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California Transparency in Supply Chains Act – First 90 Days

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Introduction

Many retail sellers and manufacturers doing business in California are subject to the website disclosure requirements of California's Transparency in Supply Chains Act, effective since January 1, 2012. The new law requires a large group of firms in these sectors to disclose their efforts to eradicate slavery and human trafficking from direct supply chains.

Companies have responded with a range of compliance approaches. Selected website disclosures in the first 90 days of the Act's application show initial compliance trends. Those companies subject to the disclosure requirements are imposing new requirements on their suppliers.

Uncertainty regarding best practices for disclosure under the Act remains because of the absence of guidance or enforcement action by California's Attorney General. Existing and proposed federal legislation in related areas should be considered in reviewing and planning compliance.

Companies Subject to the Act

All "retail sellers" and manufacturers "doing business in California" and having \$100,000,000 or more in annual worldwide gross receipts must comply with the Act.

- Retail seller or manufacturer. A company is a "retail seller" or manufacturer if it identifies retail trade or manufacturing as its principal business activity on its California tax return.
- Doing business in California. This term is defined by California Revenue and Taxation Code section 23101. A recent amendment to this statute, effective January 1, 2011, broadened the nexus standard for companies formed in other jurisdictions to be treated as "doing business in California."

Under this new standard, a company is treated as doing business in California if it actively engages in any transaction for the purpose of financial or pecuniary gain or profit in California or satisfies any of the following conditions:

1. the company is organized or commercially domiciled in California;
2. sales of the company in California exceed the lesser of \$500,000 or 25 percent of total sales;
3. real property and tangible personal property of the company in California exceed the lesser of \$50,000 or 25 percent of the taxpayer's total real property and tangible personal property; or
4. the amount paid by the company in California for compensation exceeds the lesser of \$50,000 or 25 percent of total compensation paid.

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Website Disclosure

Link and Location

Companies subject to the Act must place a conspicuous and easily understood link to the disclosures on their website home pages.

Disclosure Subject Matter

The Act requires disclosure indicating whether the retail seller or manufacturer does each of the following:

1. Engages in verifications of product supply chains to evaluate and address risks of human trafficking and slavery. The disclosure must specify if the verification was not conducted by a third party.
2. Conducts audits of suppliers to evaluate supplier compliance with company standards for prohibiting human trafficking and slavery in supply chains. The disclosure must specify if the verification was not an independent, unannounced audit.
3. Requires “direct suppliers” to certify that materials incorporated into the product comply with the laws regarding slavery and human trafficking of the country or countries in which they are doing business.
4. Maintains internal accountability standards and procedures for employees or contractors failing to meet company standards prohibiting slavery and human trafficking.
5. Provides company employees and management who have direct responsibility for supply chain management with training on human trafficking and slavery, particularly with respect to mitigating risks within the supply chains of products.

The Act requires that companies disclose the information about their supply chain compliance activities referred to above, but does not require companies to take specific verification, audit, certification, internal accountability and training actions.

Trends in Selected Disclosures – First 90 Days

Website Disclosure Link(s) and Location

Some retail sellers and manufacturers have posted a direct link to the disclosure on their homepage, with the title of the Act contained in the title of the link. Others have included the disclosure several “clicks” away from their homepage, with the initial link on the homepage, for example, stating “social responsibility.” The format and location of the disclosure content varies accordingly, either in html on the linked page or in a pdf document that is accessed from the linked page.

The Act does not specify whether the website home page link text is required to include a specific reference to the Act, or whether for purposes of the Act it is sufficiently conspicuous and easily understood for a specific reference to the Act and its criteria to appear only in a page or document elsewhere in the website.

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Verification, Audits and Certification

Companies' disclosures to date regarding verification and audits in most cases describe existing supply chain compliance policies and practices implemented prior to the Act. These suggest in particular that use of independent third parties to provide related verification and audits is not yet standard practice across industries.

In a few instances, disclosing companies' references to the Act are made in the context of well-publicized plans to launch initiatives relying on independent third parties to verify and audit compliance with international and local labor and human rights standards that include prohibitions of slavery and human trafficking. Disclosures of companies' requirements for direct supplier certification as called for by the Act so far is largely contained in descriptions of general qualification procedures, policies, representations and warranties required of suppliers that enter into supply agreements with the retail sellers and manufacturers.

Several of the largest retailers have required all of their suppliers and vendors to certify compliance. The language and scope of the certifications have varied, but in each instance companies required to provide the certification are being forced to reevaluate their own supply chains.

Defining "Verification"

The Act uses but does not define this term. Reference to the following definition of "verification" in pending federal legislation that would impose similar disclosure requirements may be helpful in reviewing and planning Act compliance:

the process by which a company is evaluated to determine compliance with its documented program, including standards on forced labor, slavery, human trafficking, and the worst forms of child labor, including an evaluation of (i) data gathered through monitoring activities to ensure results are reliable and process is credible; and (ii) the system established to remediate violations to determine if remediation is implemented and effective.¹

This pending legislation also would provide that verifications must "describe the greatest risk identified within the supply chain, and the measures taken toward eliminating those risks."²

In addition, a consultative group established by federal legislation, Section 3205 of the Food, Conservation, and Energy Act of 2008, has reported on verification criteria relevant to assessing use of forced labor and child labor that may serve as references in analyzing the Act. This suggests that a third-party verification includes, "an evaluation of the company's entire documented program to determine compliance to the program as well as to the standards for child labor and forced labor. It includes witnessing the company evaluating its suppliers."³

Defining "Direct" Supplier

The Act also does not define or provide criteria to identify a "direct" supplier, in comparison to an indirect supplier. Prior to the Act's final bill draft, the proposed legislation would have required

¹ H.R. 2759, 112th Cong., at 10-11 (2011).

² *Id.*

³ Consultative Group to Eliminate the Use of Child Labor and Forced Labor in Imported Agricultural Products, Report, Pub. L. 110-246, at p. 20 (December 15, 2010).

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companies to disclose whether they “require[d] suppliers to certify that raw materials incorporated in the product comply with the laws...”

In the final draft of the bill, however, the California Legislature limited the disclosure requirement to direct suppliers and deleted the word “raw” preceding “materials.” Consensus has not yet developed on other sources of authority that may serve as references in distinguishing direct suppliers from others for purposes of Act disclosure.

Internal Accountability and Training

Disclosures of internal accountability structures and activities so far appear to refer to practices that apply generally to governance and internal controls relevant to procurement and supply operations. Disclosures regarding employees and management training emphasize subjects that are more specifically related to international, and in some cases local, labor and human rights standards that include prohibitions of slavery and human trafficking.

Enforcement

California’s Attorney General is responsible for enforcing compliance with the Act. The Act requires the California Franchise Tax Board to provide to the California Attorney General by November 30, 2012, a list of companies that are subject to the Act’s requirements, based on information contained in these companies’ California tax returns.

The sole remedy provided under the Act for non-compliance is an action by the Attorney General seeking injunctive relief. The Act does not authorize actions by private individuals. It has not been established whether other bases for actions by private individuals related to the Act’s requirements would be recognized.

There is no publicly available information indicating that the Attorney General has commenced enforcement action or provided guidance under the Act.

Existing and Proposed Legislation in Related Areas

California enacted the Act against the background of U.S. federal and California laws imposing criminal and civil penalties for slavery and human trafficking.⁴ In addition, each of the United States’ seventeen free trade agreements currently in force requires member countries to implement laws addressing forced labor and child labor.

A bill was introduced in the House of Representative on August 1, 2011, entitled the Business Transparency on Trafficking and Slavery Act (the “Federal Act”).⁵ The Federal Act would amend Section 13 of the Securities Exchange Act of 1934 to require companies issuing securities registered with the Securities and Exchange Commission (“issuers”) to disclose their efforts to eradicate forced labor, slavery, human trafficking, and the worst forms of child labor. The Federal Act would require ten categories of disclosures, including disclosures similar to California’s Transparency in Supply Chains Act regarding verifications, audits, certifications, internal accountability, and training. In addition to requiring the disclosures in an issuer’s annual report, the Federal Act would require a

⁴ Consultative Group to Eliminate the Use of Child Labor and Forced Labor in Imported Agricultural Products, Report, Pub. L. 110-246, at p. 20 (December 15, 2010).

⁵ H.R. 2759, 112th Cong. (2011).

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company to disclose the same information on the company's website, accessible through a link on the company's homepage.

In addition, in October 2011 the House Committee on Foreign Affairs voted to amend the Trafficking Victims Protection Reauthorization Act.⁶ The amendment would require the Secretary of State to encourage companies to disclose their efforts to eradicate forced labor, slavery, human trafficking, and the worst forms of child labor. The disclosure mandate in this amendment mirrors the disclosure requirements in the Federal Act.

Conclusion

Initial trends in disclosure approaches under the Act continue to develop. For companies subject to the Act, reference to pending federal legislation that would impose similar disclosure requirements may be helpful in analyzing terms used and not defined in the Act.

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⁶ Amendment to the Amendment in the Nature of a Substitute to H.R. 2830, 112th Cong. (2011).