

# Implementing ESG plans through supply chain contracts

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With a new year underway, the climate emergency continues to impact, and draw the attention of, political, corporate, and civil society actors around the world, particularly following the mixed success of the COP 26 United Nations Climate Change Conference in November 2021. Against this backdrop, we continue our series of articles considering Environmental, Social and Governance (ESG)-related factors in the context of complex global supply chains by taking a closer look at the “E” of ESG.

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The last two years have presented major, often unprecedented, challenges, for global supply chains. The complexity, occasional fragility, and, often, inflexibility of those supply chains quickly became apparent as regions of the world, and workforces, went into lockdown and became subject to significant restrictions. The reaction, amongst many businesses, has been to review, closely and quickly, existing supply chain features and priorities, and often to use the opportunity to incorporate, and seek to embed, the “ESG principles” already in place within the buyer organisation itself, into supply chain mechanisms.

As we discussed here (<https://bit.ly/33tolck>), the global supply chain has performed an “invisible function” for decades, allowing the smooth flow of goods and services across national and regional boundaries, regardless of linguistic, cultural, religious and other differences, and notwithstanding geographical and political difficulties. Now, the supply chain is highly visible, with many businesses having to contend with delayed orders, or, as has increasingly been the case (as reported in The Financial Times, for example: “Is there an end in sight to supply chain disruption?” Jan. 9, 2022) an inability to secure freight space on container ships. As a result, the supply chain is under new scrutiny.

This new scrutiny is upending traditional ideas about relationships between buyers and sellers. Once, it seemed that buyers had the luxury, for the most part, of focusing on timely delivery of conforming goods at agreed prices. Now, prodded by highly visible supply chain problems, improving sustainability may well be a

top priority because stakeholders are increasingly aware of supply chains and increasingly likely to blame businesses and brands for failings in their supply chain. However, businesses reliant on supply chains, whilst potentially vulnerable, are also well-placed to encourage, and indeed demand, changes in approach and behaviour from and within their suppliers.

As a result, many businesses are incorporating specific, and detailed, contractual provisions into their supply chain arrangements which govern environment sustainability, whether that be in the context of progressing towards Net Zero; ensuring sustainable land use; identifying water shortages within the supply chain; or reducing food waste. Often those are drawn from the business’ or brand’s stated environmental goals or applicable laws. Here, we focus on emissions as an example.

It has been estimated by the CDP (<https://bit.ly/33pjbyb>), an international non-profit organisation focused on environmental disclosures, that an average company’s supply chain greenhouse gas (GHG) emissions are somewhere in the region of 11.4 times greater than those generated by the company’s direct operations. Thus, regulations specifically focused on GHG emissions reductions are emerging apace, and companies are starting to be held responsible for Scope 3 emissions (that is, indirect emissions or emissions associated with supply chains, in accordance with the Greenhouse Gas Protocol [<https://bit.ly/3ldL8rm>]).

The United Kingdom, for example, has adopted and enshrined in law (<https://bit.ly/3rsvt0w>) an emissions reduction target of 78% by 2035, and regulations increasingly demand emissions reporting (an early example being the Streamlined Energy and Carbon Reporting (SECR) Regulations), not only of the company’s own GHG emissions, but also of those within the supply chain. Judicial attention within the European Union is beginning to focus on holding major companies responsible for Scope 3 emissions. Failing to address supply chain emissions in a meaningful way has begun to create regulatory and litigation exposures that may once have been fanciful.

The supply chain offers businesses tremendous opportunities to reduce emissions. The World Economic Forum published its “Net-Zero Challenge: The supply chain opportunity” (<https://bit.ly/3A8aXX2>) report in early 2021. The WEF report identified how businesses can multiply their carbon impact through their supply chains, particularly where those supply chains may involve sectors and/or jurisdictions in which climate change may not be such a

high priority. The WEF recommended that companies cooperate with suppliers, lawmakers and regulators to increase transparency, develop performance metrics, and set meaningful targets for decarbonising supply chains.

How is this achieved in practice? The foundation consists of enforceable promises by suppliers to reduce and report GHG emissions. Express obligations (often by reference to those contained in the UN Paris Agreement) and reporting standards (often incorporating the Greenhouse Gas Protocol), together with express acknowledgments by the supplier of the buyer's Net Zero targets, are added to supply chain contracts. There may be commitments to implement specific organisational targets and plans (which might include, for example, committing to a Net Zero Target validated by the Science Based Targets initiative [<https://bit.ly/34SkKos>]; and/or signing up to the United Nations Race to Zero campaign [<https://bit.ly/34W1JBv>]); measurably reduce, or off-set, GHG emissions; and provide annual emissions reports (usually supported by representations and warranties as to the content of such reports) for the full supply chain.

Some suppliers re-engineer and re-tool to be able to make commitments that will retain or win business from customers who value emissions reductions. It is now common for businesses to commit to stopping, or planning to stop, sourcing from suppliers who negatively impact their carbon reduction commitments. A survey conducted by Standard Chartered (<https://bit.ly/33w6UrF>) in 2021 found that 78% of multinational corporations interviewed planned to remove slow-to-transition suppliers by 2025.

In addition to choosing suppliers based on their emissions profiles, buyers can negotiate for specific contractual commitments. For example, supply contracts can include payments tied to demonstrated reductions in GHG emissions, higher prices for products made with lower environmental impact, or

reimbursements for completing specific energy efficiency projects. Because of the long-term nature of the investments required by suppliers, buyers may offer long-term purchase commitments with premium prices, accept slower but more energy-efficient delivery, or sacrifice some emissions-intensive aspects of goods.

Buyers may also act directly. For example, in contract manufacturing arrangements, buyers have long provided tooling, equipment, raw materials, engineering, and other vital inputs. In those arrangements, buyers often have rights, for example, to swap out equipment for more energy-efficient models, designate a lower-carbon supplier of energy, or do additional engineering. The relevant provisions from contract manufacturing can also be applied in other supply arrangements.

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This is all easier said than done. There are hard choices about the trade-offs between Scope 3 emissions and other critical priorities. It can be difficult to model or verify the effect of an operational or technical change on GHG emissions. Compliance, monitoring and enforcement are costly. And, contractual terms must address the complex business, technical and regulatory challenges in ways that will work in practice and support the buyer's ESG goals.

In further articles in this series, we plan to provide practical, commercial suggestions for how to move forward.

## About the authors



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