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The Pressure in Germany Is Rising: Corporate Social Responsibility Requirements are Increasing

Compliance Considerations for U.S.-based Multinationals

Over the last few years, Germany has adopted several pieces of corporate social responsibility legislation. Additional CSR legislation–the most stringent to date–is expected to be adopted later this year. In many cases, U.S.-based and other multinationals doing business in Germany come within the scope of these requirements. In addition to increasing compliance requirements, the risk of liability is increasing, since German CSR legislation provides for administrative fines, damages based on adverse human rights and environmental impacts and even criminal sanctions. In this joint Article, Gleiss Lutz and Ropes & Gray provide an overview of current and proposed German CSR legislation for U.S.-based multinationals doing business in Germany, as well as related liability considerations.

The German CSR Regulatory Framework Is Becoming Increasingly Strict

Current Legislation

Companies doing business in Germany currently are subject to several pieces of CSR legislation:

- **A general CSR reporting obligation:** All German public companies, as well as credit institutions and insurance companies with (1) a workforce of more than 500 employees and (2) a balance sheet of more than €20 million or annual revenues of more than €40 million are required to provide information annually on environmental, employee-related and social issues, respect for human rights and the fight against corruption. This obligation is derived from the EU Non-financial Reporting Directive as transposed into German law.

  Subject companies are required to provide a description of (1) their relevant policies and due diligence processes, (2) the results of their due diligence, (3) the principal risks concerning each of the covered non-financial topics and (4) the significant non-financial performance indicators tracked by the company. This information must be provided in the annual report, published in parallel to the annual report or published within four months after publication of the annual report. The required information must be available on the company's website for a period of ten years.

  Only a small number of foreign-based multinationals are subject to these requirements. However, in April 2021, the European Commission published a draft Directive that would substantially increase the number of companies required to undertake non-financial reporting. That draft is not discussed in this Alert.

- Starting on January 1, 2021, companies that import **specified conflict minerals or metals** containing tin, tantalum, tungsten or gold (3TG) are required to comply with the EU Conflict Minerals Regulation and German law adopting the requirements of the Regulation.

  Subject importers generally are required to take steps to trace the origin of the in-scope 3TG they import, as well as to put in place internal processes and management systems to support traceability. Under specified circumstances, subject companies also must obtain third-party audits. In addition, they are subject to reporting and disclosure obligations.

  The EU Conflict Minerals Regulation generally does not apply to foreign-based multinationals doing business in Germany, since most are not direct importers of in-scope 3TG. For a more detailed discussion of the Regulation, see Ropes & Gray's earlier Alerts here, here, here, here and here.

- Companies who procure services from contractors or service providers in Germany who do not comply with their obligations to pay their employees the German **statutory minimum wage** may be subject to administrative fines of up to €500,000 if the procuring company, acting at least negligently, is not aware that the contractor or service provider does not pay the minimum wage. Liability extends to non-compliance with the Minimum Wage Act by sub-contractors and sub-service providers. In addition to administrative fines, the procuring company can be held liable for the obligation of the contractor or service provider to pay the minimum wage to its employees. Foreign multinationals doing business in Germany and their German subsidiaries can be fined and held liable for wages under this legislation.

- The Pay Transparency Act is intended to address **gender pay equality**. This Act prohibits pay differences based on gender for equal work. In addition, at companies with German workplaces with more than 200 employees, an employee generally may request information concerning how the employer determined the employee's salary and median compensation information concerning comparable employees of the other gender. Companies with more than 500 employees in Germany that are required to publish annual management reports also are required to periodically publish a report on their efforts to promote gender pay equality.

Proposed Legislation – the Due Diligence in the Supply Chain Act

Human rights due diligence has been a focus of the German Federal Government for several years. In 2016, the Federal Government published its National Action Plan implementing the UN Guiding Principles on Business and Human Rights. The NAP set out the Federal Government's expectations concerning corporate human rights due diligence. In the NAP, the Federal Government indicated it expects all enterprises to exercise human rights due diligence in accordance with the UNGPs commensurate with their size, the sector in which they operate and their position in supply and value chains.

At the time the NAP was issued, the Federal Government indicated compliance would be reviewed annually starting in 2018 and that, in the absence of adequate compliance, the Federal Government would consider further action, including legislation. The goal was that at least 50% of all enterprises based in Germany with more than 500 employees would incorporate human rights due diligence into their processes by 2020. Subsequent reviews by the Federal Government indicated this goal was not close to being achieved. The most recent study released in July 2020 indicated that between 13% and 17% of the companies surveyed met the requirements of the NAP.

As a result of the perceived inadequacy of voluntary compliance, momentum for mandatory human rights due diligence legislation began to build. Draft legislation was leaked in 2019. A term sheet, which largely tracked the 2019 draft, was published in mid-2020.

Since that time, there has been intense public discussion in Germany concerning whether companies should be subject to stricter human rights due diligence requirements. This follows on and/or parallels developments and discussions in several other European countries—including France, the Netherlands, Norway, Switzerland and the United Kingdom, among others—as well as at the European Union level.

On February 12, 2021, the political parties that form the current coalition government announced they had reached a general consensus on the key terms of a new mandatory human rights due diligence framework, often referred to in English as the Due Diligence in the Supply Chain Act (for brevity, referred to in this Alert as the "Act"). On March 3, 2021, the draft of the Act was adopted by the Federal Cabinet. The German Federal Government has committed to adopting the Act before Federal elections in September 2021.

The principal terms of the proposed Act are described below.

Subject companies. A company would be subject to the Act if it meets two threshold requirements:

- The company has its head office, principal place of business, administrative seat or statutory seat in Germany.

  This would in many cases include the German operations of U.S.-based multinationals.

- The company exceeds a specified employee count. Starting in 2023, the Act would apply to all companies with 3,000 or more employees. In 2024, this threshold would drop to 1,000 or more employees.

  For purposes of calculating the number of employees, employees at subsidiary entities would be included. Temporary workers also would be included if their assignment lasts at least six months.

  At the lower 1,000 employee threshold, the German Government estimates approximately 3,000 companies would be subject to the Act. By June 30, 2024, the German Government intends to consider whether the threshold should be further reduced.

Covered conduct. The Act would apply to a broad range of human rights risks. It would cover, but not be limited to, (1) child labor, (2) the worst forms of child labor, (3) forced labor, (4) slavery and other coercive workplace behavior, such as extreme economic or sexual exploitation or humiliation, (5) workplace safety, (6) freedom of association, (7) discrimination, (8) unfair wage practices and (9) improper use of security forces.

The Act also would apply to environmental risks that can lead to human rights violations, such as (1) soil, water, air and noise pollution and excessive water consumption and (2) unlawful eviction from and unlawful use of land, forests or water. The environmental-related obligations under the Act are based on the Minimata Convention on Mercury and the Stockholm Convention on Persistent Organic Pollutants.

Duties of care. Under the Act, corporate responsibility for managing and addressing human rights and environmental risks would extend to the entire supply chain. The manner in which the duty of care would be required to be exercised would depend on (1) the subject company's business activities, (2) its ability to influence the direct cause of the injury, (3) the typically expected severity of the injury, the ability to remedy the injury and the likelihood of its occurrence and (4) the subject company's relationship to the adverse impact. The duty of care is based on the UN Guiding Principles.

The Act would require:

- Establishment of an adequate and effective risk management system that considers the subject company's employees, the employees in its supply chain and other persons affected by its economic activity.

  The subject company would be required to assign internal responsibility for monitoring risk management, such as through the appointment of a human rights officer.

- Carrying out a risk analysis to identify human rights and environmental risks in the subject company's own business and at its direct suppliers.

  The risk analysis would be required to be carried out annually and more frequently as circumstances warrant to address significant new risks, such as those due to new products, projects or lines of business.

  The results of the risk analysis would be required to be communicated internally to relevant decision-makers, such as the procurement group, or the management board.

- Adoption of a human rights policy statement that addresses, among other things, the subject company's management, assessment, prioritization, mitigation, remediation and reporting of human rights and environmental risks.

- Preventive measures to prevent potentially negative human rights and environmental impacts in the subject company's own business and at its direct suppliers.

  At the subject company level, these measures would be required to include procurement strategies and practices intended to avoid or mitigate identified risks, training and ongoing monitoring. Compliant procurement strategies and practices may require changes in contracting practices and in some cases even suppliers.

  At the direct supplier level, these measures would be required to include the consideration of human rights and environmental expectations in supplier selection, contractual representations from direct suppliers, training, ongoing monitoring and audits.

  The effectiveness of the preventive measures put in place would be required to be assessed annually and on an ad hoc basis if there is a significant change in risk in the subject company's business or at a direct supplier.

- Taking remedial measures to address adverse human rights and environmental impacts.

  If the violation occurs at the subject company, action to end the violation would be required.

  If the violation occurs at a direct supplier and the subject company cannot end the violation in the foreseeable future, it must create and implement a concrete plan to mitigate and prevent the violation. The possibility of enforcing a corrective action plan should be reflected in supplier contracts.

  Under the Act, a business relationship only would be required to be terminated if (1) the violation is considered to be very serious, (2) the violation is not remedied within the time frame contemplated by the remedial plan put in place, (3) other less severe remedial measures are not available and (4) an increase in the ability to influence remediation is not likely.

- Adoption of a complaint mechanism.

  The complaint mechanism is intended to enable persons adversely impacted by the subject company's or a direct supplier's activities to submit a complaint.

  Information on the complaint mechanism would be required to be made publicly available in order to be accessible to potential users. The mechanism would be required to be impartial and confidential. It also would be required to be designed to ensure effective protection against retaliation.

  As is the case with some other program elements as described above, the effectiveness of the complaint mechanism would be required to be assessed annually and on an ad hoc basis as circumstances warrant.

Indirect suppliers. There would be a lower duty of care for indirect suppliers. For indirect suppliers, due diligence obligations only would apply if the subject company had substantiated knowledge of a possible human rights or environmental violation. This could occur, for example, through the complaint mechanism subject companies would be required to establish.

If the subject company has substantiated knowledge of a possible violation at an indirect supplier, it would be required to:

- Carry out a risk analysis; and
- Implement a plan for mitigating and preventing the violation.

Further regulation and guidance. The Federal Ministry of Labor and Social Affairs, in agreement with the Federal Ministry for Economic Affairs and Energy, would be authorized to issue ordinances that further flesh out the Act's due diligence requirements.

The explanatory materials accompanying the draft Act also contemplate the publication by the Federal Office for Economic Affairs and Export Control of cross-sector and sector-specific information, assistance and recommendations for compliance.

Documentation and reporting. Under the Act, subject companies would required to document their due diligence. Records would be required to be maintained for at least seven years.

In addition, subject companies would be required to annually report on their due diligence. The report would be required to discuss (1) the human rights and environmental risks identified, (2) the measures taken to fulfill the duties of care, including arising out of complaints received through the complaint procedure, (3) how the subject company assesses the impact and effectiveness of the measures taken and (4) the conclusions drawn from the assessment for future measures. The report would be required to be published on the subject company's website no later than four months after each fiscal year end and kept available for seven years. The report also would be required to be submitted to the Federal Office for Economic Affairs and Export Control.

Violations of the Act. The Federal Office for Economic Affairs and Export Control would be charged with reviewing whether a subject company has complied with the Act. Among other things, it could require the subject company to address reporting deficiencies within a reasonable time period. It also would be empowered to, with three months' notice, require a subject company to submit a plan to remedy substantive compliance deficiencies, as well as to provide a subject company with specific action items to fulfill its obligations.

Subject companies that fail to comply with the requirements of the Act, either intentionally or negligently, also would be subject to administrative fines. Depending upon the nature of the violation, the fine could be up to €8 million. However, if the subject company has an average annual turnover over the last three years of more than €400 million, the fine for failing to take remedial measures to address adverse human rights or environmental impacts in the subject company's own business and at its direct suppliers could be up to 2% of average annual sales. The subject company also could be excluded from public procurement for up to three years.

In addition, non-governmental organizations and trade unions would be entitled to sue subject companies in German courts on behalf of persons that suffer harm. However, the Act would not create an additional basis for liability. Claims would have to be brought under existing statutes or legal liability principles.

Interplay with EU-wide mandatory human rights due diligence legislation. Last March, the European Commission announced it will propose EU-wide mandatory human rights due diligence legislation in the form of a Directive that would be required to be transposed into member state national law. The Commission proposal currently is expected to be released in June. The German Government has indicated its long-term goal remains uniform European regulation. However, it has indicated that a German national law is an important step that can influence EU legislation. Said another

way, if EU legislation does not go as far as the coalition parties would like it to, Germany may adopt a more stringent mandatory human rights due diligence regime than that adopted by the European Union.

The Federal Government has indicated that, no later than six months after the adoption of EU-wide legislation, it will evaluate the Act's relative impact on labor patterns and ensuring a level playing field and its economic and human rights implications. Based on that evaluation, the Federal Government will consider whether to recommend to Parliament modifications to German law.

Next steps. At this time, it is premature for U.S.-based and other multinationals doing business in Germany to modify their compliance policies and programs in anticipation of the adoption of the Act. However, multinationals that may be subject to the Act should ensure that new longer-term contracts are sufficiently flexible to allow for compliance with the Act. In addition, multinationals should continue to monitor the status of the Act. Furthermore, it is important to keep in mind that, if adopted, the impact of the Act will extend far beyond companies that are directly subject to the Act. It also will create enhanced commercial requirements for their direct and indirect suppliers both within and outside of Germany.

Liability Risks Are Increasing

Failing to comply with obligations under both existing and, if adopted, proposed German CSR legislation may result in significant liability. Companies may be fined by administrative authorities or governmental bodies for regulatory non-compliance. They also may be held liable in civil suits. Liability may include damages under German tort law, which is increasingly being construed as imposing duties of care derived from the CSR regulatory framework. Therefore, even in the absence of new legislation, U.S.-based and other multinationals doing business in Germany need to take the evolving litigation and enforcement environment into account in their compliance policies and procedures.

To contact the primary authors:

Jacob Andreae: jacob.andreae@gleisslutz.com
Eric Wagner: eric.wagner@gleisslutz.com
Johannes Hertfelder: johannes.hertfelder@gleisslutz.com
Marc Ruttloff: marc.ruttloff@gleisslutz.com
Michael Littenberg: michael.littenberg@ropesgray.com

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