GERMANY'S NEW CORPORATE DUE DILIGENCE OBLIGATIONS FOR THE PREVENTION OF HUMAN RIGHTS VIOLATIONS IN SUPPLY CHAINS ACT — KEY CHALLENGES AND RISKS FOR THE CONSTRUCTION SECTOR

3 FEBRUARY 2023 • ARTICLE

"The Act for the first time legally regulates corporate responsibility for compliance with human rights, as well requiring certain environmental and social standards for businesses across their global supply chains."

Germany's new Corporate Due Diligence Obligations for the Prevention of Human Rights Violations in Supply Chains Act (the "Act") came into force on 1st January 2023. The Act for the first time legally regulates corporate responsibility for compliance with human rights, as well requiring certain environmental and social standards for businesses across their global supply chains.

While the impact of other legal acts on trade, especially on the clothing industry, has been widely discussed, other sectors have received only limited attention so far.

This article focusses on the Act's impact on the construction industry, in particular on contractors and their subcontractors, and how they need to keep the new laws and regulations in mind when drafting new contracts *and* managing existing ones.

OVERVIEW OF THE ACT

Previously, adhering to corporate social responsibility guidelines was optional. Now, the Act obliges businesses to respect human rights and certain environmental and social standards by implementing due diligence obligations as it now defines them in detail. This applies to businesses regardless of their entity legal form or whether they were set up under German, EU or other law, as long as they have their central administration, principal place of business or administrative headquarters, statutory seat or even a branch office in Germany pursuant to Section 13d of the German Commercial Code (*Handelsgesetzbuch*). At present, only businesses with 3,000+ employees are affected by the Act. From 2024, those with 1,000+ employees (including temporary workers) will fall under the Act's remit. When calculating the number of employees, temporary agency workers must also be considered and in the case of affiliated companies, as per Section 15 of the German Stock Corporation Act (*Aktiengesetz*), all employees of all group companies employed in Germany.

"This article focusses on the Act's impact on the construction industry, in particular on contractors and their subcontractors, and how they need to keep the new laws and regulations in mind when drafting new contracts and managing existing ones."

The Act aims, amongst other measures, to sanction and prevent child labour, the use of mercury, drinking water pollution, discrimination (e.g. by ethnicity, class, health status, disability etc.) and exploitation (e.g. forced labour, slavery, no or too low wage payment). Its due diligence obligations relate to a business's own operations and the actions of their contractual partners and of other (indirect) suppliers and subcontractors. This means that a business's responsibility no longer ends at their own factory but extends across their entire global supply chain. The points of reference for understanding what constitutes a business' supply chain are a business's own business unit, and both direct and indirect suppliers and contractors. Different due diligence requirements apply to each party.

One of the key new due diligence requirements in the Act is the establishment of a risk management system in order to identify and avoid or minimise the risks of human rights violations and damage to the environment based on an annual risk analysis. Based on the results of said analysis, Section 7 (1) of the Act requires businesses to take appropriate remedial action immediately after a risk analysis reveals violations. Otherwise, German businesses are at risk of being fined and must also work to ensure any violations are eliminated. In the event of a serious violation of any protected interests, a business is required under Section 7 (2) No. 3 of the Act to terminate its contractual relationship with the violating partner as a measure of last resort. If the business does not put an end to any violations, it can be forced to end them with the aid of coercive measures.

Fines can be up to €800,000 per infringement and in the case of legal entities/associations with an average annual turnover of €400m or more, an additional fine of up to 2% of their worldwide annual turnover can also be applied, resulting in a potential total fine of up to €8m. When determining the average annual turnover for a legal entity/association, this includes worldwide turnover for the last three financial years for all group entities, insofar as they operate as a single economic unit.

If a fine exceeds a threshold value of €175,000, in addition to the fine, that business can be excluded from public contracts for up to three years by means of entry in the competition register, until it has proved that it has dealt with all violations pursuant to Section 125 of the Act against Restraints of Competition (*Gesetz gegen Wettbewerbsbeschränkungen*). Violations can have very serious economic consequences.

"Fines can be up to €800,000 per infringement and in the case of legal entities/associations with an average annual turnover of €400m or more, an additional fine of up to 2% of their worldwide annual turnover can also be applied, resulting in a potential total fine of up to €8m."

SUPPLY CHAIN DUE DILIGENCE LAW IN THE CONSTRUCTION AND PLANT ENGINEERING SECTORS

In (international) construction and plant engineering projects, it is customary for numerous works to be carried out by subcontractors of the contractor who bring special qualifications or cost advantages to the respective tasks they are engaged on. The operator has a single contractual partner with the contractor, whilst the contractor regularly uses or must use a large number of subcontractors. The selection and number of subcontractors is generally at the discretion of the contractor. Thus, the activities of the subcontractor also belong to the supply chain of the German contractor and fall within the scope of the Act. All subcontractors must therefore also comply with human rights standards, as well as certain environmental and social standards.

This requirement arises under both existing and new contracts as the Act also covers ongoing construction projects.

PROBLEMS REGARDING NOMINATED SUBCONTRACTORS

Additional difficulties with regard to the Act may arise in particular if an operator nominates subcontractors.

"This requirement arises under both existing and new contracts as the Act also covers ongoing construction projects."

Subcontractors are nominated if an operator reserves the right to name a business/person as a subcontractor to perform specific parts of a project. For this purpose, the subcontractor does not necessarily have to have a contract with both the operator and contractor. A contractual relationship exclusively with the contractor is sufficient. If clauses regarding the selection of subcontractors are included in a contract, the contractor loses its freedom of decision with regard to the selection of subcontractors and thus bears the economic risk of non-compliance with the protected interests in the Act, although it could not influence the selection of said subcontractor.

Therefore nominated subcontractor clauses in construction or plant engineering contracts on the specification of subcontractors can be highly problematic for contractors. This is because, on the one hand, contractors are contractually obliged to work with a subcontractor who may commit relevant violations of protected rights or allow these to occur unhindered along the subcontractor's supply chain. On the other hand, the contractor must comply with the requirements of the Act. If a contractual relationship (or the initial non-assignment of a specified subcontractor) with a specified subcontractor is broken off, the German business is simultaneously in breach of contract vis-à-vis the operator and thus risks contractual penalties, claims for damages or even termination of the construction or plant engineering contract without notice.

SUGGESTED SOLUTIONS AND APPROACHES

It is imperative that businesses comply with the due diligence requirements set out in Section 3 of the Act, in particular that they set up a risk management system, appoint responsible employees, conduct regular analyses, set up a complaints office, conduct comprehensive training courses and thoroughly document all these measures and activities.

When concluding new contracts, it is particularly important to ensure that the risk of a violation of the Act lies with the party that selected the subcontractor, especially when the operator nominates them. The contractor should therefore have a right to object to a subcontractor nominated by the operator. Although the contractor remains responsible for fulfilling any obligations under the Act, it would then be exempt from any claims for damages and contractual penalties due to non-fulfillment of the construction or plant engineering contract as well as from any penalties due to the relationship between itself and the operator. In addition, the contractor should agree on a liability limit in any construction and plant engineering contract with a client.

"Even businesses that do not now fall under the scope of the Act can be subject to an obligation to comply with its requirements by means of an agreement under the law of obligations (Schuldrecht)."

CONCLUSION

The impact of the Act will be most noticeable on international construction and plant engineering projects, as they are generally labour and material-intensive and thus naturally more susceptible to violations of human rights and environmental and social standards (with nominated subcontractors potentially exacerbating matters). It presents plant manufacturers with a choice: mandatory compliance with the requirements of the Act on the one hand or adherence to contractual agreements with the operator on the other. In the future, contractors in these sectors will have to examine clauses stipulating subcontractors with particular care and renegotiate them. Existing contracts should be evaluated with regards to these liability risks.

Even businesses that do not now fall under the scope of the Act can be subject to an obligation to comply with its requirements by means of an agreement under the law of obligations (*Schuldrecht*). Although the legal consequences outlined in the Act would not then apply in the event of any violation, financial liability could, depending on the provisions in the agreement. The effectiveness of such an agreement depends on the individual case. A formal clause obliging to comply with the requirements in the Act is not likely to be sufficient for this purpose. A contractor who is obliged, under the law of obligations, to comply with the Act must ensure when subcontracting that the obligation to comply with the statutory duties of care in the Act are passed on in an effective contract.

KEY CONTACTS

TETIANA ARKHIPOVA
TRANSACTION LAWYER
• MUNICH

T: +49 89 237 086 122

TArkhipova@wfw.com

DISCLAIMER

Watson Farley & Williams is a sector specialist international law firm with a focus on the energy, infrastructure and transport sectors. With offices in Athens, Bangkok, Dubai, Dusseldorf, Frankfurt, Hamburg, Hanoi, Hong Kong, London, Madrid, Milan, Munich, New York, Paris, Rome, Seoul, Singapore, Sydney and Tokyo our 700+ lawyers work as integrated teams to provide practical, commercially focussed advice to our clients around the world.

All references to 'Watson Farley & Williams', 'WFW' and 'the firm' in this document mean Watson Farley & Williams LLP and/or its affiliated entities. Any reference to a 'partner' means a member of Watson Farley & Williams LLP, or a member, partner, employee or consultant with equivalent standing and qualification in WFW Affiliated Entities. A list of members of Watson Farley & Williams LLP and their professional qualifications is open to inspection on request.

Watson Farley & Williams LLP is a limited liability partnership registered in England and Wales with registered number OC312252. It is authorised and regulated by the Solicitors Regulation Authority and its members are solicitors or registered foreign lawyers.

The information provided in this publication (the "Information") is for general and illustrative purposes only and it is not intended to provide advice whether that advice is financial, legal, accounting, tax or any other type of advice, and should not be relied upon in that regard. While every reasonable effort is made to ensure that the Information provided is accurate at the time of publication, no representation or warranty, express or implied, is made as to the accuracy, timeliness, completeness, validity or currency of the Information and WFW assume no responsibility to you or any third party for the consequences of any errors or omissions. To the maximum extent permitted by law, WFW shall not be liable for indirect or consequential loss or damage, including without limitation any loss or damage whatsoever arising from any use of this publication or the Information.

This publication constitutes attorney advertising.