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**Research Report**

## Responsibility in supply chains: Germany's due diligence act is a good start

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# SWP Comment

NO. 21 MARCH 2021

## Responsibility in Supply Chains

Germany's Due Diligence Act Is a Good Start

*Günther Maihold, Melanie Müller, Christina Saulich and Svenja Schöneich*

On 3 March, the Federal Cabinet adopted an act on corporate due diligence in supply chains. This represents an important step towards German businesses assuming full and proper responsibility for the supply chains associated with their goods and services. The move puts Germany in a group of European countries like France and the Netherlands that have already instituted legal frameworks of their own. However, by choosing to exclude civil liability the German government has left aside a powerful tool for applying targeted pressure to companies that fail to fulfil their obligations. In order to maximise the law's impact, the German Bundestag and government should therefore adopt additional flanking measures. At the European and international levels, Germany can also contribute to making companies assume greater responsibility for their own supply chains.

The Due Diligence Act proposed by the German government will require companies to analyse human rights risks in their supply chains, fulfil due diligence and reporting obligations, and establish complaints mechanisms. Companies that fail to comply with these new regulations face fines. Fundamentally, corporate due diligence requirements can be defined more or less narrowly, for example to include human rights and the impact of business activity on the environment. The same applies to civil liability for neglecting or failing to address risks. On this latter point the involved ministries were unable to agree and ultimately opted for a compromise.

### The Components of the Draft Law

In 2016 the German government made its first step towards implementing the United Nations Guiding Principles on Business and Human Rights (UNGP, adopted 2011), by passing the National Action Plan for Business and Human Rights (NAP). This required companies above a certain size to assess and address human rights risks in their supply chains, to report on measures implemented, and to establish complaints mechanisms enabling external actors to inform them of risks and human rights violations. The NAP is a voluntary instrument, with no repercussions for non-compliance.

A monitoring process conducted by the German government found, however, that



in 2020 only “13 to 17 percent of the enterprises observed complied with the NAP requirements”. The new Due Diligence Act sets out to create binding rules for business. The agreed draft includes the following points:

*Affected companies:* The legislation will apply to companies with more than 3,000 employees — of which there are about 600 in Germany — starting in 2023. From 2024 companies with at least 1,000 employees will also be included.

*Reach:* Companies will be required to ensure that there are no human rights violations in their *immediate* business activity and the business operations of their direct suppliers. Risk analysis in the rest of the supply chain (*indirect* suppliers) is only required where a German company is informed about a human rights violation. In that event they must also conduct risk analysis and institute preventive measures, although the requirements are less stringent in these cases.

*Scope of human rights:* The legislation focuses in particular on the social and political rights of workers and others immediately affected by business operations. Concretely this comprises the right to life, health, fair working conditions, and a decent standard of living; child protection; freedom from slavery and slavery-like working conditions; as well as the right of association, the right of assembly and the prohibition of torture. In terms of environmental protections, the draft only covers exposure to mercury (as defined in the Minamata Convention) and persistent organic pollutants (as defined in the Stockholm Convention).

*Representative action:* In the case of violations of human rights and environmental standards at the “far end” of the supply chain, for example by the extractive industry, NGOs and trade unions are entitled to represent foreign victims of business-related abuses who are unable to appear in court themselves.

*Enforcement:* Rather than civil liability the bill proposes fines of up to 2% of the average annual turnover for companies with

average annual revenues of more than €400 million that fail to meet their obligations. The maximum fine for companies with annual revenues below this threshold is €800,000. These fines will be supplemented with federal government funds and used to promote human rights due diligence in the global economy.

*Monitoring:* The Federal Office for Economic Affairs and Export Control (BAFA) will be responsible for monitoring compliance and imposing fines. It reports to the Federal Ministry for Economic Affairs and Energy.

## The Distinction between Due Diligence Obligations and Supply Chain Responsibility

Germany is taking an important step forward with its Due Diligence Act, and joining the European front-runners in this area. The legislation will require major companies to take precautions to prevent human rights risks and violations. Moreover, the enforcement of human rights due diligence in their own immediate business operations will generate pressure on their suppliers and business partners to do the same in their own supply chains.

The German economy is globally significant. Germany is the world’s third-largest importer, accounting for 6.4 percent — worth US\$1,234.2 billion. This puts it behind only China (10.8 percent) and the United States (13.4 percent; both figures as of 2019). The German government’s reason for limiting due diligence obligations to the immediate supply chain and companies with more than 3,000 employees is to avoid excessive bureaucracy and focus the new requirements on entities large enough to fulfil them. The legislation seeks to initiate a cascade effect by starting with the aforementioned 600 largest companies but expecting knock-on effects on smaller firms.

However, restricting corporate risk analysis to the company’s own activities and immediate suppliers significantly curtails the reach of the legislation. One prominent

example is the area of metal imports. In 2019 Germany imported basic metals worth €56.86 billion and metal products worth €30.89 billion. German firms rarely source directly from the mine, normally purchasing metals in refined and processed forms. Yet most of the human rights violations in these supply chains occur in the mines themselves, in addition to severe environmental damage caused during the mining process. This demonstrates that it is not enough to concentrate exclusively on tier-one suppliers: achieving sustainability along the entire supply chain requires a more thorough approach.

### **The Potential of a “Smart Mix”**

The German system of due diligence is based on a combination of internal corporate risk analyses, preventive measures, and the mitigation of adverse impacts. The idea is that a smart mix – similar to the “Green Button” certification mark for textiles introduced in 2019 – could reduce burden of reporting and strengthen existing sectoral initiatives. A “smart mix” would allow firms to demonstrate partial compliance with certain environmental and social standards through certification by private-sector organisations. Such forms of certification are widely used in the food and textile sectors, specifically “Fair Trade” and various organic marks. It will be crucial, however, to recognise only ambitious standards defined with the participation of relevant actors (for example firms, NGOs and trade unions in so-called multi-stakeholder initiatives). Compliance with private standards should not release firms from conducting internal corporate risk analyses, including on-site visits, to avoid a situation where the applied standards only cover individual human rights and environmental aspects. Including such standards requires state accreditation, oversight and auditing of certification systems.

A smart mix offers multiple benefits. Firstly, it would reward companies that set ambitious targets. Secondly, it would promote the dissemination and establishment

of exacting standards. Thirdly, new binding sectoral standards could be developed in sectoral dialogues with BAFA, companies and civil society actors. These would have knock-on effects on smaller firms that are not yet directly affected by the legislation. BAFA would be able to prevent the proliferation of a confusing multitude of parallel standards, while granting companies a degree of freedom in how they implement their due diligence obligations.

### **Strengthen Civil Society Participation**

The legislation provides for NGO and trade union involvement in a central aspect, the possibility to represent foreign victims in court. But effective implementation will require civil society participation elsewhere too.

*Risk analysis and prevention:* Requiring firms to conduct risk analyses and institute preventive measures faces them with new operational and logistical challenges – and opens opportunities to improve their knowledge of their own supply chains and minimise possible risks. Drawing on the expertise of the diverse actors along the supply chains is crucial to identifying and preventing risks in an adequate manner. Discussion in multi-stakeholder forums will be central to harnessing the existing knowledge of these actors.

*Monitoring compliance:* It certainly makes sense for the state authority BAFA to have a robust mandate to ensure obligations are fulfilled. This will also enable the state to acquire data and expertise. Verifying compliance requires extensive knowledge about the different raw materials, global supply chains and their actors, as well as the conditions in production, processing and manufacturing, and the human rights violations typically associated with them. Miscalculations of risks, for instance when granting state guarantees to secure untied loans by German-based banks for resource extraction projects, raise questions whether the required competence has (yet) been adequately established at the state level. The involve-

ment of civil society actors with an additional control function is therefore an important addition.

*Managing funds for human rights due diligence:* The participation of civil society actors in detecting risks in supply chains, monitoring corporate compliance and representing victims in court requires human and financial resources. The funds earmarked for promoting human rights due diligence could be used for that purpose. Funding decisions should also play out in a multi-stakeholder context involving trade unions, civil society organisations and business representatives. The fund could represent a legislative innovation and a litmus test for the seriousness of the desire to integrate a wide spectrum of stakeholders. It could also finance support and targeted assistance for persons affected by human rights violations so as to account for Germany's own share of responsibility for human rights abuses. Solid participation by the various actors will only be possible if the fund receives stable baseline funding from the outset, and is not forced to rely solely on fines and government top-ups.

### **Strengthening Organisations on the Ground**

The proposed complaint and representative action processes will be important for securing a legal representation of marginalised groups affected by human rights violations associated with economic activity. Preparing complaints and court cases requires the aggregation of knowledge and evidence about human rights violations on the ground, and a certain degree of organisation of the victims at the local level. It also presupposes the formation of transnational networks between German NGOs, trade unions and the victims and/or their organisations. This creates openings for German development cooperation: measures that could strengthen the participation of local actors include supporting local civil society organisations and research bodies that represent victims of human rights violations and environmental damage, gather

information, or participate in preparing complaints and court cases. Other flanking measures in the sphere of development cooperation could be directed towards establishing and expanding local institutions that process complaints, such as ombudspersons and national human rights institutes. Institutions of that nature in countries like Peru and Chile already contribute to safeguarding basic rights in the mining sector and enjoy strong popular legitimacy.

As well as supporting victims and vulnerable groups, such local bodies are also important resources for corporate risk analyses and prevention. Highly complex supply chains with numerous stages involving multiple actors are often rather impenetrable for the companies responsible for analysing them. Conflicts of interest between actors generally lead to elevated risk for the resilience of the supply chain and thus also for the firms involved. Collective representation of interests at the local level gives companies reliable partners and in turn increases the potential for productive cooperation and greater transparency. Strengthening local organisations is therefore not only in the interest of German development cooperation, but of the companies as well.

### **Differences between the German and European Debates**

The German Due Diligence Act will put Germany in a group with EU member states like France and the Netherlands, which have already passed comparable legislation. The French »Loi de Vigilance« came into force in 2017 and introduces the principle of civil liability; the first cases are already in process. At the European level there is a broad consensus behind ambitious legislation on corporate due diligence: In December 2020 the Council of the EU asked the Commission to initiate an EU Action Plan in the course of 2021, "focusing on shaping global supply chains sustainably, promoting human rights, social and en-

vironmental due diligence standards and transparency". In its Conclusions of 1 December 2020 the Council also called on the Commission to prepare a proposal for "an EU legal framework on sustainable corporate governance, including cross-sector corporate due diligence obligations along global supply chains". On March 10 the European Parliament voted by a large majority to accept a legislative initiative report in favour of due diligence legislation. The report states that businesses need to ensure that their purchasing policies do not cause harm and proposes fines and other administrative sanctions in case of non-compliance or complaints. The law is expected to be tabled in June 2021. This means that, while Germany is not pre-empting European regulation, it will have to adapt its national arrangements to conform to the future European legal framework. The discussion about a European corporate due diligence law diverges from the German Due Diligence Act in two main respects:

*Reach:* The discussion in the European Parliament – and the Commission – proposes far-reaching obligations applying to indirect as well as direct suppliers. There is still debate over a proportionality principle to scale corporate reporting and tracing duties according to risk. The alternative would be to make company size the criterion for formal procedures and risk assessment and prevention, potentially complemented by independent external certification systems to reduce the reporting burden.

*Enforcement:* In January 2021 the Legal Affairs Committee of the European Parliament voted almost unanimously to adopt a draft legislative initiative calling on the Commission to present a corporate due diligence law. Justice Commissioner Didier Reynders has repeatedly announced his intention to propose cross-sectoral rules. The public consultation has just ended, and the legislative proposal is expected in the second quarter of 2021. The legislative initiative report of the European Parliament includes corporate civil and administrative liability, which the German bill excludes.

The European proposal suggests a corporate duty comparable to the "comply or explain" principle in banking supervision in a European directive. This would require firms to justify any non-fulfilment of their due diligence obligations to their national oversight body. The point of common minimum due diligence obligations and liability arrangements is to avoid regulatory fragmentation as well as material and procedural discrepancies in the internal market. On the other hand, it would not prevent member states from adopting special (for instance sectoral) due diligence requirements that go further than the joint EU rules; the same also applies to current and future regional and international standards.

The regulatory depth and compliance requirements of the German governing coalition compromise thus fall well short of the stringency of the proposed European corporate due diligence law in its current iteration. The legal implications of the latter would in specific cases lead to the termination of particular suppliers if reported risks were not remedied. There is also discussion about an import ban for products associated with grave human rights violations (such as child labour).

## Germany's Potential Role in the EU Discussion

Germany has a number of different paths to choose between. The government could join with trade unions and companies that already fulfil their due diligence obligation to forge the path to an ambitious Europe-wide solution with stricter liability, firm enforcement and a comprehensive directive to be implemented in national legislation. Given that the European legislative initiative report enjoys cross-party support, the timeframe for implementation could be kept short. That would also support efforts already under way to have standards, reporting duties and the associated costs included in company accounts. And it would make full use of the potential of a multi-stakeholder approach for governing

due diligence processes: The inclusion of public and state actors in consultation and participation processes would benefit corporate implementation, not least with respect to pressure from financial markets and investors.

Rules should apply across the EU to ensure that a European corporate due diligence law harmonises the existing national laws and regulations and prevents unfair competition in the European Union. That means ensuring that the rules that apply to EU-based companies are also applied to non-EU-based companies operating in the European Single Market. A European directive could represent a meaningful next step, closing the gaps in the German law. The idea of channelling fines into a fund to promote human rights due diligence, as proposed in the German bill, could enrich the European discussion.

Germany, as a key trading power, could adopt an active pathfinding role within the European legislative process. A comprehensive corporate due diligence law would allow Germany and the EU to increase the pressure on China – which is a central node in many supply chains – to observe environmental and social standards. Beijing has recently adopted its own guidelines for sustainable commerce orientated on the existing OECD standards. But enforcement has been weak to date, due to the lack of pressure from the authoritarian leadership.

An overly cautious German stance – coloured by fears in parts of the business community that the expense of reporting and research could increase costs and impinge on competitiveness – would also weaken the EU's position at the international level, for example in the UN negotiations for a Binding Treaty on Business and Human Rights. That would leave Germany less able to align itself with actors in states of the Global South. The argument that strong human rights obligations would place a disproportionate burden on these countries is unconvincing. States across the globe have implemented the UNGP in national law with National Action Plans on Business and Human Rights, or are dis-

cussing doing so. The OECD's more ambitious standards already apply to member states like Chile and accession candidates like Peru, while the African Union's Agenda 2063 also codifies implementation of social and environmental standards as an objective.

## Next Steps

Aside from human rights, there are other benefits to pursuing high social and environmental standards. A steadily growing market for sustainable and fairly traded products has emerged and grown substantially in recent years. For instance, an Infratest dimap survey in Germany published in September 2020 found that 75 percent support a supply chain law. 91 percent believe it is the responsibility of the government to ensure that German companies respect social and environmental standards abroad.

## A Plea for a Strong German Law

It is important to take seriously the concerns over costs and competitive disadvantages associated with stronger regulation in certain business areas, and to shape processes that avoid creating excessive bureaucracy. In fact that is a very good argument for strong legislation, because it will create a guiding framework with clear and binding rules. The cornerstones of the bill as it now stands should not be watered down any further in the legislative process.

## Flanking Measures

The German government should also enhance the legislation's impact and reach with flanking measures. Specifically, it should seek the participation of actors along the supply chain in corporate risk analyses, in compliance monitoring and in the allocation of funding to strengthen human rights due diligence. Restricting the reporting duty to direct business partners must not lead to a situation where atten-

tion is paid to further removed elements of the supply chain only in the event of a complaint. The goal must still be to prevent such cases through comprehensive and binding risk analyses. That will also improve supply chain transparency and traceability and thus resilience. The support of local institutions that gather knowledge about human rights violations attributable to corporate activity and support victims is also important.

## Germany at the European level

At the European level Germany should press for strong regulation and ensure that the same rules apply to EU-based and non-EU-based companies and that the EU can play a leading role internationally. It should also work to have environmental human rights adequately anchored in the European legislation. The restriction to specific substances and environmental harm affecting only individual human rights – as in the German legislation – fails to adequately address the extent of environmental damage attributable to corporate activity. Additional approaches for strengthening the implementation and enforcement of human rights standards should be developed in dialogue with partner countries in the Global South.

## Complementarity with Trade Policy

In the interest of coherence in its external relations the EU should work to address the issue of complementarity of supply chain regulation and trade policy. The preventive character of a corporate due diligence law, which functions by regulating corporate behaviour, can be complemented by bilateral, inter-regional and international trade agreements. That could mean updating existing trade agreements or includ-

ing corresponding arrangements in multilateral trade law. Reviving the World Trade Organisation could also generate new openings for a European initiative.

## Use the German G7 Presidency

The German government could also use its G7 presidency in 2022 to discuss the issue of sustainability in supply chains with its G7 partners and to develop a joint framework for action. It should insist that corporate due diligence forms part of the G7 countries' relationships with governments and civil society actors in the Global South.

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