

Client Alert

Latham & Watkins Corporate Department

The California Transparency in Supply Chains Act (SB 657)

The California Transparency in Supply Chains Act of 2010 (SB 657) (the Act) requires certain companies, including some companies headquartered outside of California but doing business in California, to report on their websites the activities they engage in to monitor their supply chains to prevent human trafficking and slavery. To be in compliance with the Act, a covered company must post on its website, in accordance with the specifications of the Act, what it is doing regarding human trafficking and slavery in its direct supply chain for tangible goods offered for sale. As further described below, the Act covers retail sellers and manufacturers doing business in California that have annual worldwide gross receipts exceeding one hundred million dollars (\$100,000,000). **The Act goes into effect on January 1, 2012.**

The Act does *not* require covered companies to undertake the anti-slavery or anti-trafficking activities listed in the Act,¹ but covered companies do need to make the mandatory disclosure regarding the listed activities. If a covered party fails to post the mandatory disclosure, the California Attorney General can seek injunctive relief as the sole remedy for breach of the Act.

Companies may find it beneficial for public relations purposes or as part of their general corporate responsibility

program, however, to go beyond baseline compliance with the Act. The stated legislative purpose of the Act is to provide consumers and businesses with information to inform their purchasing decisions in an effort to use market forces to prod companies to help eradicate human trafficking and slavery.

Below are details on which companies are covered by the Act, followed by an outline of the mandatory action which covered companies should take in order to comply with the Act and possible effects of noncompliance. We also offer suggestions regarding discretionary actions companies could consider pursuing.

Companies Impacted By the Act

As described in more detail below, the Act covers companies meeting certain conditions specified in the Act. Additional companies may be indirectly affected as well. The Act may influence covered companies to flow through obligations to their supply chain to help the covered companies fulfill policy commitments they make as a result of their compliance with the Act.

A. Companies Covered by the Act:

The Act covers every retail seller and manufacturer doing business in California which has annual

worldwide gross receipts that exceed one hundred million dollars (\$100,000,000).² As the definitions below illustrate, the Act even covers companies that are domiciled outside of California and have relatively insignificant activity in California. In essence, this is a self-reporting approach, although, as noted below, a list of covered companies will be available to the California Attorney General, who can bring an action for noncompliance.

1. *Retail Seller and Manufacturer:* A company is a "retail seller" or "manufacturer" under the Act if retail trade or manufacturing is its principal business activity code, as reported on the entity's tax return filed under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code.³
2. *Doing Business in California:* "Doing business in this state" has the meaning set forth in Section 23101 of the Revenue and Taxation Code.⁴ A company is doing business in California if it actively engages in any transaction for the purpose of financial or pecuniary gain or profit,⁵ or, for taxable years beginning on or after January 1, 2011,⁶ if any of the following conditions is satisfied: (a) the company is organized or commercially domiciled in California, (b) the company's sales in California⁷ exceed the lesser of five hundred thousand dollars (\$500,000) or 25 percent of the taxpayer's total sales,⁹ or (c) the company's property in California¹⁰ or payroll in California¹¹ exceed the lesser of fifty thousand dollars (\$50,000) or 25 percent of the taxpayer's total property or payroll.¹²
3. *Annual Worldwide Gross Receipts:* "Gross receipts" has the same meaning as set forth in Section 25120 of the Revenue and Taxation Code.¹³ "Gross receipts" generally means the gross amounts realized on the sale or exchange of property,¹⁴ the performance of services, or the use of property

or capital in a transaction that produces business income, in which the income, gain, or loss is or would be recognized under the Internal Revenue Code, subject to exceptions listed in the definition.¹⁵

4. *Monitoring Applicability:* Under the Act, the California Franchise Tax Board is to make available to the Attorney General a list of retail sellers and manufacturers required to disclose based on tax returns filed during the previous calendar year. The first list is to be submitted to the Attorney General by November 30, 2012, and a list is to be submitted annually each November 30 thereafter.¹⁶

- B. *Companies Affected Indirectly:* Vendors in the direct supply chains of covered companies may be indirectly affected by the Act to the extent that covered companies decide to monitor their supply chains. Covered companies will likely need the assistance of suppliers as they prepare mandatory disclosures, which are described in detail below.

Mandatory Action (Baseline Compliance)

Below is a description of what covered companies should do to comply with the Act as well as the possible effects of not complying. The California Attorney General's Office has indicated that it may issue a general response to questions the Office has received about the Act, but nothing has been released as of the date of this writing.

- A. *Content of the Disclosure:* Every company which the Act covers must post on its website¹⁷ information regarding to what extent, if any, the company does each of the five things listed below.¹⁸ While the Act does not actually require covered companies to undertake the activities listed in these five elements, covered companies do need to make the mandatory disclosure regarding what efforts the company is making regarding the listed activities. For practical reasons,

covered companies may find it best to work within existing company structures and emphasize what is already being done.

1. *Verification*: The company needs to describe to what extent, if any, it engages in verification of product supply chains to evaluate and address risks of human trafficking and slavery. The company needs to specify if the verification was *not* conducted by a third party.
2. *Auditing*: The company also needs to describe to what extent, if any, it conducts audits of suppliers to evaluate supplier compliance with company standards regarding human trafficking and slavery in its supply chain. This appears to contemplate compliance with law auditing, not just technical or financial auditing. The company has to specify if the verification was not done via an independent, unannounced audit.
3. *Certification*: The company further needs to describe to what extent, if any, it requires its direct suppliers to certify that materials incorporated into its product comply with laws regarding slavery and human trafficking in the country or countries in which they are doing business. What constitutes a "direct supplier" is undefined.
4. *Internal Accountability*: The company must describe to what extent, if any, it maintains internal accountability standards and procedures for employees or contractors who fail to meet company standards regarding slavery and trafficking.
5. *Training*: Finally, the company must describe to what extent, if any, it provides company employees and management, who have direct responsibility for supply chain management, training regarding human trafficking and slavery issues, particularly with respect to mitigating risks within the supply chain.

B. *How to Post the Disclosure*: Every company covered by the Act must

post the required disclosure on its website, with a "conspicuous and easily understood link" to the required information placed on the company's homepage.¹⁹

C. *When to Post the Disclosure*: The disclosure should be posted by January 1, 2012, because the Act becomes operative on that date.²⁰

D. *Noncompliance*: The exclusive remedy for noncompliance under the Act is an injunction brought by the California Attorney General.²¹ There are no specified damages, monetary penalties, or a private right of action. The type of injunctive relief is unspecified, and the legislative history provides no guidance regarding what is contemplated. Given that the Act's requirement is to specify on a website the covered company's activities, the likelihood is that the injunctive relief would require the company to make the necessary disclosures. However, covered companies should note that noncompliance could theoretically lead to a claim under California's Unfair Competition Law, which allows for injunctive relief, restitution, and civil penalties, plus a private right of action in addition to government action.²²

E. *Accuracy*: The Act does not limit remedies available for violation of any other state or federal law,²³ so any disclosure should be accurate and void of mischaracterizations in order to reduce the risk of claims such as false advertising.²⁴

Discretionary Action (Exceeding Compliance)

Depending on what a covered company decides it wants to do from a public relations perspective, it should consider undertaking some or all of the following measures.

A. *Corporate Image*: It would likely be beneficial to get public relations, corporate communications, marketing, and sales teams involved in crafting an approach to the corporate policies

the company wants to include in the disclosure and how to characterize them and the company's efforts regarding them, with an eye to effects on human rights organizations, consumers, investors, and other interested parties.

- B. *Enforcement of Policies*: Companies should enforce any adopted policies to avoid running into problems with regulators who look at what companies are actually doing to address supply chain issues. It could well be worse from a public relations perspective, and perhaps from a liability perspective, to have an unenforced supply chain management policy than to have no policy at all.
- C. *Commitment*: In addition to the mandatory disclosure, a covered company may consider posting (and enacting) plans for future action and improvements and a statement of the importance to the company of supply chain management for legal compliance and ethical purposes. Remember that all posts should be accurate.
- D. *Contracts*: Companies may consider revising standard procurement contracts and existing agreements with vendors to include or expand legal compliance sections and, most importantly, to include audit rights regarding legal and ethical compliance.
1. Audit rights would preferably be unannounced, with the flexibility to include third party or internal audits.
 2. Consider clauses requiring compliance with a published ethical code of conduct with vendors.
 3. Make violation of the code of conduct a material breach of the contract.
- E. *Initiatives*: Companies may find it beneficial to join a sector-specific group, such as the Pharmaceutical Supply Chain Initiative²⁵ or the Electronic Industry Citizenship Coalition (EICC).²⁶ Suitable supply chain management policies are likely to vary by industry.
- F. *Performance Reviews*: For the internal accountability standards and procedures reported under the Act, a covered company may choose to carry out performance reviews which incorporate written performance objectives, targets, and implementation plans to improve performance regarding supply chain management, including compliance with ethical and legal standards and the company's supplier code of conduct.
- G. *Vendor Training*: In addition to training employees and managers to comply with the supplier code of conduct, a covered company may consider offering training for its vendors regarding their obligations to detect and prevent human trafficking and slavery in compliance with their local laws.
- H. *Best Practices*: Companies may want to adopt best practices aimed at finding and seeking to prevent human trafficking and slavery where it exists in the supply chain and resolving the abuses when they are found.²⁷ Companies should periodically self-evaluate adopted practices.
- I. *Benchmarking*: There are a range of approaches that covered companies can take to respond to the Act. Companies should consider gathering data points of what other companies are doing – especially competitors. Consultants, both internal and external, may also be helpful in developing an appropriate response to the Act.

Summary

The only action a covered company must take under the Act is to conspicuously post the mandatory disclosure outlined in the Act on its website. The disclosure can be based on what a company is already doing to monitor its supply chain. The Act does not require a covered company to make any affirmative attempt to actually monitor or eradicate slavery or human trafficking in its supply chain; it merely requires covered companies

to accurately describe the measures they take in specific categories to police slavery and human trafficking in their supply chains. However, for ethical reasons or for public relations purposes, companies may consider it beneficial to undertake some or all of the activities specifically listed in the Act and to report those activities in compliance with the Act. Whatever policies they adopt, companies should follow through on any actions that they publicly commit to undertake.

Endnotes

- ¹ The bill as originally introduced included language requiring covered companies to “develop [and] maintain” efforts to eradicate slavery and human trafficking from their supply chains. That language was dropped, however, and the bill as signed into law only requires covered companies to disclose their efforts to do so on their websites. See SB 657 as amended on June 30, 2010, *available at* http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb_0651-0700/sb_657_bill_20100630_amended_asm_v96.html (last accessed Nov. 8, 2011).
- ² Cal. Civ. Code § 1714.43(a)(1) (2011).
- ³ Cal. Civ. Code § 1714.43(a)(2)(C) and (D) (2011).
- ⁴ Cal. Civ. Code § 1714.43(a)(2)(A) (2011).
- ⁵ Cal. Rev. & Tax. Code § 23101(a) (2011).
- ⁶ The Franchise Tax Board revises the amounts annually. See Cal. Rev. & Tax. Code § 23101(c)(1) (2011).
- ⁷ Sales is defined in subdivision (e) or (f) of Section 25120 as applicable for the taxable year. Rev. & Tax. Code § 23101(b)(2) (2011).
- ⁸ Sales in California is to be determined using the rules for assigning sales under Sections 25135 and 25136 of the Revenue and Taxation Code and the regulations thereunder, as modified by regulations under Section 25137. Rev. & Tax. Code § 23101(b)(2) (2011).
- ⁹ Sales of the taxpayer include sales by an agent or independent contractor of the taxpayer. Cal. Rev. & Tax. Code § 23101(b)(2) (2011).
- ¹⁰ The value of real and tangible personal property and the determination of whether property is in California is to be determined using the rules contained in Sections 25129 and 25131 of the Revenue and Taxation Code and the regulations thereunder, as modified by regulations under Section 25137. Rev. & Tax. Code § 23101(b)(3) (2011).
- ¹¹ Compensation in California is to be determined using the rules for assigning payroll contained in Section 25133 of the Revenue and Taxation Code and the regulations thereunder, as modified by regulations under Section 25137. Rev. & Tax. Code § 23101(b)(4) (2011).
- ¹² Cal. Rev. & Tax. Code § 23101(b) (2011).
- ¹³ Cal. Civ. Code § 1714.43(a)(2)(B) (2011).
- ¹⁴ Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold. Cal. Rev. & Tax. Code § 25120(f)(2) (2011).
- ¹⁵ Cal. Rev. & Tax. Code § 25120(f)(2) (2011).
- ¹⁶ Cal. Rev. & Tax. Code § 19547.5 (2011).
- ¹⁷ A covered company without a website must provide consumers the written disclosure within 30 days of receiving a written request for the disclosure from a consumer. Cal. Civ. Code § 1714.43(b) (2011).
- ¹⁸ Cal. Civ. Code § 1714.43(c) (2011).
- ¹⁹ Cal. Civ. Code § 1714.43(b) (2011).
- ²⁰ See Cal. Civ. Code § 1714.43(e) (2011).
- ²¹ Cal. Civ. Code § 1714.43(d) (2011).
- ²² See Cal. Bus. & Prof. Code §§ 17200-17210 (2010).
- ²³ Cal. Civ. Code § 1714.43(d) (2011).
- ²⁴ See Cal. Bus. & Prof. Code §§ 17500-17509 (2010).
- ²⁵ See <http://www.pharmaceuticalsupplychain.org/> (last accessed Nov. 7, 2011).
- ²⁶ See <http://www.eicc.info/> (last accessed Nov. 10, 2011).
- ²⁷ See, e.g., Verité, “Compliance is Not Enough: Best Practices in Responding to The California Transparency in Supply Chains Act,” November 2011, *available at* http://www.ungift.org/doc/knowledgehub/resource-centre/Verite_Compliance_is_not_enough.pdf (last accessed Nov. 4, 2011); Pharmaceutical Supply Chain Initiative, “Pharmaceutical Industry Principles for Responsible Supply Chain Management,” *available at* http://www.pharmaceuticalsupplychain.org/downloads/psci_principles.pdf (last accessed Nov. 4, 2011); Pharmaceutical Supply Chain Initiative, “Pharmaceutical Industry Principles for Responsible Supply Chain Management: Implementation Guidance,” *available at* http://www.pharmaceuticalsupplychain.org/downloads/psci_guidance.pdf (last accessed Nov. 4, 2011).

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