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## CALIFORNIA TRANSPARENCY IN SUPPLY CHAINS ACT

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On January 1, 2012, the California Transparency in Supply Chains Act of 2010<sup>1</sup> (the “Act”) will become effective. This legislation will require every large retailer and manufacturer doing business in California to publicly disclose whether it has taken specified actions to eliminate slavery and human trafficking<sup>2</sup> from its product supply chain. The Act does not require a company to make any effort to eliminate slavery or human trafficking, but only to disclose the extent, if any, to which it has taken the actions listed in the Act. The impact of the Act ultimately will depend on the extent to which consumers, investors and activists use the required disclosure to pressure companies to monitor and eliminate abuses in their supply chains. On August 1, 2011, federal legislation modeled on the Act was introduced.<sup>3</sup>

### Purposes of the Act

California’s economy is the tenth largest in the world, with a GDP of \$1.8 trillion. The Act is premised on the belief that the magnitude of California’s economy enables California businesses and consumers to demand products produced without the use of slavery and human trafficking.<sup>4</sup> The Act seeks to encourage companies doing business in California to voluntarily take steps to eliminate slavery and human trafficking from their supply chains by providing consumers with the information necessary to patronize those companies that manage their supply chains in a socially responsible manner.<sup>5</sup> In addition, the Act seeks to level the playing field for socially responsible companies in their effort to compete against companies that seek to obtain an unfair advantage by reducing their cost of goods by purchasing products from suppliers who use forced labor.

### Required Disclosure

The Act requires every retail seller and manufacturer doing business in California and having annual worldwide gross receipts of more than \$100 million to disclose, at a minimum, to what extent, if any, it takes the actions described below to eliminate slavery and human trafficking from its direct supply chain for tangible goods offered for sale. The required disclosure must be posted on the company’s website with a conspicuous and easily understood link to the information on the homepage. If the company does not have a website, a consumer must be provided the disclosure in writing within 30 days of the company receiving a written request from the consumer.

The required disclosure, at a minimum, shall set forth to what extent, if any, the company does each of the following:

- engages in verification of product supply chains to evaluate and address risks of slavery and human trafficking, and disclose if the verification was not conducted by a third party;
- conducts audits of suppliers to evaluate supplier compliance with company standards for slavery



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and human trafficking in supply chains, and disclose if the audits were not independent and unannounced;

- requires direct suppliers to certify that materials incorporated into the product comply with the laws regarding slavery and human trafficking of the countries in which they are doing business;
- maintains internal accountability standards and procedures for employees or contractors failing to meet company standards regarding slavery and human trafficking; and
- provides company employees and management, who have direct responsibility for supply chain management, training on slavery and human trafficking, particularly with respect to mitigating risks within the supply chains of products.

#### Companies Subject to the Act

The Act applies to every “retail seller” and “manufacturer” that is “doing business in the state” of California and has annual worldwide “gross receipts” in excess of \$100 million,<sup>6</sup> as each of these terms is defined in the Act. An estimated 3,200 companies, or approximately 3.2% of the companies doing business in California, which account for over 87% of the total sales of goods in California, are subject to the Act.<sup>7</sup>

A “retail seller” or “manufacturer” is a business entity that has retail trade or manufacturing, respectively, as its principal business activity code as reported on its California tax return.<sup>8</sup>

A company is considered to be “doing business in the state” of California if any of the following conditions is met:<sup>9</sup>

- it is organized or commercially domiciled in California;
- sales in California<sup>10</sup> for the applicable tax year exceed the lesser of \$500,000 or 25 percent of the company’s total sales;
- the real property and the tangible personal property of the company in California exceeds the lesser of \$50,000 or 25 percent of the company’s total real property and tangible personal property; or
- the amount paid in California by the company for compensation exceeds the lesser of \$50,000 or 25 percent of the total compensation paid by the company.

A company meeting any of these four conditions and hav-

ing annual worldwide gross receipts in excess of \$100 million is subject to the Act even if it is organized or domiciled outside of California. The threshold is based on global gross receipts. Large retailers and manufacturers domiciled outside of California may be subject to the Act even if their operations in California are relatively small. The requirement that annual worldwide gross receipts exceed \$100 million was intended to exempt only those companies that lack the ability to exert economic influence on their suppliers. It was not intended to exempt larger companies with the power to eliminate abuse from their supply chains but that only have relatively small operations in California.<sup>11</sup>

The term “gross receipts” means gross amounts realized on the sale or exchange of property in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code.<sup>12</sup>

A company that is not itself subject to the Act, either because it is not doing business in California or because it does not have annual worldwide gross receipts in excess of \$100 million, nevertheless may be affected by the Act as a result of the compliance efforts of its customers that are subject to the Act. It is likely that the Act will result in an increase in the number of large retailers and manufacturers that require suppliers to certify as to the absence of human rights abuses, adopt human rights policies, perform internal audits, establish employee grievance procedures, and submit to audits by the customer and independent auditors.

#### Remedies

The exclusive remedy for a violation of the Act is an action brought by the state Attorney General for injunctive relief.<sup>13</sup> The Franchise Tax Board is required to provide annually to the Attorney General a list of companies subject to the Act based upon the prior year tax returns.<sup>14</sup>

The Act also provides that it shall not be construed to limit remedies available for a violation of any other state or federal law.<sup>15</sup> The California Unfair Competition Law<sup>16</sup> and the Consumers Legal Remedies Act<sup>17</sup> may allow a consumer, competitor, or activist to seek actual damages, punitive damages, injunctive relief, restitution, ancillary relief and attorneys’ fees

for the failure to comply with the Act or any misstatement in the disclosure made in response to the Act. In addition, a company that seeks to affect the business practices of its suppliers should consider the possibility that such efforts may make it a “joint employer” responsible for the suppliers’ treatment of their workers.<sup>18</sup>

### Evolution of the Act

As initially proposed, the Act required retailers and manufacturers doing business in California to take certain actions to eliminate forced labor from their supply chains. The required actions included developing and implementing a policy that, at a minimum, (1) committed the company and all of the suppliers in its supply chain (including suppliers of the raw material incorporated into the product) to comply with the laws regarding forced labor in the countries in which they do business, and (2) obligated the company to make a good faith effort to eradicate forced labor from its supply chain and not merely “stop doing business in the area where it discovers that its supply chain is tainted by slavery or human trafficking.” The proposed bill initially exempted only companies having less than \$2 million in annual sales. The proposed bill also would have established a nine-member commission composed of political appointees to investigate complaints concerning forced labor or the failure of a company to have a policy complying with the statute, to establish educational programs and “best practices,” to review company policies and certify that the policies comply with “best practices,” to recommend additional legislation, and to “charge fees to companies who use its services.” Four members would have been appointed from nominees of a statewide business organization, three from nominees of an organization whose primary purpose is the eradication of slavery and human trafficking, and one as a representative of organized labor nominated by the California Labor Federation, and one would have been the Secretary of Business, Transportation and Housing. As a result of the opposition of the California Chamber of Commerce and other business groups, the bill was amended to require only that a company subject to the Act publicly disclose the extent, if any, to which it has voluntarily taken specific actions to eliminate slavery and human trafficking from its supply chain.<sup>19</sup>

### Responding to the Act

As adopted, the Act does not impose any substantive regulation on supply chain management, including any affirmative duty to determine whether forced labor exists in the supply chain. A company could comply with the Act by simply disclosing that it has no policy regarding, and does not monitor, labor conditions involved in the production of its products or the materials incorporated in its products. This response, however, may have a negative public relations consequence with a cost far greater than what would have been incurred in implementing a policy and internal controls to monitor and mitigate the negative impact of forced labor in the supply chain.<sup>20</sup> Human rights organizations can be expected to develop score cards to evaluate a company’s commitment to eliminating forced labor from its supply chain based upon the disclosure made in response to the Act. Socially responsible investors and consumers are likely to be influenced by the attendant publicity in making their investment and purchasing decisions. Furthermore, the proliferation of shareholder proposals<sup>21</sup> and legislation<sup>22</sup> relating to corporate social responsibility suggests that governments, investors, consumers and other stakeholders increasingly will demand that companies take adequate measures to identify, prevent and mitigate the potential impact on human rights associated with their business operations and to remediate any actual impact they cause or to which they contribute.<sup>23</sup> A company with detailed knowledge of its supply chain, including the role played by forced labor, will be better able to respond to the continuing evolution of legislative, investor and consumer sentiment regarding corporate social responsibility, as well as maximize the efficiency of its supply chain.

The means that a company should employ to address human rights abuses in its supply chain may depend on many factors, including the complexity and geographic extent of the supply chain, the company’s importance to its suppliers, the availability of alternative suppliers, the depth of the company’s management resources, and whether it conducts business through a corporate group, as well as the severity of the adverse human rights impact. The process of addressing a company’s human rights impact is ongoing with the risk changing over time as the company’s operations evolve. The process should

be initiated early in the development of a new business activity or relationship so that potential human rights risks can be identified, prevented or mitigated at the stage of structuring the activity or relationship, and should be renewed throughout the life of the activity or relationship prior to major decisions such as product launch, design changes or changes in sourcing. With the varying ability of retailers and manufacturers to affect the labor practices of their suppliers, there is no one-size-fits-all response to the Act. The elements that may be considered include the following:

- Assess the likelihood that the supply chain is tainted by slavery and human trafficking in light of the specific circumstances of the company's operations, and the business, legal and reputational risks to the company. A high-end retailer of leading U.S. brands may rely more heavily on its suppliers' own policing of their manufacturing operations and supply chains than a seller of value-priced, private label merchandise produced in less developed nations.
- Develop a company policy on slavery and human trafficking. The adoption of a policy forcefully condemning forced labor is a necessary, but not in itself sufficient, response to the legal, operational and reputational risks associated with a supply chain tainted by human rights abuses or to the demands of investors, customers and other stakeholders for the elimination of forced labor from the product supply chain. The rejection of forced labor should be embodied in processes that identify, prevent and mitigate the impact of forced labor in the supply chain, such as those processes described below.
- Communicate the company's policy to suppliers, managers, employees, investors, customers and other stakeholders on a regular basis.
- Assess the risk of forced labor presented by each direct supplier. The initial risk assessment may be based on factors such as the supplier's location, the type of product provided, publicly available information concerning the supplier's record of respect for human rights, and reports of human rights organizations. Higher risk suppliers may be required to complete a self-assessment questionnaire to

identify problematic practices, thereby promoting a dialog between the company and the supplier concerning the company's expectations, and providing a basis on which to develop a plan to rectify deficiencies.

- Implement mechanisms to verify and audit compliance by suppliers. Consider the role of internal audits and self-reporting by suppliers, the use of the company's own employees to conduct audits, the appropriate circumstances in which to use independent auditors, the use of key performance indicators and anonymous employee grievance procedures, and the practicality of forming a coalition of similarly situated customers to jointly implement verification and auditing procedures. Consider imposing on the company's direct suppliers the responsibility for monitoring compliance of their own suppliers.
- Integrate the policy into the management of the supply chain. Determine the functional area within the company that will be responsible for implementing the company's policy, and establish incentives and consequences to ensure accountability. Consider making compliance with the company's policy an explicit condition of supplier agreements and purchase orders and requiring suppliers to certify that the products provided by them, and the materials incorporated in these products, are manufactured in compliance with the company's policy and the laws relating to slavery and human trafficking of the countries in which the suppliers do business. Provide training on the company's policy to employees of the company and its suppliers on a regular basis.
- Determine the consequences of a supplier's failure to comply with the company's policy, taking into account the repugnance of forced labor, as well as the importance of the product or service to the company's operations, the availability of alternative sources, and whether terminating the supplier relationship would itself have adverse human rights consequences. In general, it would be appropriate to require a supplier using forced labor (or engaging in any other practice that presents a risk of serious harm to the health or safety of the supplier's community) to immediately rectify the violation or be terminated

as a supplier. The correction should be verified through follow up audits. Where the company may lack the ability to effect change in the behavior of a supplier, consider methods of enhancing the company's leverage, such as collaborating with similarly situated customers.

- Consider methods of enhancing the ability of suppliers to comply with the company's policy, such as assisting suppliers in developing their internal audit capability and employee grievance procedures.
- Review the content of the company's website disclosure, as well as other forms of publicly disclosing the extent and effectiveness of the company's efforts to eliminate forced labor from its supply chain.

### Conclusion

With the effective date of the Act rapidly approaching, large retailers and manufacturers doing business in California must be prepared to respond to the disclosure requirements of the Act. Whether as a matter of corporate social responsibility or to manage their public image, they also should consider the extent to which they will go beyond the minimum requirements of the Act and seek to address the existence of slavery and human trafficking in their supply chains. ■

### Endnotes

1 California Senate Bill 657, *available at* [http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb\\_0651-0700/sb\\_657\\_bill\\_20100930\\_chaptered.pdf](http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb_0651-0700/sb_657_bill_20100930_chaptered.pdf), codified as section 1714.43 of the California Civil Code and section 19547.5 of the California Revenue and Taxation Code.

2 The definition of "human trafficking" is contained in California Revenue and Taxation Code section 236.1. For convenience, the term "forced labor" is used in this article synonymously with "slavery and human trafficking," although not all cases of forced labor involve slavery or human trafficking.

3 Business Transparency on Trafficking and Slavery Act, H.R. 2759, *available at* <http://www.govtrack.us/congress/bill.xpd?bill=h112-2759>, if enacted, would require every company required to file periodic reports with the U.S. Securities and Exchange Commission to disclose in its annual report and internet homepage the measures it has taken to identify and address

slavery, human trafficking, forced labor and child labor within its supply chains, including the extent to which the reporting person has taken the specific actions set forth in the bill.

4 California State Assembly Committee on Judiciary, Analysis of Senate Bill 657, June 28, 2010, at 9, *available at* [http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb\\_0651-0700/sb\\_657\\_cfa\\_20100628\\_112914\\_asm\\_comm.html](http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb_0651-0700/sb_657_cfa_20100628_112914_asm_comm.html), notes that "California consumers and businesses appear to be uniquely positioned to drive human rights violations out of the supply chain of products sold within California borders by virtue of their . . . choice and simple purchasing power."

5 Section 2 of the Act provides, in part: "The Legislature finds and declares . . . (j) [i]t is the policy of this state to ensure large retailers and manufacturers provide consumers with information regarding their efforts to eradicate slavery and human trafficking from their supply chains, to educate consumers on how to purchase goods produced by companies that responsibly manage their supply chains, and, thereby, to improve the lives of victims of slavery and human trafficking."

6 The legislative history does not contain any analysis of whether a company with gross receipts of \$100 million is of a sufficient size to affect the labor practices of its suppliers.

7 California State Assembly Committee on Judiciary, Analysis of Senate Bill 657, June 28, 2010, at 9-10.

8 CAL. CIV. CODE § 1714.43(a)(2)(C)-(D).

9 CAL. CIV. CODE § 1714.43(a)(2)(A); CAL. REV. & TAX. CODE § 23101.

10 Sales of the company are deemed to include sales by an agent or independent contractor. *See* CAL. REV. & TAX. CODE § 23101. Whether sales are deemed to be in California is determined using the rules contained in California Revenue and Taxation Code sections 25135-25136 and the regulations thereunder.

11 California State Assembly Committee on Judiciary, Analysis of Senate Bill 657, June 28, 2010, at 9.

12 CAL. CIV. CODE § 1714.43(a)(2)(B); CAL. REV. & TAX. CODE § 25120.

13 CAL. CIV. CODE § 1714.43(d).

14 CAL. REV. & TAX. CODE § 19547.5.

15 CAL. CIV. CODE § 1714.43(d).

16 California Business and Professions Code sections 17200-17209 protect consumers and competitors against unlawful, fraudulent, or unfair business acts and practices, and section 17500 prohibits false advertising.

17 California Civil Code sections 1750-1784 protect consumers against specified practices in a transaction involving the sale or lease of goods or services to a consumer, including “representing that goods or services have sponsorship, approval, characteristics, ingredients, uses, benefits, or quantities which they do not have.”

18 *But see Doe I v. Wal-Mart Stores, Inc.*, 572 F.3d 677, 682-683 (9th Cir. 2009) (finding a code of conduct included in a U.S. retailer’s supply contracts with foreign suppliers did not result in the retailer being deemed the employer of the suppliers’ employees on the facts alleged).

19 The letters of the California Chamber of Commerce in opposition to the Act are *available at* <http://www.calchamber.com/Pages/BillSearch.aspx>.

20 In a letter dated June 24, 2010 to the Assembly Committee on Judiciary, opposing passage of the Act, *available at* <http://www.blob.capitoltrack.com/09blobs/f0981bed-65fe-498e-a0bl-4bdebb173670>, the California Chamber of Commerce and other business organizations noted: “The effect of this legislation . . . will be to hold certain companies up for ridicule and condemnation for ‘failing’ to address issues they are powerless to address.”

21 For a review of shareholder proposals on environmental and social issues during the 2011 proxy season in the United States, see Institutional Shareholder Services, Inc., 2011 U.S. Season Review: E&S Proposals, *available at* <http://www.iss-governance.com/docs/ESProposals>.

22 Recent legislation includes section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (requiring SEC reporting companies to disclose whether products contain certain minerals produced in the Democratic Republic of the Congo or an adjoining country); section 1504 of the Dodd-Frank Act (requiring SEC reporting companies in extractive industries to disclose payments to governments); and California’s green chemistry initiative, codified as sections 25252-25257.1 of the California Health and Safety Code

(increasing regulatory authority over chemicals in consumer products.)

23 On June 16, 2011, the United Nations Human Rights Council endorsed a comprehensive set of guiding principles regarding the responsibility of businesses to address the adverse impact on human rights of their operations. The United States co-sponsored the resolution. The guiding principles are a part of the Report of the Special Representative of the Secretary General on the Issue of Human Rights and Transnational Corporations and Other Business Entities, *available at* <http://www.ohchr.org/EN/Issues/TransnationalCorporations/Pages/SRS-GTransCorpIndex.aspx>.