

How Germany's New ESG Law Will Affect Suppliers Globally

The Supply Chain Act poses new challenges to suppliers when conducting business with new or existing German-based customers.

Key Points:

- The Supply Chain Act obliges in-scope companies to identify, address, and report on human rights-related and environmental risks in their supply and value chains.
- Suppliers to German businesses should familiarize themselves with this legislation and anticipate that their German customers will require ESG-related information and related contractual safeguards.
- Suppliers should update their compliance management systems, allocate internal responsibility to communicate with customers falling within the scope of this Act, consider undertaking a (voluntary) risk assessment, and update their own supplier code of conduct.

On 1 January 2023, the German Act on Corporate Due Diligence Obligations in Supply Chains (Lieferkettensorgfaltspflichtengesetz, LkSG — the Supply Chain Act¹) entered into force. The Supply Chain Act requires companies based in Germany with more than 3,000 employees (and from 1 January 2024, more than 1,000 employees) (In-scope Companies) to identify, address, and report on human rights-related and environmental risks in their supply and value chains.

The Supply Chain Act is an important milestone continuing the trend of increasing environmental, social, and governance (ESG) regulation of businesses worldwide, and will impact markets far beyond Germany. Companies falling within the Supply Chain Act's scope must perform risk assessments, implement risk management systems, and establish complaint procedures. Failure to do so may result in fines of up to 2% of the average global annual turnover of the company in question. Businesses with a presence in Germany should accordingly verify if they fall within the scope of the Supply Chain Act.

Furthermore, suppliers to German businesses, irrespective of their location and size, should familiarize themselves with this legislation and anticipate that their German customers will require ESG-related information and impose related safeguards as a condition of continuing to do business with them.

This Client Alert examines the practical impact of this legislation on suppliers and offers guidance on what suppliers can do now.

Does the Supply Chain Act target suppliers or impose any obligations on them?

The Supply Chain Act does not directly impose any obligations on suppliers who are not subject to the Act (i.e., Germany-based companies below the employee threshold and non-German companies). However, the Supply Chain Act does differentiate between direct suppliers and indirect suppliers of In-scope Companies, with different corresponding implications.

- A direct supplier is defined as a “partner to a contract for the supply of goods or the provision of services whose supplies are necessary for the production of the (In-scope) Company’s product or for the provision and use of the relevant service”.
- An indirect supplier is “any enterprise which is not a direct supplier and whose supplies are necessary for the production of the (In-scope) Company’s product or for the provision and use of the relevant service”².

Direct suppliers will be impacted by the Supply Chain Act, as an In-scope Company must implement appropriate preventative measures vis-à-vis its direct suppliers to ensure compliance with human rights and environmental obligations. Such measures include:

1. considering human rights and environmental expectations when selecting a supplier;
2. obtaining contractual assurances from the direct supplier to comply with human rights and environmental obligations and addressing these within the supplier’s own supply chain;
3. implementing training measures in order to comply with the direct supplier’s contractual assurances; and
4. agreeing on appropriate contractual control mechanisms.

If the direct supplier violates a human rights-related or environmental obligation, both the In-scope Company and the direct supplier are required to engage in a joint effort to end or minimize the violation as soon as possible.

Although indirect suppliers are not directly impacted by the Supply Chain Act in the same way as direct suppliers, the impact on direct suppliers will trickle down to the indirect suppliers of In-scope Companies. For example, a direct supplier might ask the indirect supplier to give account of their human rights-related and environmental compliance systems. In addition, if an In-scope Company learns of a (potential) violation by an indirect supplier, the In-scope Company must carry out an ad hoc risk analysis and implement appropriate prevention, cessation, or minimization measures.

What is the practical impact on suppliers?

In light of the above, the Supply Chain Act’s impact on a supplier will depend on a number of factors, in particular, the nature of a supplier’s activity and its customer base. For example, one of the main determining factors will likely be the extent to which a supplier is in the supply chain of In-scope Companies and/or direct suppliers, as well as the proportion of the total sales to those In-scope Companies and/or direct suppliers. In addition, a supplier’s responsibilities will depend on how susceptible to risk their area of business is — the higher the risk, the higher the scrutiny that obliged customers will exercise in order to fulfil their own obligations. Some risk factors include the location (e.g., locations outside Europe are considered higher risk) or the industry (e.g., the construction industry is

considered high risk, while forestry — as long as conducted in Germany — is considered low risk).³ A further consideration for suppliers is whether public tenders are relevant for its business, as certain violations of the Supply Chain Act may lead to the exclusion of an In-scope Company from public tenders for up to three years, including the failure to implement preventative measures vis-à-vis their direct suppliers.

In the context of these factors, Latham anticipates that in order to ensure their own compliance with the Supply Chain Act, German companies will seek to impose a number of additional requirements on both direct and indirect suppliers, wherever they are located.

For example, when exercising their due diligence obligations under the Supply Chain Act, In-scope Companies may start requesting (more) human rights-related and environmental information from their direct suppliers, e.g., via self-disclosure forms or an external audit. According to publicly available guidance from the Federal Office for Economic Affairs and Export Control (Bundesamt für Wirtschaft und Ausfuhrkontrolle — BAFA),⁴ suppliers' isolated self-disclosure is not sufficient for In-scope Companies to comply with their due diligence obligations, but should be taken into account alongside other risk assessment methods.⁵

Further, as In-scope Companies are now legally required to consider human rights-related and environmental expectations when selecting a supplier, providing comprehensive documentation on compliance with human rights-related and environmental obligations will become more important in order to secure a contract. When providing information, for example via questionnaires or internet-based profiling applications, a supplier may also need to consider the extent to which they should disclose sensitive business information (e.g., confidential supplier information). Without any empirical data on the level of disclosures, suppliers should exercise caution in handling sensitive information until a general standard emerges.

The Supply Chain Act will likely also affect existing supply contracts. In-scope Companies may need to renegotiate contractual terms with their suppliers in order to formalize human rights-related and environmental expectations in the supply contracts, implement training, and obtain or enhance existing audit rights. An increased focus on audit rights is likely. While companies may have previously failed to enforce their audit rights, the increased due diligence obligations might prompt companies to exercise these rights more rigorously.

In-scope Companies) may also request suppliers to sign a supplier code of conduct or an updated version incorporating the In-scope Company's obligations under the Supply Chain Act. In-scope Companies may also wish to introduce so-called transfer clauses, which oblige the direct supplier (as the contractual partner) to enforce the In-scope Company's supplier code of conduct also against its own contractual partners through suitable contractual regulations.

What can suppliers do now?

The Supply Chain Act provides suppliers with the opportunity to develop their own standards and establish themselves as reliable and preferential partners for In-scope Companies. If suppliers can show that they have already taken steps to comply with human rights-related and environmental requirements, thereby streamlining the risk assessment for their customers, they may increase their business share. On the other hand, suppliers that hesitate to provide information or update their contractual terms will likely lose business.

As such, suppliers (in particular those with a large number of In-scope Companies among their customers), should accordingly consider the following steps:

- Update their compliance management system as soon as possible to reflect the new requirements obliged customers face.
- Allocate internal responsibility within the supplier's compliance organization to ensure effective and competent communication with obliged customers.
- Suppliers, in particular direct suppliers, can conduct a (voluntary) risk assessment covering In-scope Companies' duties under the Supply Chain Act. As In-scope Companies must screen their suppliers' business for human rights-related and environmental risks, any supplier that supports or even anticipates this analysis will likely benefit as a result. Many In-scope Companies will deal with a large number of suppliers and thus face a considerable bureaucratic burden.
- Suppliers should consider preparing or revising their own supplier code of conduct and ensuring that it aligns with the supplier code of conduct of the supplier's major German customers (while maintaining awareness of the needs of international customers who may have similar requirements as a matter of best practice). This will facilitate a smoother risk assessment process for In-scope Companies vis-à-vis the supplier.
- Suppliers should consider implementing their own as well as customer audit rights in their own supply contracts. This will allow them to more easily respond to any inquiries from In-scope Companies regarding suspected violations of environmental and human rights laws by an indirect supplier to the In-scope Company.

In addition, suppliers may choose to certify their compliance management systems in order to strengthen their compliance claims' credibility. Certificates and other proven documentation provide obliged customers with important information about existing guidelines and how the organization implements them in practice. Such documents can also help prove a high level of sustainability in business practice.

What are the risks for suppliers?

Suppliers that fail to consider the requirements of the Supply Chain Act do not risk fines or exclusion from public tenders.⁶ However, they may still face adverse consequences for existing business relationships between suppliers and In-scope Companies.

If a direct supplier violates a human rights-related or environmental obligation, the obliged customer may temporarily suspend business relationships. In more severe cases, the law requires the termination of the business relationship.⁷

Non-compliance with human rights-related or environmental obligations may also lead to a loss of business opportunities in Germany: many In-scope Companies will avoid dealing with non-compliant suppliers due to the risk of high fines.

What will happen next?

Although the Supply Chain Act does not address suppliers directly, both direct and indirect suppliers of In-scope Companies should definitely familiarize themselves with the new requirements and take steps to ensure compliance with human rights-related and environmental responsibilities.

Human rights-related and environmental responsibilities in the supply chain continue to be a hot topic. In 2022, the European Commission adopted a proposal for a directive on corporate sustainability obligations that, if implemented, would impose even stricter requirements on corporations than the Supply Chain Act. The next step in the ongoing legislative process will be the European Parliament's statement expected in May 2023. Since ESG is a topic in constant flux, stakeholders should stay abreast of regulatory developments. Latham will continue to provide relevant updates.

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Endnotes

- ¹ A translation of the Supply Chain Act is available at https://www.csr-in-deutschland.de/SharedDocs/Downloads/EN/act-corporate-due-diligence-obligations-supply-chains.pdf;jsessionid=2339A714689CD79EDE791BA2644D163D.delivery2-master?_blob=publicationFile.
- ² See section 2 paragraphs 7, 8 Supply Chain Act.
- ³ See Explanatory Memorandum to the Supply Chain Act, BT-Drs. 19/28649 p. 27 *available at* <https://dserver.bundestag.de/btd/19/286/1928649.pdf>.
- ⁴ See BAFA, FAQ to the Supply Chain Act, *available at* https://www.bafa.de/DE/Lieferketten/Ueberblick/ueberblick_node.html.
- ⁵ See BAFA, FAQ to the Supply Chain Act, Question X.4 *available at* https://www.bafa.de/DE/Lieferketten/Ueberblick/ueberblick_node.html.
- ⁶ Explicitly stated by the Federal Government, BT-Drs. 19/28642 p. 4 *available at* <https://dserver.bundestag.de/btd/19/286/1928642.pdf>.
- ⁷ This is the case if (i) the violation of a protected legal position or an environment-related obligation is assessed as very serious, (ii) the implementation of the concept to remedy the violation has not remedied the situation and (iii) the customer has no other, less severe means at its disposal and increasing the ability to exert influence on the supplier has no prospect of success; see section 7 paragraph 3 Supply Chain Act.