

E-Bulletin

SUPPLY CHAIN DUE DILIGENCE AND THE GROWING RISKS OF FAILING TO EFFECTIVELY MONITOR YOUR SUPPLIERS

Over the past few years, it has become evident that there is growing legal and reputational risk for companies in the Western world that have failed to adequately monitor and remedy substandard working conditions in the factories of their suppliers in the developing world. The fact that such suppliers are not subsidiaries or affiliated in any corporate sense increasingly does not insulate them from liability. Such issues have become particularly acute in the textile and apparel sector where vast quantities of textiles and apparel destined for Western consumers is now produced in developing countries such as Bangladesh and Vietnam.

The sourcing of specific minerals from certain African countries afflicted by civil war has also become an important issue following the passage of the conflict minerals legislation in the U.S. as part of the Dodd Frank amendments. What these two seemingly dissimilar industrial sectors have in common is a growing legal liability and reputational risk that can arise if sourcing of products for their supply chains is not subject to adequate due diligence and ongoing monitoring, particularly in the developing world.

The Bangladesh Factory Collapse

On April 24, 2013, a horrific building collapse at the Rana Plaza factory complex in Dhaka, Bangladesh resulted in the deaths of over 1000 garment workers. This event, together with a series of previous fires and other factory mishaps has put the spotlight on large and small Western apparel manufacturers and retailers operating in least-developed countries such as Bangladesh.

The lessons learned in this unfortunate incident are also relevant to companies with transnational operations in other industrial sectors unrelated to the textile and clothing sector where supply chain issues recently rose to prominence.

Initiatives to Deal with Working conditions in the Textile and Clothing Sector

1- Private Sector

A number of such retailers in Western Europe and North America, including Walmart, Gap, Target, Adidas, Esprit, Tesco, Mothercare and numerous others, have undertaken two separate initiatives whose aims are to improve the safety and security of local employees in Bangladeshi garment factories following the factory collapse in 2013.

These two agreements are the **Accord on Fire and Building Safety in Bangladesh** and the **Alliance for Bangladesh Worker Safety**.

- **The Accord on Fire and Building Safety in Bangladesh**, is a private regulatory code whose signatories include over 150 apparel corporations from 20 countries, two global trade unions, and numerous Bangladeshi unions. The Accord puts in place building and fire safety inspection and training programs and includes a comprehensive inspection program for Bangladesh garment factories. The Accord is a five-year, legally binding agreement between international labor organizations, non-governmental organizations, and retailers engaged in the textile industry to maintain minimum safety standards in the Bangladesh textile industry. The objective of the Accord is to create an environment for a safe and sustainable Bangladeshi ready-made garment industry where workers need not fear fires, building collapses, or other accidents preventable through reasonable health and safety measures. The Accord was signed by a first group of companies in May 2013 and numerous companies have subsequently signed on since that time. In October 2013, it was announced that 1,600 Bangladeshi factories were covered by the accord, representing about 1/3 of the Bangladeshi textile industry. Evidently much remains to be done in this area to achieve fuller coverage.
- **The Alliance for Bangladesh Worker Safety**, which is comprised of 26 North American retailers,¹ has embarked on a comprehensive program of factory inspection. As of June 2014, the Alliance has submitted 10 factories to the Government Established Review Panel for consideration of factory suspension or closure.

¹ This group of 26 currently includes the following companies: Ariela and Associates International LLC; Canadian Tire Corporation, Limited; Carter's Inc.; The Children's Place Retail Stores Inc.; Costco Wholesale Corporation; Fruit of the Loom, Inc.; Gap Inc.; Giant Tiger; Hudson's Bay Company; IFG Corp.; Intradeco Apparel; J.C. Penney Company Inc.; The Jones Group Inc.; Jordache Enterprises, Inc.; The Just Group; Kohl's Department Stores; L. L. Bean Inc.; M. Hidayat & Company Inc.; Macy's; Nordstrom Inc.; Public Clothing Company; Sears Holdings Corporation; Target Corporation; VF Corporation; and Wal-Mart Stores, Inc.; YM Inc.

To address these challenges, foreign apparel distributors and retailers are increasingly taking the initiative to ensure that safety issues are identified and adequately addressed and that sufficient funds are made available to carry out monitoring and repair work, while workers at these factories continue to receive salaries and wages for the work they do

2- Government Sector Initiatives

The Government of Bangladesh and local industry representatives have also created a “Tripartite National Plan of Action on Fire Safety for the Ready-Made Garment (RMG) Sector” to improve safety standards in Bangladeshi factories. The Plan utilizes expert panels, headed by the Bangladesh University of Engineering and Technology (BUET) in its work program.

However recent factory inspections by the Bangladeshi authorities have continued to uncover serious building code violations, including issues such as cracked support beams, extra floors built without required permits and exposed electrical cables. Overweight structures on roofs, widespread use of substandard building materials and reportedly even an unauthorized helicopter pad were also among the problems revealed in the first round of inspection reports.

An associated serious concern for organizations with significant supply chains in developing countries is bribery and corruption, particularly as it relates to the reliability and credibility of safety inspections and certifications. In the case of Bangladesh for example, under Transparency International's Corruption Perception Index (CPI), Bangladesh is ranked 136 (out of 177 countries) with a score of 27 (out of 100). The CPI scores are based on how corrupt a country's public sector is perceived to be. The lower the score, the more corrupt the country.

Knowing complicity in the payment of bribes by local suppliers under contract to foreign retailers can in some circumstances, lead to serious criminal liability under anti-corruption legislation prohibiting the paying of bribes to foreign government officials in all OECD countries, including the U.S. Canada, the United Kingdom, Germany, France and Australia. Apart from criminal liability, there is the equally unappetizing prospect of severe reputational damages to a retail brand arising out of a company's indiscriminate purchase of garments from factories in the developing world that fail to meet basic minimum standards.

3- Coordination Issues

These various government and private sector initiatives have, in some cases, led to problems of coordination including:

- Supplier factories driven by high production targets in a very competitive garment sector have had to face numerous, continuous and often overlapping inspections from different groups.
- Given the lack of “ownership” of the entire safety initiative across all three of the above named groups, there is a problem of accountability in the event that violations occur particularly when such violations lead to injury or loss of life.

There is also the related problem of who should be responsible for mitigating the risk of corruption in factory safety inspections. In mid-2013, seven inspectors in Bangladesh were suspended after having reportedly renewed licenses without bothering to check safety conditions in the Rana Plaza building that collapsed on April 24 in Dhaka, killing more than 1,000 people. This incident might well have been prevented if adequate anti-corruption measures had been more strictly enforced. Western retailers are increasingly feeling compelled to ensure that adequate anti-corruption measures be undertaken in their suppliers’ operations.

4- The Challenge

Given both the risks arising out of claims of bribery and corruption under the legislation outlawing payment of bribes to foreign officials in most Western countries, as well as the significant reputational risk involved in doing business with garment factories that violate factory safety, human rights and anti-corruption norms, companies with significant transnational operations should focus on creating and implementing a comprehensive supply chain governance, risk, and compliance program across their entire supply chain.

This in turn will require that companies integrate their compliance, risk, and audit programs including initial supplier’s compliance assessments, security and anti-corruption audits, corporate social responsibility compliance audits, quality inspections, production capacity audits, sustainability audits and environmental compliance audits to obtain a comprehensive view of their suppliers’ performance. The company’s Chief Compliance Officer (CCO) should work with the supply chain, CSR and sourcing teams to mitigate the risk of corruption and non-compliance with home country law as well as local law in the jurisdictions where the suppliers operate.

5- Developing Your Company’s Supply Chain Governance, Risk Management and Compliance Program

Companies with transnational operations, including textile and clothing distributors and retailers, can address the risks arising out of corruption and factory safety violations by adopting a number of measures including:

- **Implementation of a stringent supplier pre-qualification process:** this would involve conducting a risk assessment of a supplier prior to contracting with them, involving the collection and verification of the accuracy of supplier information including its production capacity, facility conditions, supplier's own supply chain and its use of sub-contractors. If the information provided raises any doubts, an independent third-party audit should be conducted to verify the details, and identify alternative suppliers if needed.
- **Implementation of a risk-centered supplier compliance program:** identify and understand the prevalent compliance and corruption risks in the supplier's country. This necessarily involves conducting due diligence, and implement effective risk mitigation controls on a continuing basis.
- **Establish rights to supply chain monitoring in the supply chain contractual framework itself** – this includes developing supplier codes of conduct with restrictions or prohibitions on sub-contracting, broad audit rights and provisions for indemnification by suppliers if liability arises from non-compliance.
- **Monitor supplier activities on an ongoing basis:** Establish headquarters as well as local teams to monitor supplier operations and third-party dealings on a continuous basis.
- **Foster dialogue and collaboration with suppliers rather than a confrontational attitude:** In some instances, the institution of a whistle-blower program to address employee concerns and incidents of non-compliance can be very beneficial.

6- The Legal Dimension

All of the measures recommended above will require appropriate documentation that is drafted to cover both national legal concerns as well as the legal requirements of the jurisdiction where the apparel is being produced. As well, supplier contracts, supplier codes of conduct and appropriate procedures for vetting new suppliers and monitoring their performance must be drafted. These documents will necessarily include adequate contractual frameworks and related procedures for the rules to be enforced and should conform to both national and international norms of corporate social responsibility.

Conclusion

A robust compliance program, covering the establishment of ethical supply chains as well as their ongoing operation and governance, can help a company to achieve satisfactory levels of factory safety, increase its ability to monitor and improve performance, meet other legal and regulatory compliance obligations and help avoid future harm to the company's reputation in the marketplace.



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To the extent that a company can effectively coordinate various aspects of its compliance programs, issues of duplication of effort and inefficiency in meeting anti-bribery, corruption and other compliance obligations can be minimized, if not avoided altogether.

Sills Egsgard LLP, a Toronto-based law firm specializing in international trade and investment and related regulatory compliance issues, has the experience to help your firm develop the necessary internal systems to ensure that an ethical supply chain structure is in place for your company's operations.

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