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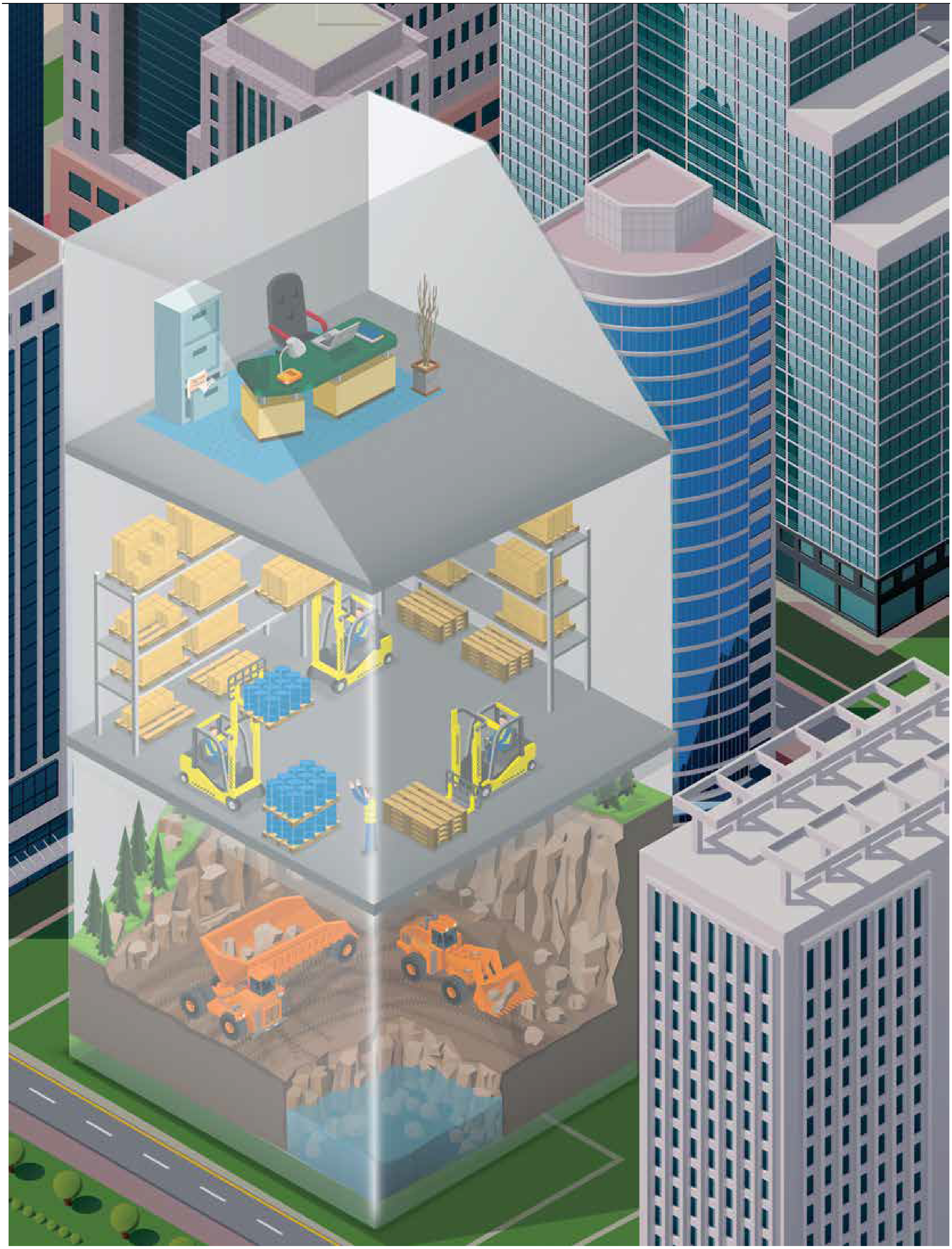
Complying with Transparency Requirements in Procurement and Avoiding Legal Pitfalls

Compliance and Ethics



CHEAT SHEET

- ***Know your supply chain.*** The United Kingdom leads the way in mandating that companies in a wide variety of industries verify that they do not do business with suppliers engaging in human trafficking.
- ***Mind your minerals.*** Companies operating in the United States face the task of verifying that any minerals they procure were not used to finance conflicts in the Congolese region.
- ***Beware of country-specific privacy laws.*** The EU forbids the transfer of personal data to countries without robust data privacy laws.
- ***Don't fear the regulator.*** Beware shareholder activism or class action suits from the general public, who may take an interest in your supply chain practices.

The past five years have seen a dramatic increase in supply chain and procurement transparency laws and regulations. Motivated largely by a desire to provide consumers with more information about the corporate practices employed by the companies from whom they make purchases, these laws require manufacturers and retailers to know more than ever about what goes on at each stage of global supply chains, and to disclose this information to consumers. As supply chains have become more global and diverse, however, this is no easy task. Even first-tier suppliers can be uncooperative and unresponsive. It is even more difficult to get information from raw material suppliers many steps removed from your supply chain.

However, legal departments need to ensure that they are up to this task. Failing to make required supply chain disclosures, and failing to ensure that these disclosures are correct can lead to a variety of unpleasant pitfalls, from government action compelling compliance, to lawsuits or bad publicity. Recent lawsuits filed against Costco and Nestlé USA Inc. allege that supplier conduct violated those companies' supply chain practices. Cases like these are likely to become more prevalent. Given the expanding regulatory framework, companies should expect transparency obligations to multiply.

This article will review the most prominent global supply chain transparency laws and regulations, discuss how companies can implement robust compliance programs, examine the pitfalls that can accompany supply chain policies and disclosures, and describe how to deal with problems that arise.

Prominent supply chain transparency regulation

Anti-slavery laws

Slavery and human trafficking thrive in opaque environments. Modern supply chains are complex and often opaque. Materials are shipped far from where they are bought and incorporated into finished goods that change hands along the way. Complex supply chains provide opportunities for bad actors. Governments increasingly rely on businesses to help stop these bad actors through laws and regulations that require companies to police their supply chains and publicly disclose their supply chain policies regarding slavery and human trafficking. Perhaps not surprisingly, in the United States, California has taken the lead in passing laws related to supply chain transparency, with the United Kingdom quickly following.

The California *Transparency in Supply Chains Act of 2010*, which became effective January 1, 2012, is designed to reduce human trafficking in corporate supply chains. This law, which applies to retailers and manufacturers doing business in California with annual revenues of US$100 million or more, requires companies to disclose detailed information on their websites describing the actions the company is taking to eradicate slavery and human trafficking in their supply chains. If no action is being taken, that must be affirmatively disclosed as well.

Specifically, compliance requires company disclosures to conspicuously state: (1) the extent to which companies verify that human trafficking and slavery are not taking place in their supply chains, including whether verification is done by third parties; (2) whether companies conduct supplier compliance audits; (3) whether companies require their suppliers to certify that their products comply with all applicable laws regarding slavery and human trafficking in the countries in which they do business; (4) whether companies maintain accountability standards and procedures for employees or contractors that fail to meet corporate slavery and human trafficking policies; and (5) whether supply chain employees and management are provided training on slavery and human trafficking.

Similarly, the United Kingdom's *Modern Slavery Act 2015* requires companies with revenues of £36 million and greater to disclose whether they are making efforts to eliminate slavery in supply chains. However, the UK law goes beyond the California law in that it applies to industries beyond retail and manufacturing. Like California, companies to which the UK law applies must publish annual "slavery and human trafficking statements" disclosing the steps they have taken to prevent slavery and human trafficking in their supply chains. The law includes suggested disclosure topics, including (1) corporate structure, business, and supply chain information; (2) information concerning company policies in relation to slavery and human trafficking; (3) information concerning company due diligence processes regarding slavery and human trafficking in the corporate business and supply chains; (4) corporate risk areas with respect to slavery and human trafficking, and the steps that responding companies have taken to assess and manage that risk; (5) information about responding companies' effectiveness in ensuring that slavery and human trafficking is not taking place, measured against performance indicators that responding companies consider appropriate; and (6) information concerning employee training on the subject of slavery and human trafficking. Disclosure statements must be approved by responding companies' boards of directors, signed by a director, and published on responding companies' websites. Alternatively, responding companies can state that they have not taken steps to eliminate slavery in their supply chains but, of course, this increases the risk of greater scrutiny and public pressure.

Additional laws are almost certain to follow. The "Business Supply Chain Transparency on Trafficking and Slavery Act of 2015" is currently pending before the United States House of Representatives. The law would amend the Securities Exchange Act of 1934 to require publicly-traded companies with more than US$100 million in global gross receipts to disclose in their annual reports and on their websites information describing any measures the company has taken to identify and address conditions of forced labor, slavery, human trafficking, and the worst forms of child labor within the company's supply chains. Similar legislation has also been proposed in New York.

Conflict minerals regulations

Amid growing reports that armed groups engaged in mining operations in the Democratic Republic of Congo region (Covered Countries), used mining proceeds to finance regional conflict, and subjected indigenous people to serious human rights abuses, the US government's Dodd-Frank Wall Street Reform and Consumer Protection Act, which included section 1502 (the Rule) covering conflict minerals, was passed. The Rule generally applies to all US publicly traded companies — or foreignowned companies — that are required to report to the Securities and Exchange Commission (SEC). It requires these companies to trace and audit how certain minerals — tantalum, tin, gold, and tungsten, collectively referred to as “3TG” — are purchased and ensure they do not originate from the Covered Countries. The Rule is not a prohibition on the use of conflict minerals; the Rule is a reporting obligation.

Adhering to the Rule is no easy task for many companies. The Rule itself, as codified in the Code of Federal Regulations (CFR), is only a few sentences, but the explanation and rationale for the Rule is 356 pages. According to a recent *Wall Street Journal* article, 90 percent of the 1,262 companies that filed conflict-minerals reports with US securities regulators last year said they could not determine whether their products were conflict-free.

“Conflict Minerals” are defined in Section 1502(e)(4) of the Rule as (A) columbite-tantalite, also known as coltan (the metal ore from which tantalum is extracted); cassiterite (the metal ore from which tin is extracted); gold; wolframite (the metal ore from which tungsten is extracted); or their derivatives; or (B) any other mineral or its derivatives determined by the Secretary of State to be financing conflict in the Democratic Republic of the Congo or an adjoining country.

If a company determines that it is using conflict minerals from one or more Covered Countries, and not as a recycled or scrap source, the company must complete a Conflict Minerals Report (CMR), conduct an independent audit of its due diligence process, and file its CMR with the SEC. That CMR must include: (1) a description of the company’s due diligence efforts to identify the source and chain of custody of the conflict minerals; (2) a disclosure of the country or countries of origin for the conflict minerals; (3) a description of efforts “to determine the mine or location of origin with the greatest possible specificity;” (4) a description of all facilities used to process the materials; and (5) a description of any products that are not “DRC conflict free.” Additionally, the SEC is very specific that to complete the CMR correctly, companies must follow a “nationally or internationally recognized” due diligence process which includes auditing by an independent private sector auditor.

If none of the company’s 3TG materials come from a Covered Country or only comes from recycled or scrap material, transparency obligations still exist. In these cases, a company must file a “Form SD” with the SEC, describing its due diligence process and providing a basis for why it “reasonably believe[s]” that its products “are from recycled or scrap sources.”

“Made in America” marketing and labeling requirements

In the United States, the appeal of purchasing something “Made in America” includes an implied commitment to quality, American jobs, and civic pride. Consumer Reports notes, given a choice and all things being equal, 78 percent of Americans would buy an American product over one from another country.

In an effort to keep jobs in the United States and level the playing field with cheaper imports, lawmakers at the US state and federal level have enacted a variety of laws requiring supply chain transparency for retailers that want to label or advertise their products as “Made in the USA.” Perhaps surprisingly, products are not required to be 100 percent domestically sourced in order to make this claim. On the federal level, the Federal Trade Commission (FTC) mandates that products “must be all or virtually all” produced in the United States to bear a “Made in the USA” label, but the FTC has refused to provide further guidance as to what “all or virtually all” means. If a retailer markets or labels a product as “Made in the USA,” it must have a “reasonable basis” for the claim at the time it was made. The FTC recommends diligence with suppliers before making “Made in the

USA" claims.

California has its own "Made in the USA" law, which recently was relaxed from its original 1961 requirements. Until September 1, 2015, products sold in California could not be advertised as being "Made in the USA" if any part of the product was "entirely or substantially made outside of the United States." However, as of January 1, 2016, California Senate Bill 633 will allow "Made in the USA" labeling if (1) less than five percent of a product's wholesale value comes from foreign components, or (2) less than 10 percent of a product's wholesale value comes from foreign components that are unavailable in the United States. No state other than California has adopted "Made in the USA" labeling or advertising requirements.

Furthermore, US law *requires* retailers of certain products to disclose if their products are manufactured in the United States. The Textile Fiber Products Identification Act and the Wool Products Labeling Act mandate a "Made in USA" label on textile or wool clothing and household products that are manufactured in the United States or fabric that is manufactured in the United States. Textile or wool products partially manufactured in the United States and partially manufactured elsewhere must be labeled to reflect both US and non-US manufacturing. (Catalogues and promotional materials that advertise textile and wool products, including on the internet, must also follow these labeling rules.) Finally, the American Automobile Labeling Act requires that automobiles sold in the United States bear labels disclosing where each car was assembled, the percentage of equipment that originated in the United States and Canada, and the country of origin of the engine and transmission. (These laws are separate and distinct from border protection laws and regulations that require country of origin identification for goods imported from one country to another, which are common worldwide.)

These labeling laws require companies to have transparency into where their supply chains source their components, which like other supply chain transparency laws, requires the cooperation of suppliers and sub-suppliers. It is not sufficient for a company to know from where its suppliers ship. Companies subject to "Made in the USA" laws must map the components' country of origin all the way down the supply chain to the origin of its raw materials. Making a mistake in this area can result in an FTC enforcement action or state law consumer lawsuits, both of which can entail penalties, injunctions, and mandated corrective advertising.

Data privacy laws

A number of countries have enacted data privacy laws to ensure that personal information collected by companies is not improperly used or disclosed. To date, over 80 countries have adopted data privacy laws, with the European Union having the most rigorous protections. EU data privacy laws require that companies notify individuals when data is collected, explain why data was collected, provide an opportunity to opt out of collection, and secure the data that is collected. EU data privacy laws also allow data collection only for specified and legitimate purposes.

The EU forbids the transfer of personal data to countries without sufficiently robust data privacy laws, which includes the United States. The United States has not yet passed any data privacy legislation. This restriction presents issues, and a heightened need for supply chain transparency, for supply chains that have both EU and US members. US companies can gain access to EU data by establishing that they have enacted corporate data protection measures that are as strong as EU laws require. Further, Mexico's data privacy laws are similar to those adopted in the European Union.

Thus, data privacy laws also require transparency into supply chain partners' data management practices. Violation of data privacy laws generally entails fines and penalties that can be substantial.

Pharmaceutical supply chain laws

US law now also requires pharmaceutical companies to begin to enable the identification and tracing of certain prescription drugs as they move through the supply chain. In 2013, the United States enacted the Drug Quality and Security Act (DQSA) to protect consumers from pharmaceutical contamination.

Title II of the DQSA requires participants in the pharmaceutical supply chain, over the next 10 years, to place unique product identifiers on prescription drug packages, create a system to trace pharmaceuticals as they flow through the supply chain and be able to verify, detect, and respond to issues in pharmaceutical supply chains promptly using this new product verification and tracing system. These new requirements obviously require a high degree of transparency in pharmaceutical supply chains and cooperation between supply chain partners.

Managing supply chain transparency disclosures properly

One thing is clear — managing supply chain disclosures is not a trivial exercise. Each of the laws identified require different types of information to be gathered and made available to the public. Simply stating that a company complies with applicable laws is not an option. Each company must determine what transparency obligations apply. However, it can be very difficult to find a definitive answer to that question. So what is a company to do?

First, understand the issue. Do you have in-house counsel fluent on supply chain risks and transparency obligations? If so, great. This is the person that should help you address compliance obligations in the supply chain. If not, now is the time to partner with outside counsel ASAP. Find an expert in this area willing to partner with your legal department and develop a plan of action for your company. However, be aware that someone from your company will need to remain closely involved to ensure that outside counsel fully understands your business and supply chain operations.

Second, understand that compliance is not a one-person-band. Accurate disclosure requires significant input from those within the organization that make product-design and product-sourcing decisions. As functional support for every department within the organization, in-house counsel is in the unique position to marshal the troops and establish cross-functional teams to examine product origins. Within large organizations or companies with highly complex products, these cross-functional meetings can be an interesting experience; the conference room may be filled with people who have never met or spoken to one another before, even though, collectively, these are the people who have created or sourced the individual parts that form your company's products. These team members will all contribute to the solutions that will shape your disclosures.

Third, decide which parts of the business will be covered by your disclosures and how much information will be shared. Transparency obligations vary depending on subject matter and applicable law. There may be legitimate business reasons why your company would want to share detailed information on one subject but not as much on another. Working with your supply chain counsel and cross-functional team, you will be able to determine what levels of disclosure make sense for your company.

Fourth, ensure that your company's supply chain professionals are aware of the laws that apply to supply chain disclosures. Confirm that employees responsible for making purchasing decisions, personally or through the legal department, are (1) performing due diligence on the company's suppliers; (2) reviewing contracts to make certain that suppliers are required to certify compliance with applicable laws; and (3) including contract language requiring suppliers to submit to mandatory compliance audits (and then do the audit!).

Finally, managing supply chain transparency risk cannot be done without training, and lots of it. Companies must identify potential areas and jurisdictions that pose risks and then invest in training the employees that work in this space. At a minimum, the trainee group should include those in supply chain management and procurement teams. Those making purchasing and sourcing decisions should be educated on the laws that apply to selecting suppliers and sourcing product.

Pitfalls of supply chain disclosures and how to manage them

By now, most legal departments understand that there are negative consequences associated with failing to manage supply chain transparency disclosures properly. In addition to the direct legal government action that can follow disclosure failures, there often can be significant indirect consequences as well.

The most significant indirect consequence comes in the form of civil lawsuits in US courts. Companies whose practices do not live up to their supply chain disclosures often find themselves the targets of US consumer and shareholder class actions. In August 2015, for example, Costco Wholesale Corporation and some of its supply chain partners were named as defendants in the first-ever California consumer class action alleging that the company failed to live up to its California Transparency in the Supply Chains Act disclosure statement.

A week after the Costco lawsuit was filed, a similar California class action was initiated against Nestlé USA Inc., alleging that Nestlé's supply chain practices violated its corporate supply chain policies regarding slavery and human trafficking. In both the Costco and Nestlé cases, the plaintiffs alleged that seafood products the companies obtained from waters near Thailand and Indonesia were harvested using illegally trafficked labor by their supply chain partners, in violation of the companies' anti-slavery policies. Both cases alleged violations of California's broad consumer protection and false advertising laws.

While the Costco and Nestlé cases are the first of their kind alleging violations of corporate anti-slavery supply chain policies, these cases have ample precedence in consumer class actions that allege improper "Made in the USA" labeling. Because the FTC has never provided specific guidance as to when foreign content reaches the level that a Made in the USA label becomes inappropriate, this area has been fraught with litigation. Many well-known US companies have been targets of lawsuits, including Sears & Robuck, Macy's, Citizens for Humanity, Peg Perego, Land's End, Nordstrom, Trader Joe's, and Weber. These cases often settle, typically with large plaintiff attorney fees, though a minority are litigated.

At least in theory, consumer class actions based on supply chain disclosures can be brought in any state based on any statement made by a retailer that consumers find relevant in their purchasing decisions. There is no requirement, for instance, that violations of a company's California Transparency in Supply Chains Act of 2010 disclosure statement be litigated in California only. Indeed, consumers could assert breaches of UK Modern Slavery Act disclosures as a basis for US litigation in any state, as long as they can prove that they relied on the disclosure and were damaged in some ascertainable way. While state law varies as to how similar consumers' reliance and damages have to be for a class to be certified, improper supply chain disclosures pose very real liability risks across jurisdictions.

These liability risks are not confined to consumer class actions. Shareholder class actions are also a possible consequence of supply chain disclosures that do not accurately describe a company's practices. For example, conflict minerals disclosures, as a creation of SEC rulemaking, pose an obvious risk of shareholder litigation, although no such cases have yet been filed.

Shareholder activism to address supply chain corporate social responsibility issues is nothing new, however. A prominent example of a shareholder lawsuit that focused on supply chain practices is the November 2012 litigation brought by the Louisiana Municipal Police Employees' Retirement System against The Hershey Company in Delaware Chancery Court. The Hershey lawsuit sought access to corporate records that allegedly would show that Hershey's executive management knew that Hershey's cocoa suppliers in West Africa used illegal child labor to harvest cocoa. Three years later, this case is still being litigated.

The challenge of consumer and shareholder litigation is that they tend to be one-party litigation, in which plaintiffs often must show little more than that they purchased the consumer product or company shares. This means the focus is entirely on the defendant's conduct. Defendants then bear the entire litigation burden of producing documents, preparing and appearing for depositions, and opposing class certification.

Class actions based on supply chain disclosures or practices are not indefensible, however. While some courts in California do not require plaintiffs to prove that all members of a proposed class relied equally on a retailer's representation or that they sustained identical damages (although some California decisions are not in accord), many other jurisdictions require plaintiffs to make this showing to certify a class. In consumer or shareholder cases involving supply chain practices, it is unlikely that all consumers or share purchasers would have relied on, or even considered, a seller's supply chain disclosure statements.

In addition, establishing that a company in fact followed its supply chain disclosures and policies is a great defense. Just as AriZona Beverages USA, LLC successfully defended itself against a consumer class action alleging that its products were not "all natural" by showing that they were, defendants in supply chain class actions can hopefully show that their operations are precisely as their supply chain disclosures and policies represent. In the Costco and Nestlé human trafficking cases, for instance, the corporate policies and disclosures at issue do not guarantee that the companies' supply chains are free from unsavory labor practices. Rather, they establish rules and procedures that the companies have adopted concerning human rights abuses — which very well may have been followed. Thus, while this new wave of litigation based on supply chain disclosure statements and policies may impact companies, companies that have enacted sensible compliance policies and manage them well may have viable defenses.

Conclusion

Serving as in-house counsel and advising public companies has always been a complex task, but it is becoming even more complex as the traditional policing roles of the government are being shifted to companies. Particularly, what was once a social and environmental concern is now a regulatory and shareholder consideration. This paradigm shift significantly impacts the role of in-house counsel and their relationship with supply chain and procurement colleagues.

Further Reading

See Calif. Bus. & Prof. Code § 17533.7.

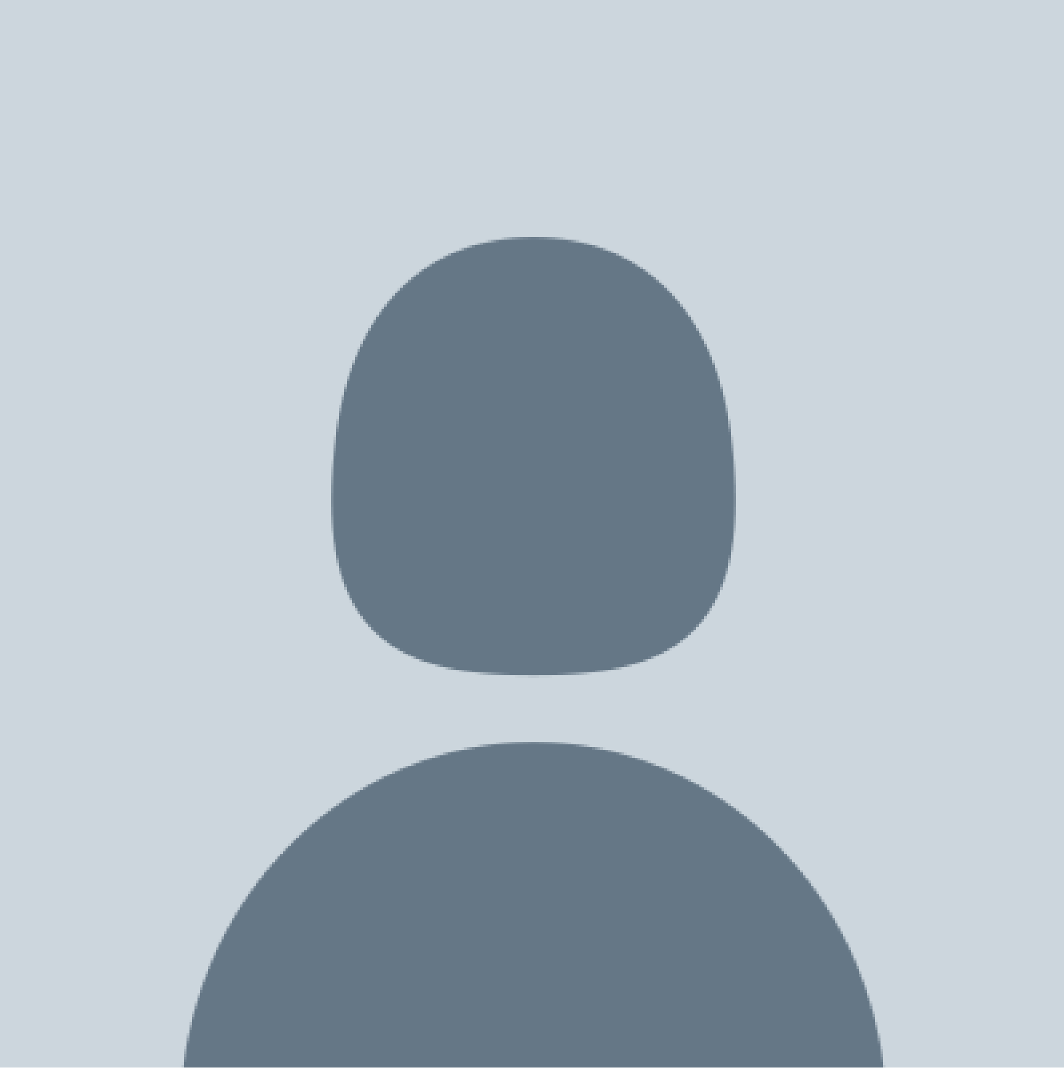
15 USC 41, et seq.

15 USC 68, et seq.

49 USC 32304.

21 USC 353, et seq.,

Anza D'Antonio

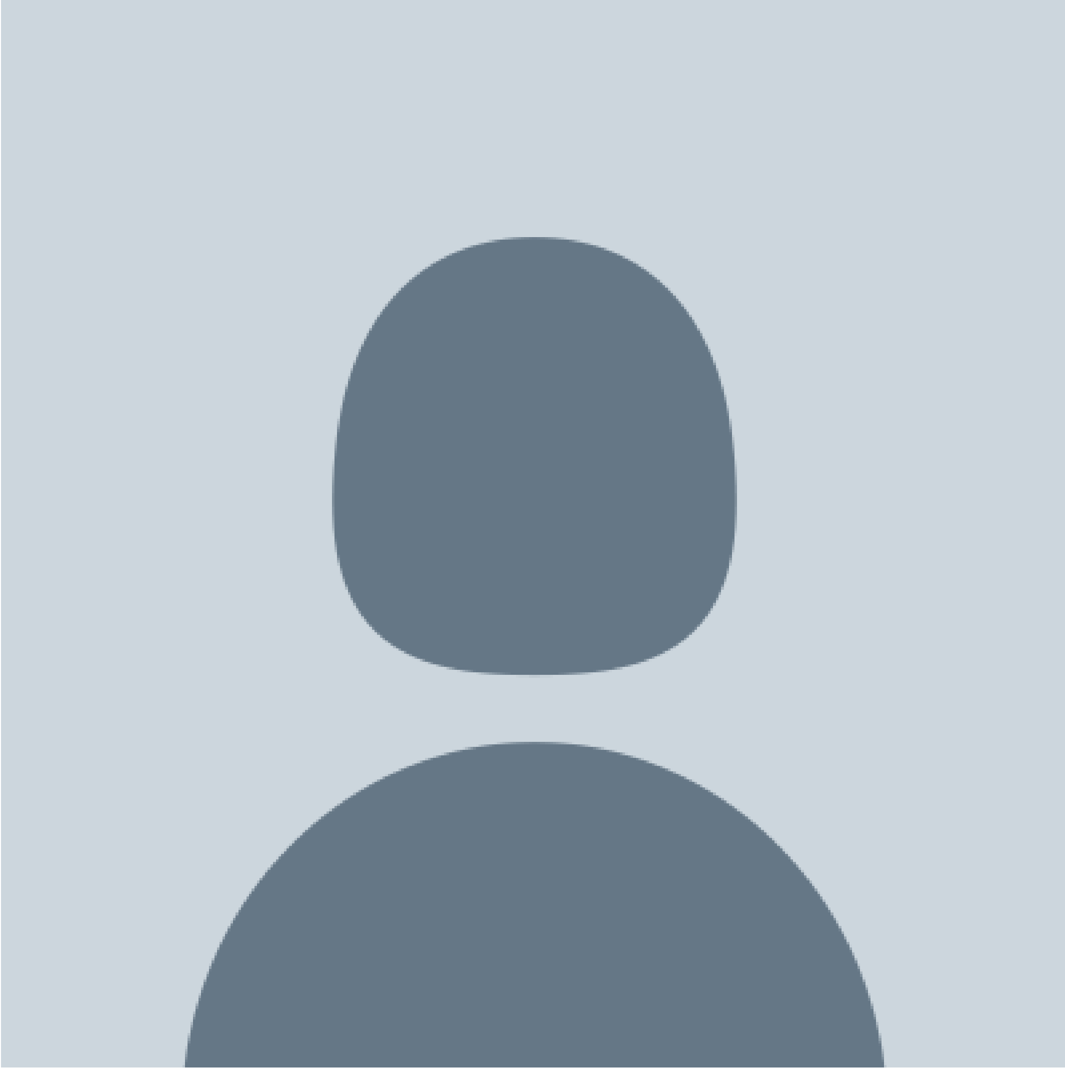


Assistant General Counsel

A. O. Smith

Anza D’Antonio has drafted just about every type of contract. She especially enjoys mitigating supply chain risk and providing quick, practical, and thoughtful advice on legal issues that impact innovative manufacturing companies.

Sarah Rathke



Partner

the Cleveland office of Squire Patton Boggs

She focuses her practice on supply chain issues, and primarily supply chain disputes. She is also an editor of the Squire Patton Boggs Global Supply Chain Law Blog.