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E S G A R T I C L E S

Lieferkettensorgfaltspflichtengesetz: a mouthful of new supply chain regulations

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Alongside China, Germany is still considered to be the world's leading exporting nation. *Made in Germany* has long been an indication of superior quality and standards. The great reputation of German products extends to the import of raw materials, finished goods, components and subcomponents around the world. However, it is clear that human rights and environmental protection standards may not be uniformly met by all international companies in such extensive and complex supply chains.

After long disputes regarding how to achieve the goal set in the 2016 Coalition Agreement to protect human rights and the environment through new requirements affecting the supply chains of large companies, the German *Bundestag* passed the draft law on Due Diligence in Supply Chains (*Lieferkettensorgfaltspflichtengesetz/LkSG*) on June 11. The main foundation for the proposed law is especially constituted by the UN Guiding Principles on Business and Human Rights. The overarching objective of this law is to prevent child labor, forced

labor, discrimination and inadequate safety standards throughout the supply chain. It also aims to prevent occupational accidents and work-related health risks by ensuring adequate working conditions and avoiding environmental hazards. As a result, this new law incorporates the protection of the environment and human rights into corporate duties that apply not only to a company's own production but also to all its direct suppliers, as well as the indirect ones to a lesser degree.

Consequently, as of January 1, 2023, all German companies with more than 3,000 employees (in Germany) will be subject to this law, and, as of 2024, it will also apply to companies with at least 1,000 employees. Moreover, foreign companies with subsidiaries that operate within German territory will also be subject to this law if they have the same number of employees as mentioned above working in Germany. In concrete terms, this Supply Chain Act requires companies to take the following measures:

- o A precise **risk management** process to identify any possible violations of human rights and environmental protection.
- o The subsequent **risk analysis** within the risk management process - at least executed once a year - to properly identify, assess and prioritize relevant violations of environmental protection standards and human rights within the production chain.
- o A **public statement** by the company's management after the risk analysis has been completed in order to publicly state its corporate strategy for the protection of human rights and the environment.
- o The integration of appropriate **prevention measures** for all types of company activities.
- o The implementation of **immediate corrective measures** in the event of any violation of human rights or environmental protection standards within the company or by a direct supplier.
- o The incorporation of an **internal company whistleblower procedure**, through which any individual can file a complaint about risks to human rights or the violation of environmental protection standards.
- o **A mandatory informative document** covering the company's due diligence. This must be drafted on an annual and on-going basis, and it must be kept for at least seven years.

In addition to the responsibility it imposes on the conduct of direct suppliers, the law also establishes certain obligations with respect to indirect suppliers - that is, suppliers of suppliers. However, since it is actually impossible for a company to control even indirect suppliers in detail, the LkSG contains so-called "effort obligations" for companies. These obligations establish that there is neither an obligation to succeed nor a guarantee liability. All the duties of care imposed are thus subject to an appropriateness clause, which gives companies discretionary scope and leeway in their actions.

Non-compliance with the LkSG can result in penalties ranging from fines of EUR €50,000 (as much as twice

as high as the usual range of administrative penalties) to sanction of up to 2% of average annual turnover for companies that have a turnover of more than EUR €400 million. The calculation is based on worldwide turnover for the last three business years prior to the sanction. The calculation for the amount of compensation may encompass, among other elements, the extent, duration and effects of the infringement, as well as the efforts made to remedy any damage caused. In addition, companies with serious breaches of due diligence and a fine of at least EUR €175,000 may be excluded from participating in public contracts and concessions.

So, what impact could this new law have on Mexico? The market and investment revolution are guided by the new ESG (Environmental, Social and Governance) policies. The LkSG is the first step by the German nation to implement this type of practice throughout the entire production chain, regardless of where the companies are located.

Given that Mexico is one of the world's leading producers of auto parts, among other goods, the LkSG will also play an important role in the country. Thus, Mexican companies that are part of the supply chain of German corporations should begin to make major changes with respect to production processes, driving changes that improve the conditions that benefit the protection of the human rights of their workers and environmental conservation.

In view of the foregoing, it is necessary to begin taking measures to avoid losing foreign investment already present in Mexico. Great attention must be paid to the very specific catalog offered by the LkSG regarding the obligations that the company must follow. Consequently, the importance of establishing an internal body in charge of these new responsibilities must be considered, as well as the transition to true compliance and legal actions that uphold the law. In addition, an exhaustive risk analysis process should be reconsidered in major issues such as M&A (mergers and acquisitions), as well as when evaluating the due diligence compliance of the company's established and potential partners.

Now, although any Mexican companies that are part of the supply chain of German companies subject to the

LkSG cannot be fined or penalized directly for non-compliance, there are other types of repercussions. While Mexican companies will not be fined, their German clients will be if its supply chain does not comply with the legislation. Therefore, a very possible future scenario will be that clients (German companies) will ask for special certifications from the production companies that form part of their production chain to prove that they are operating in compliance with

the LkSG regardless of their physical location (outside German territory).

It is therefore very important that Mexican companies in this context have the advice, backing and support of experts to enable them to implement and adhere to the measures established by the new law in order to prevent the loss of German customers who need to adjust their supply chain to the LkSG.

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