Companies therefore do not have to guarantee that no human rights or environmental obligations are violated in their supply chains. Rather, they must be able to demonstrate that they have implemented the due diligence measures described in the law that are feasible and appropriate in their individual context.

In this regard, the legislator requires companies to take a whole range of measures, starting with the establishment of a risk management system, the definition of internal responsibilities (e.g. appointment of a human rights officer who reports to the management), regular risk analyses, adoption of a policy statement, anchoring of preventive measures, taking remedial action in the event of identified violations, establishment of a complaints procedure (whistle-blower system), implementation of due diligence obligations also towards indirect suppliers, up to documentation and reporting.

These are the classic components of an efficient compliance management system, which follows the Prevent-Detect-Respond model established in practice. However, this general model must be adapted to the special requirements of the Due Diligence in Supply Chains Act.

In the case of indirect suppliers, there should be a cause-related duty, only when the company has factual indications that make a violation of a human rights-related or an environmental obligation at indirect suppliers seem possible (substantiated knowledge). The legal term "substantiated knowledge" is new. According to the explanatory memorandum of the government draft, it should exist if the company

has verifiable and serious information about a possible human rights or environmental violation through indirect suppliers. According to the explanatory memorandum, this can also be information about risks in a certain region in which a company or several suppliers are active. Here, however, it remains completely open whether any press reports are "verifiable" and "to be taken seriously" or how regions are to be assessed in which there are per se risks of environmental or human rights violations.

The human rights due diligence obligations include, among other things, the avoidance of child and forced labour, slavery or practices similar to slavery, child prostitution, extraction of and dealing of drugs by children, but also the disregard of occupational health and safety obligations if this gives rise to the risk of occupational accidents or work-related health hazards (e.g. inadequate safety standards, lack of protective measures to prevent the effects of chemical, physical or biological substances or to prevent excessive physical or mental fatigue due to inappropriate work organisation with regard to working hours or rest breaks). Human rights due diligence also includes disregarding freedom of association (founding and joining trade unions; freedom of trade unions to operate, e.g. the right to strike) and prohibiting unequal treatment in employment, for example on the basis of national and ethnic origin, social origin, health status, disability, sexual orientation, age, gender, political opinion, religion or belief, unless this is justified by the requirements of the employment. Furthermore, the human rights obligation of due diligence also includes the prohibition of causing harmful soil contamination, water pollution, air pollution, harmful noise emissions or excessive water consumption, which is likely to impede the basis for food production, safe drinking water or sanitary facilities or to damage the health of a person. In this respect, the legislator is following the guidelines of the Federal Constitutional Court.

The Act defines the environmental due diligence obligations with reference to the international agreements mentioned in the annexes (Minamata Convention of 10 October 2013 on Mercury and Stockholm Convention of 06 May 2005 on Persistent Organic Pollutants and Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal of 22 March 1989).

3. Sanctions

The Act contains a long catalogue in section 24, which imposes fines on almost all of the required measures. The documentation and reporting obligations are also sanctioned. For individual persons, the fines are up to € 800,000 and for companies up to € 8,000,000 due to the reference to section 30 para. 2 sentence 3 of the Law on Regulatory Offences (OWiG). For companies whose average worldwide annual turnover is more than € 400 million, administrative offences can be punished with up to 2% of the annual turnover. It is important to note that the authorities may also estimate the annual turnover and that foreign turnover should be attributed as long

as the affiliated companies operate as an economic unit. This increased fine framework only applies to violations due to failure to take remedial action because of incidents in the own business area and in the area of the direct supplier.

As a further sanction, a company may be excluded from the award of public contracts until it has proven a self-cleansing pursuant to section 125 of the Act against Restraints of Competition (Gesetz gegen Wettbewerbsbeschränkungen), up to a maximum period of 3 years.

Within the framework of the assessment of the fine, the legislator takes up the idea of mitigating the sanction if an appropriate compliance management system existed in advance to avoid and detect administrative offences or if the company made an effort to uncover the administrative offence and to make good the damage. Measures taken after the offence to avoid and detect administrative offences are also to be taken into account. Thus, this Act - just like the Draft Association Sanctions Act (Verbandssanktionengesetz) and the Act on Strengthening Financial Market Integrity (FISG) - also strengthens the importance of an efficient compliance management system within the company.

4. Civil Liability

The Due Diligence in Supply Chains Act states explicitly that this Act shall not give rise to civil liability. However, it also states that any civil liability established independently of this Act shall remain unaffected. Hence the general tort law or law of obligations standards as well as private international law apply. Claims against companies by persons under civil law for violations of legal positions addressed in the Due Diligence in Supply Chains Act therefore remain possible.

Persons whose "paramount" legal position, such as life or limb, has been violated can authorise trade unions and non-governmental organisations (NGO's) to assert their rights to litigation. This is a special case of a representative action ("Prozesstandschaft"), which only requires the effective authorisation of the person concerned. According to the explanatory memorandum of the Act, the use of the term "paramount" is not intended to imply any difference in assessment with regard to individual human rights, which are universal and indivisible.

Also unaffected are liability risks of the executive bodies arising from section 93, paragraph 2, sentence 1 of the German Stock Corporation Act (AktG) or section 43, paragraph 2 of the German Limited Liability Companies Act (GmbHG), for example, from damages of the company towards third parties or the imposition of fines due to deficits in the compliance management system. Obligations to take recourse due to barring the awarding of contracts are also conceivable.

5. Conclusion

Although the obligations for companies under the Due Diligence in Supply Chains Act do not come into force until 01 January 2023, the Act has various preliminary effects that must be taken seriously in order to avoid risks.

These include:

- Conducting a risk analysis at an early stage to identify human rights and environmental risks in one's own business area as well as with one's direct suppliers;
- Developing covenants in supply contracts to ensure contractual leverage to enforce remedial action in the event of violations of protected legal positions;
- Review the existing compliance management system to determine whether the necessary adjustments have been made (e.g. establishment of an appropriate and efficient whistleblower system and third party management) or establish a new CMS with the necessary elements;
- Review the human rights policy statement as an integral part of the corporate social responsibility policy and as part of the communication strategy;
- Selection and appointment of a human rights officer;
- Increased attention to due diligence for M&A transactions to avoid unidentified liability risks;
- From the perspective of the supervisory board, the board's reporting obligations should include supply chain risks and their mitigation;
- Review of insurance law aspects with regard to D&O insurance.

6. The Brazilian case

Brazil and Germany share a long and solid trade history. In 2020, Germany was Brazil's fourth largest trading partner in the world and the first in Europe. And Brazil, in turn, is one of Germany's most important economic partners, especially in commodity exports.

Germany is one of top 10 importers of agricultural and mineral products from Brazil, such as coffee, cellulose, wood, meat, leather and copper and iron minerals.

Clearly, Brazil is a country that plays a significant role in German companies supply chains.

In Brazil, the production chains of agricultural and mineral products have, on several occasions, been the target of allegations of human rights violations and environmental crimes. The new Due Diligence in Supply Chains Act requires that German companies ensure, more than ever, the integrity and respect for human rights and the prevention of the environment throughout their entire supply chain.

German companies that import from Brazil or manufacture in Brazil, must certify the integrity of their supply chain also in Brazil. Unfortunately forced labor, child labor, work discrimination, as well as deforestation, soil and water pollution and even unprecedented environmental tragedies are part of the Brazilian reality.

Some factual information is worth mentioning.

Human Rights in Labor

One instance of concern is respect for human rights in labor. The Brazilian Sub-secretariat of Labor Inspection (SIT) of the Ministry of Economy estimates that more than 55,000 workers have been rescued from contemporary slave labor in the last 25 years. In 2020, 936 workers were rescued. According to the statistics, agribusiness is the sector that concentrates most exploited workers, which includes beef cattle raising, coffee, sugar and rice cultivation and alcohol production.

With regard to child labor, a research made by the Brazilian Institute of Geography and Statistics (IBGE) in 2019 shows that 4.7% of Brazilian children between 5 and 17 years old are working. Although the percentage has dropped over the years, it corresponds to over 1.8 million children working mostly on the agriculture sector.

Environmental Catastrophes

Brazil has also faced unprecedented environmental tragedies related to mineral extraction. In 2015 a dam located in the city of Mariana broke. The ore sludge killed 19 people, destroyed the houses of hundreds of people, devastated the Rio Doce River and reached the ocean. Until now, the destroyed communities have not been rebuilt nor answers have been given about the extension of the environmental damage.

In 2019, in the city of Brumadinho, another dam broke. The sea of mud killed 270 people and 10 are still missing. Years later, the authorities still cannot estimate the damage in order to accurately determine the people affected and seek compensation. The Brazilian mining company Vale and the German company TÜV SÜD, which had attested the stability of the dam, are facing criminal lawsuits.

In addition to the thousands of people that were affected by the tragedies, the environmental damage is almost immeasurable. The mud polluted the water of rivers, caused the death of tons of fish and other animals and destroyed the food chain and the forests on the locations. According to some biologists, the impact was so profound that it is impossible to estimate a timeframe for the environmental balance reestablishment.

Several German companies import minerals extracted from Brazil, which is why a closer look at the supply chain is essential. For purposes of the new law, a German company cannot ignore the recent tragedies and current environment.

Brazil is well known for its natural richness - its great diversity of biomes and wildlife. However, the destruction of the environment has always been a reality. Over the last few years, the deforestation in Brazil has become a bigger issue.

Deforestation of the Rainforest

According to scientists, a total of 11,088 km² of the Amazon rainforest was destroyed from August 2019 to July 2020, an increase of 9.5% from the previous year. Not only is the Amazon Forest an essential carbon store that slows down the pace of global warming, but it also houses millions of plant and animal species, and several indigenous people communities.

Mostly, the deforestation in Brazil is related to cattle raising (as well as grains that feed them, such as soybeans) and illegal timber harvesting. The deforestation leads to a severe loss of the environmental biodiversity and wildlife, it increases the pollution of water climate change as well as endangers the lives of indigenous peoples.

In 2020, Brazil, which owns one of the world's largest cattle herd, reached a record in meat exports: 2.016 million tons. In addition, over 82 million tons of soy grains were exported as well.

In the same year, the rainforest lost an area of 11,088 km², the largest of the last 12 years, according to the National Institute for Space Research (Inpe). Certainly, a portion of the export numbers is directly connected to deforestation and fires in the Amazon.

Activists claim that large landowners and cattle breeders illegally cut down - and even burnt down - large areas of the original environment for the farming and breeding industries. In 2020 the Amazon's deforestation and fires reached the news around the world and brought to the public opinion awareness on the matter.

It is important to note that meat is not the only export-product that results of deforestation: leather and illegal lumber are also largely traded.

According to a report of the Rainforest Foundation Norway, one of the world's leading organizations in rainforest protection, leather from cattle raised in areas of illegal deforestation is possibly used for car seats by several companies, including Germany's BMW, Volkswagen and Daimler.

This material could also be largely used by German companies on other industries, such as clothing and shoe industries. According to the 2019 Brazilian import and export statistics, Germany was the fifth largest destiny of the Brazilian leather exports.

The illegal deforestation (specially of the Amazon) also foments another business: the smuggling of lumber. In 2017, the Brazilian Federal Police apprehended 120 containers of 2,400 m³ of illegal lumber. According to police investigations, the lumber was to be sold to companies in Belgium, Denmark, Netherlands, France, Italy, Portugal, UK as well as Germany.

Unfortunately, police investigations that aim seizing illegal lumber are not uncommon in Brazil. The Federal Police is currently investigating a scheme that facilitates forest products smuggling to United States and Europe. One of the targets of the investigation is the prior Brazilian Environment Minister Ricardo Salles, who resigned on 23 June 2021 amid accusations of environmental crimes. According to the Federal Police, he acted to change environmental rules in order to regularize shipments of lumber seized abroad. The Federal Police investigates suspected corruption by authorities, public servants and businesspeople.

In addition to the prior Environment Minister, several other officials are investigated, including the president of the Brazilian Institute for the Environment and Renewable Natural Resources (IBAMA), Eduardo Bim. Thirty-five search warrants in Brasília, São Paulo, and the Amazonian state of Pará were issued in this recent scandal.

Consequences

Upon the adoption of the German Act on Due Diligence in Supply Chains, German law will require companies to ensure the integrity of their business as to human rights and environmental protection, including the actions of direct and indirect suppliers.

In this sense, it is essential that the companies implement a risk management system in order to carry out risk analyses as well as implement preventive measures, not only inside their companies but also at their suppliers, especially the ones that are thousands of miles away.

The requirements of the new law as to due diligence procedures apply not only "new" suppliers (engaged after the adoption of the Act), but also current suppliers, which are already part of the supply chain.

Another relevant aspect to be considered is the importance of starting to implement these measures as soon as possible. Implementing a risk management system, carrying out due diligences and even elaborating commercial contract provisions or amendments that provide compliance comfort in the supply chain will require organization and time. The Due Diligence in Supply Chains Act is expected to enter into force in January 2023 for companies that employ 3,000 people, which implies in less than 2 years of preparation.

Other European countries have similar laws and European Union is expected to enact rules with regard to supply chains. The European Commission will likely deliver a proposal by the end of the year.

Many European companies have expressed concerns with regard to the costs the Act will impose and the impact on their competitiveness.

On this topic, it has been proven that the costs related to prevention will never exceed the penalties nor other forms of financial impact such as loss of contracts and reputational damage.

Outlook

Finally, the Act provides that all companies take responsibility in the supply chain's integrity. Companies that committed to this in a voluntary declaration made in 2011, but have not fulfilled the commitment, will be expected to do so now. In this sense, the Act will benefit those companies and level the playing field. It is no longer tolerated that companies profit on human rights violations.

The German Due Diligence in Supply Chains Act is a significant step in the direction human rights protection in the corporate world and has global impact. The Brazilian reality brings specific challenges that should be carefully considered by the German companies. The protection of human rights is a matter of interest to the whole mankind and laws dealing with the matter are by their nature bound to have impact outside national territories.

In case of any topics related to the German Due Diligence in Supply Chains Act, especially in relation to supply chains reaching to Brazil please contact COMINDIS (Dr Eric Decker and Dr Ingo Kühl) and FLESC H LAW (Dr Esther Flesch and Sophia Flesch).

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