Reuters Legal News

ESG and supply chain: rethinking contracts

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NOVEMBER 4, 2021

In the first article in this series, we provided an overview of ESG-related risks and opportunities specifically in the context of complex global supply chains, including in relation to security and resilience, and potential exposures in different jurisdictions that may arise, such as litigation and regulatory risks; political and trade-related risks; and, of course, market and reputational risks. In the remainder of this series, we will consider specific risks and laws. In this article, however, we want to focus on the opportunity.

The global supply chain is undeniably a triumph of human imagination and ingenuity. Until the pandemic, it was "the invisible function" providing goods and services steadily faster, better and cheaper yet hardly creating a ripple. Goods and services have flowed smoothly for decades despite religious, cultural, linguistic and national differences. Billions of people have been lifted out of poverty, and vast wealth has been created.

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In our experience, that has been the result of extraordinarily skilled, hard-working people in procurement, manufacturing, logistics and other supply chain functions. Even when we are involved in a contentious dispute, we see that an incredible amount of the work is accomplished through good-faith collaboration across enterprises and engineering with a relentless focus on specificity and innovation. The transparency permitted by cloud computing, smart devices, supply chain software and other technology is only accelerating the capabilities of supply chain professionals.

This presents a great opportunity in that "Two-thirds of the average company's environment, social, and governance footprint lies with suppliers." ("Buying into a more sustainable value chain," McKinsey, Sept. 22, 2021, https://mck.co/3BBgLXZ.) And, supply chain teams have for decades been optimizing ESG-like objectives for cost reasons, such as reducing energy and raw material requirements to reduce cost and finding new production methods that broaden opportunity for people to join the workforce to increase their access to lower-cost labor.

The challenge, as supply chain professionals know, is that supply chains are built to maximize the value of the products over the costs. Traditionally, the value of products has been calculated based on the net revenue from reselling the products obtained from suppliers, which are in the end determined by what the end consumer will pay. And, traditionally, what the end consumer will pay depends little on the ESG impact of the product.

The supply chain will not be directed toward ESG objectives through high-level platitudes or even demands that every supplier represent and warrant its compliance with particular goals. As David Snyder and Susan Maslow wrote as chairs of the Working Group to Draft Model Contract Clauses to Protect Human Rights in International Supply Chains, American Bar Association (ABA) Section of Business Law:

> "The regime of representations and warranties, with their accompanying strict liability—if they are not true, there is breach — is unrealistic and ineffective, and often so much so as to be downright fictitious. Frequently, this regime is thought to lead to what is called a 'tickbox' or 'checkbox' approach to supply chain management in which buyers require a laundry list of representations of compliance from their suppliers. Suppliers mechanistically provide them by checking the boxes, and everyone goes home happy (although they may be more than a little resentful of time wasted filling forms). Little is achieved." *See* Full Report: Balancing Buyer and Supplier Responsibilities in International Supply Chains, https://bit.ly/3CIq3mv.

Generally, broad contractual requirements only have a weak effect if the managers at the buyer and supplier are aligned on some other objective, such as obtaining products at the minimum cost. Lisa Bernstein, professor at the University of Chicago Law School, is one of the world's pre-eminent scholars on how supply markets actually function. She notes that while the "shadow of the law" has an influence, the "shadow of the future" is more important. Suppliers care most about whether the buyer will reduce the buy, terminate, impose costly requirements, delay or withhold payments or harm the supplier's reputation. Litigation and damages are, for the most part, relatively remote possibilities.

There are two requirements for generating ESG progress through the supply chain: metrics and measurements. Everyone involved — the managers at every company, the procurement and contracting teams, and the engineers — needs to have *measurable targets* that can be used as requirements in engineering, sourcing and accepting delivery. With that, a supply chain that produces everything from fast fashion to planes that fly for decades can turn itself, end to end, to achieving the measurable targets. However, as Japanese quality innovator Taiichi Ohno is often quoted as saying, "Without a standard, there can be no improvement."

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There is good news on setting of measurable targets. Many key supply chain participants are setting clear targets for themselves. Science Based Targets (https://bit.ly/3EGvW43), for example, reports as of Oct. 29, 2021, 998 companies with science-based targets and 96 with "ambitions for 1.5°C." Also, organizations are rapidly identifying metrics, such as the 21 core and 34 expanded metrics that the World Economic Forum recommended in September 2020 (https://bit.ly/3mEwhOw) and the S&P Global Corporate Sustainability Assessment (https://bit.ly/3bAl2As). At the same time, governments are increasingly performing their role in managing externalities by setting measurable targets.

For this to succeed, however, it will require a great deal of innovation in the legal arrangements. Contracts with metrics primarily around delivery time, conformance to requirements and cost must be rewritten to include ESG goals and metrics. And, those metrics must be defined in ways that are meaningful and measurable, reducing the risk that gaps, ambiguities and conflicts will allow suppliers to report that they have achieved targets without in fact doing so.

The new contracts must address the fact that suppliers are for-profit businesses that may not, on their own, value the ESG objectives. As the ABA Working Group noted, buyers may need to rethink their own contracts and demands that may make it more difficult to achieve ESG objectives.

We look forward, in this series, to considering ways for supply chain participants to work together to achieve ESG objectives, and we are confident that the supply chain is a substantial part of the solution to ESG challenges.

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This article was first published on Reuters Legal News and Westlaw Today on November 4, 2021.