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Preparing for the Next Compliance Battleground: Eliminating Trafficking, Forced Labor, Child Labor, and Slavery from Global Supply Chains

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A fresh wave of legislation designed to foster and promote what its backers alternatively describe as responsible corporate citizenship or corporate social responsibility is cresting on U.S. businesses' shores–and this time the aim is to combat the world's most serious forms of labor exploitation. But unlike, say, the Foreign Corrupt Practices Act[1] or the Dodd-Frank Act's proposed Conflict Mineral Provision,[2] this regulatory intervention designed to advance ethical and moral imperatives has arrived with little fanfare. That said, its importance should not go unnoticed. In fact, the requirements of substantial due diligence and disclosures, the corresponding threat of negative publicity in the case of non-compliance, state and federal legislative actions and public pronouncements, potential down-stream Alien Tort Claims Act lawsuits, and the real risk of class action lawsuits if disclosures are thought to be incomplete or inaccurate[3] are all signs that the vetting of global supply chains for evidence of human trafficking, forced labor, slavery, and child labor is poised to become the next hot topic in corporate boardrooms and compliance offices.

Deconstructing the Landmark California Transparency in Supply Chains Act

Labor exploitation, particularly in the developing world, is a genuine problem. A 2010 U.S. Department of Labor study, for example, found that some 128 different products from 70 countries were made with forced labor (which includes situations in which workers are forced to hand over nearly all of their wages to recruiters to pay off bogus "debts") and child labor in violation of international standards. Additionally, the U.S. Department of State's comprehensive Trafficking in Persons Reports[4] annually highlight those regions of the world having the greatest trafficking and labor exploitation issues.[5] Consider the case of Apple, even after applying significant (not to mention well-publicized) supply chain due diligence and vetting efforts, the company recently reported that over a quarter of its suppliers were not compliant with its labor and human rights standards (including 22 percent supplier non-compliance in the area of *forced labor*).[6]

Signaling the U.S. Government's authentic, strengthening intention both to recruit and motivate private enterprises into the supply chain fight, Secretary of State Hillary Rodham Clinton recently said:

> [T]he United States and the international community have made the solemn commitment to fight this scourge wherever it exists. . . . [The U.S. Government] must work with industry leaders so that consumers can know that the products or services they buy *come from responsible sources*.[7]

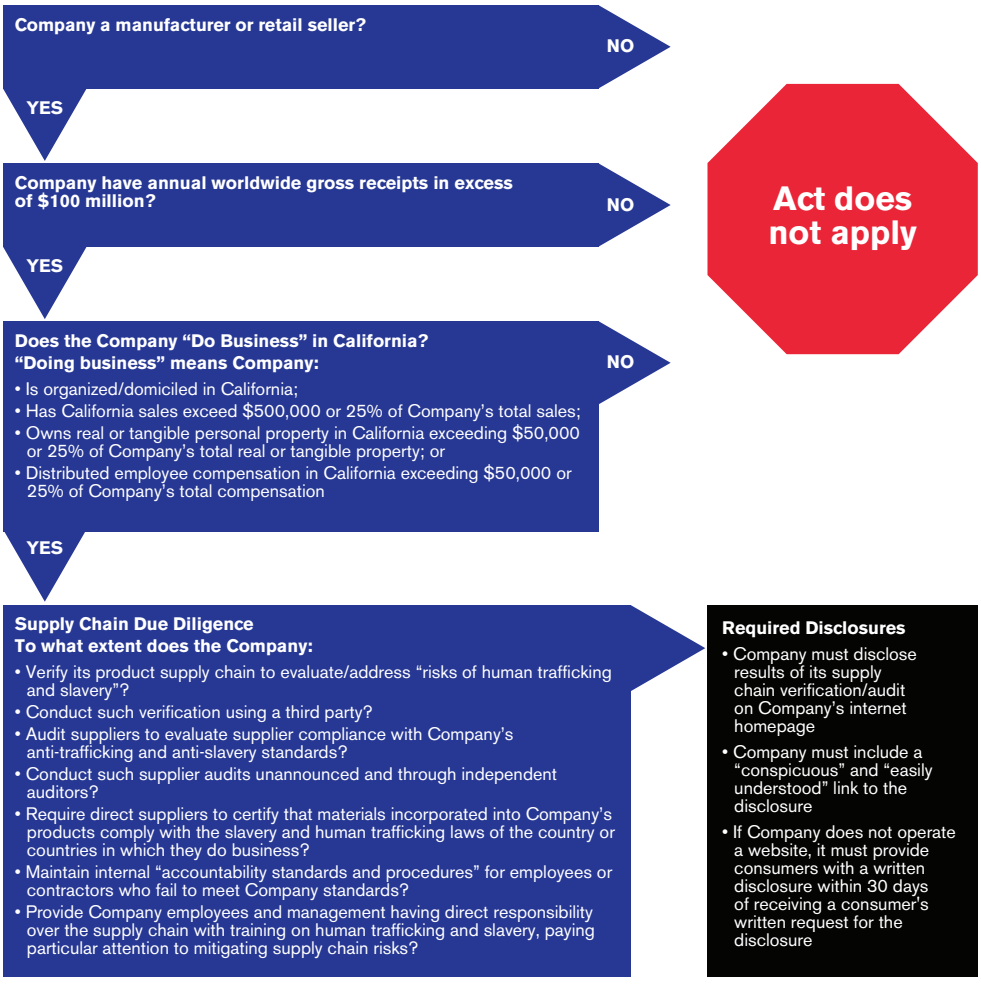
In response to such increasingly vocal calls for action, in 2011 the California legislature passed the landmark California Transparency in Supply Chains Act of 2010 (SB 657).[8] Effective January 1, 2012, the California Act requires qualifying companies to detail and publicly disclose the nature and scope of their efforts to eradicate human trafficking, slavery, child labor, and forced labor from their worldwide supply chains.

As sketched out in the below flow chart, to trigger the California Act's rather extensive disclosure provisions a company must:

1. Be a retail manufacturer/seller;
2. With annual gross worldwide receipts exceeding $100 million; and
3. Be "doing business" in California.[9]

The California Act's relatively broad definition of "doing business" includes companies that, for example, have California sales in excess of $500,000; own real or tangible personal property in California exceeding $50,000; or have a California payroll exceeding $50,000. Given California's economic standing as the ninth largest economy in the world, almost all global companies meeting the annual receipts threshold will likely have to comply with the Act's public disclosure requirements.

BREAKING DOWN THE CALIFORNIA TRANSPARENCY IN SUPPLY CHAINS ACT



Setting aside policy arguments about the wisdom of attempting to legislate responsible corporate citizenship overseas (and through often difficult-to-control third parties), the California Act's vision of a compliant supply chain certainly requires heightened corporate due diligence and vetting efforts. Consider, for example, that, as illustrated above, companies falling under the Act must report not only their training programs and efforts to audit and vet each and every one of their direct global suppliers, but they must *also* set forth what they have done to ensure that their *suppliers' suppliers* are compliant.

What this means is if, for example, a U.S. sporting goods retailer doing business in California purchases soccer shoes from an overseas supplier, the U.S. retailer is expected to not only ensure that the direct supplier/manufacturer of the shoes has not used trafficked, slave, forced, or child labor in the manufacturing of the shoes, but the U.S. retailer must *additionally* certify that the supplier's supplier(s)–including the overseas shoe manufacturer's source for the raw materials to make the shoe, such as the rubber soles, leather, and shoe laces–are not engaged in such labor practices. This, indeed, heralds a new era of supply chain scrutiny.

The California Act's net impact is that, for a company to be able to report a clean bill of supply chain health, the retailers or manufacturers must conduct relatively far-reaching due diligence into their various supply chains (and sub-chains). In turn, this might well change the contractual relationship between a manufacturer or retailer and its suppliers. Consider, for example, that a company subject to the Act might well find it necessary to:

(1) adopt contractual provisions conferring sweeping audit rights into its suppliers' labor practices;

(2) insist on broadly-worded, actionable representations, certifications, and warranties that address these labor practices; and

(3) include indemnification provisions that hold upstream suppliers responsible for any damages or liabilities it suffers–whether pecuniary or even reputational–for a contractual breach.

Given these heightened due diligence obligations, a company in theory could of course opt to violate the Act by not making the requisite disclosure, or, alternatively, could choose to publicly disclose that it has not conducted a thorough analysis of its supply chains. These largely unacceptable alternatives, combined with the specter of class action lawsuits for false advertising based on misleading disclosures, underscore the need for careful, strategic, and thorough supply chain due diligence conducted by experienced practitioners.

The Federal Response to California's Act: Introducing Congress' Business Transparency on Trafficking and Slavery Act

Hot on the heels of the California Supply Chains Act is the "Business Transparency on Trafficking and Slavery Act,"[10] introduced in Congress on August 1, 2011. If the Trafficking and Slavery Act's Congressional sponsors prevail, it will amend 15 U.S.C. § 78m (which, perhaps somewhat ironically, is located on the same legislative block as its older and much more well known sibling, the Foreign Corrupt Practices Act). This Act indeed picks up the California legislation's *leitmotiv*: "[T]he United States is the world's largest importer, and in the twenty-first century, investors, consumers, and broader civil society increasingly demand information about the human rights impact of products in the United States market." Put another way, the express intent is to fight global labor exploitation one supply chain at a time.

FEDERAL BILL H.R. 2759: "BUSINESS TRANSPARENCY ON TRAFFICKING AND SLAVERY ACT"

Company (1) publicly traded or (2) otherwise required to submit annual reports to the SEC?

NO → **Act does not apply**

YES ↓

Company have annual global receipts in excess of $100 million?

NO → **Act does not apply**

YES ↓

Supply Chain Due Diligence Concerning Forced Labor, Slavery, Human Trafficking, and the Worst Forms of Child Labor

Company must file annual report titled "Policies to Address Forced Labor, Slavery, Human Trafficking and the Worst Forms of Child Labor" detailing whether it:

- Maintains a policy aimed at identifying and eliminating supply chain risks concerning such exploitation.
  - If so, Company must disclose text or description of policy
- Prohibits use of Company's corporate products, facilities, or services to obtain or maintain persons under such exploitative conditions
- Verifies supply chain to evaluate and address such exploitation risks
  - If Company conducts such verification, it must disclose:
    - > Greatest risks identified within supply chain and measures taken to eliminate them
    - > Whether verification conducted by a third party
    - > Whether verification process (1) included consultations with independent unions, workers' associations or workers within the workplace, and (2) whether the results of such consultations were incorporated into the verification process
- Ensures that supplier audits are conducted in order to evaluate supplier compliance with Company policy/standards.
  - If audits conducted, are they conducted without advance notice and by independent auditors?
- Assesses suppliers' management & procurement systems to verify whether suppliers have in place appropriate systems to identify such exploitation risks within the suppliers' supply chain
- Requires supplier certification that materials incorporate into products comply with laws governing such exploitation in the countries in which they are doing business
- Maintains (1) internal accountability standards, (2) supply chain management and procurement systems, and (3) procedures concerning how to address employees or contractors failing to meet Company's standards.
  - If so, must describe standards and systems
- Provides training to Company employees and managment having direct responsibility for supply chain management (with special focus on risk mitigation)
- Ensures that suppliers' recruiting practices comply with Company's standards for eliminating exploitative labor practices contributing to such exploitation.
  - If so, must disclose whether labor recruiters are audited and results of any such audits

If exploitation identified in Company's supply chain, was remediation provided to the victims?

Required Disclosures

- Mandatory disclosures concerning answers to foregoing must be made available on Company's internet homepage through a "conspicuous and easily understood" link to Company's "Policies to Address Forced Labor, Slavery, Human Trafficking, and the Worst Forms of Child Labor."
- If no website, provide written disclosure within 30 days of investor or consumer's written request

As the above flow chart demonstrates, the Trafficking and Slavery Act by its own terms tracks the California Act in virtually all substantive aspects, and in those areas where there is a difference the pending bill is even more forward-leaning. If passed, the Trafficking and Slavery Act will in effect federalize (and, indeed, expand) the California Act's core requirements, thereby making it applicable to every company in the country falling within its jurisdictional reach.

The Laws of Other States

Other state laws can be used to charge companies found to have trafficked or forced child or slave labor in their supply chains. In terms of a broad overview, state approaches to business liability for human trafficking violations have generally fallen into three categories:

- *Approach #1: "Business as Persons" Approach*. Many states include business entities in the legal definition of a "person," thus imposing business liability under specific criminal offenses, without addressing it in a separate section.
- *Approach #2: Enhanced Penalties for Businesses*. Other states provide additional penalties, fines, and sanctions for businesses if the business is found liable. Like the first approach, however, this does not create a separate standard for finding businesses liable.
- *Approach #3: Separate Standards for Businesses*. Finally, some states provide a standard by which a business entity may be found liable for certain violations. For example, Georgia's statute states that "a corporation may be prosecuted under this Code section for an act or omission constituting a crime under this Code section only if an agent of the corporation performs the conduct which is an element of the crime while acting within the scope of his or her office or employment and on behalf of the corporation and the commission of the crime was either authorized,

  > requested, commanded, performed, or within the scope of his or her employment on behalf of the corporation or constituted a pattern of illegal activity that an agent of the company knew or should have known was occurring." A typical crime within this section provides that "[a] person commits the offense of trafficking a person for labor servitude when that person knowingly subjects another person to or maintains another person in labor servitude or knowingly recruits, entices, harbors, transports, provides, or obtains by any means another person for the purpose of labor servitude." In turn, "labor servitude" is defined as "work or service of economic or financial value which is performed or provided by another person and is induced or obtained by coercion or deception."

Although these laws certainly do not target the supply chain as directly as the California Act and the pending federal bill, they are worth noting because they are capable of being interpreted in a way that could create liability for companies who, for example, either know about or consciously disregard a high probability that their products are made with such exploited labor.

So What Is A Company To Do?

The California Transparency in Supply Chains Act and the Trafficking and Slavery Act both focus on companies with the greatest revenue (that is, those companies who, according to the laws' backers, have the most economic power over their supply chain). These same large, successful companies are also most easily targeted by consumer and human rights groups in the United States, Europe, and elsewhere. Whether from non-governmental organizations or from state, federal, and international government, the pressure to broadly mandate supply chain scrutiny is mounting. Vetting one's supply chain is quickly shaping up to be the new compliance–not to mention public relations[11]–crisis. But what is a savvy, proactive company to do?

In general terms, companies should consult with subject matter experts to: (1) assess their particular risk profile and identify the areas of greatest liability exposure; (2) devise appropriate standards of conduct and incorporate them into their existing policies and procedures; (3) implement these standards throughout their supply chain; and (4) devise an audit program and perform audits to vet their supply chain (and sub-chains) and, as needed, retain experienced white collar and investigations counsel to conduct internal investigations into potential instances of non-compliance and to help tailor appropriate crisis responses. These steps can of course be integrated into a broader corporate social responsibility policy that encompasses consideration such as safe working conditions, anti-corruption efforts, government/community/media relations, avoidance of significant environmental threats, and whistleblower protections.

Moving from the general to the specific, here are just some of the concrete steps a company that wants to stay ahead of this developing regulatory trend should consider:

- Integrate a clear, concise policy against the use of trafficked, forced, and child labor into the company's existing code of business conduct and ethics;
- Assess the company's supply chain risk profile by conducting country and industry-specific inquiries;
- Institute a training program for those employees and managers having direct responsibility over supply chain management in order to raise awareness and give company personnel the tools necessary to identify and respond to exploitative labor practices;
- Operate an anonymous hotline to which instances of labor exploitation can be reported;

- Maintain accountability standards and procedures for employees and transaction partners;
- Establish a system of basic due diligence for current and prospective suppliers, making labor-related questions part of the standard transaction partner questionnaires;
- Require direct suppliers to annually certify that materials incorporated into their products or services comply with the company's policy against trafficking, forced, and child labor, as well as with all applicable U.S. and foreign laws and regulations; and
- Conduct limited, targeted supplier audits to evaluate supplier compliance with company standards for labor exploitation.

Like it or not, the new era of supply chain due diligence is about to be upon us, so proactively designing appropriate measures to ward off negative public relations–not to mention costly litigation and adverse regulatory complications–is simply smart business.

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[1] *See generally* T. Markus Funk, *Breaking Down the FCPA and Travel Act*, *Bloomberg BNA* (Jan. 30, 2012).

[2] Under the SEC's proposed rules, issuers must disclose their use of conflict minerals (that is, cassiterite, columbite-tantalite, gold, wolframite, or any other minerals or their derivatives the State Department determines are used to finance the ongoing conflict in the Democratic Republic of Congo) in their annual reports to the SEC. Manufacturers of digital cameras, cellphones, computers, and video games, among a host of others, have raised objections to the new rules, pointing out the practical challenges of conducting country-of-origin, content, and supply-chain due diligence to determine whether even trace amounts of the minerals used in their products (or minerals an issuer obtains from recycled or scrap sources) can be certified "DRC Conflict Free."

[3] *See generally* David A. Wernick, "Secondary Stakeholders as Agents of Influence: Three Essays on Political Risk, Reputation and Multinational Performance," *Florida International University Digital Commons* (August 31, 2011) (finding that [t]he statistical analysis performed showed that target firms experience a significant decline in share price upon filing and that both industry and nature of the lawsuit are significantly and negatively related to shareholder wealth. . . . Given the sharp rise in human-rights related lawsuits against MNEs in recent years, managers need to have a better understanding of the likelihood and costs (both direct and indirect) of litigation prior entering new markets. . . . [A]ctivist groups sometimes choose their corporate targets with the aim of changing the practices of social performance laggards (i.e., based on what they do). But they also indicate that some [Alien Tort Statute] lawsuits are targeted at highly profitable firms, irrespective of their social performance (i.e., based on who they are). It is possible to infer from these results that stakeholder groups are motivated by both interest and identity-based rationales in choosing corporate targets for ATS lawsuits–a finding that is broadly consistent with past empirical research on stakeholder activism.").

[4] *See e.g.*, US Department of State, Trafficking in Persons Report 2011.

[5] *See generally* Secretary of State Hillary Clinton's Letter from the Secretary, Trafficking in Persons Report 2011 ("We must improve the capacity of governments to protect victims and hold traffickers accountable. Countries known for well-established adherence to the rule of law cannot just rest on their laurels, but must work to deliver the justice and services that trafficking victims deserve.").

[6] *See* Apple 2012 Progress Report (available on the company's website) (last visited February 15, 2012).

[7] *Id.* (Emphasis added).

[8] Codified in Section 1714.43 of the California Civil Code and Section 19547.5 of the California Revenue and Taxation Code.

[9] If any of the following apply, then a company is considered to be "doing business" in California: the company actively engaged in transactions for the purpose of financial or pecuniary gain or profit (1) is domiciled in California; (2) has annual sales in California exceeding the lesser of $500,000 or 25 percent of the company's total assets; (3) owns real property or tangible personal property in California exceeding the lesser of $50,000 or 25 percent of the company's total real or tangible property; or (4) provides compensation in California exceeding the lesser of $50,000 or 25 percent of the company's total compensation. *See* California Revenue and Taxation Code Section 23101(a).

[10] H.R. 2759, 112th Cong. (2011).

[11] Negative PR consequences include private political activity such as boycotts, protests, civil lawsuits, and shareholder (proxy) resolutions, as well as public political activities such as lobbying legislators and regulators and seeking favorable judicial interpretations.