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Alerts

ESG Continues to Extend its Reach into Global Supply Chains

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In our latest edition of the *ESG Business Insights* alert series, we take a look at why Environmental, Social, and Governance (ESG) is no longer a matter of concern just for publicly held or large businesses compiling formalized ESG disclosures or reporting.

In fact, ESG is increasingly reaching into value and supply chains. The result is every business along those chains could be made to take up ESG efforts, regardless of a given business's order of magnitude.

We outline seven of the latest indicators of this shift:

1. Supply Chain Scrutiny

As an initial matter, overlooking supply chains in crafting and implementing ESG strategies could scuttle those plans. Businesses that fail to address ESG factors in their supply chains expose themselves to regulatory, litigation, and reputational risk based on claims that their ESG representations do not accurately reflect what the business is doing and how it is doing it.

That means that the entities in those supply chains will, in turn, be called upon to undertake ESG efforts and make ESG disclosures on which the businesses to whom they supply goods and services can rely.

2. Consumer Market Demands

Market demands are creating ESG pressure for supply chains.

In 2021, PwC reported that 76 percent of consumers would "discontinue their relationships with companies that treated the environment, employees or the community in which they operate poorly."

And, even more recently, McKinsey reported on a five-year survey of United States sales data across 44,00 brands in 32 different categories. The results indicated higher consumer loyalty to brands with more ESG claims.

Attorneys

Emma Elizabeth "Bessie" Antin Daschbach

Service Areas

Sustainability & ESG

To the extent the expectations of consumer markets may be shifting, so may be how businesses are meeting consumer demands, which could very well include adjustments at the supply chain level.

3. Scope 3 Emissions Reporting

In March of last year, the U.S. Securities and Exchange Commission (SEC) proposed rule changes that would require companies to disclose information about greenhouse gas emissions—namely:

direct emissions (Scope 1),

indirect emissions arising from purchased energy (Scope 2), and

emissions from upstream and downstream activities (Scope 3).

The proposal remains pending, and the inclusion of Scope 3 emissions has been hotly debated. But, if the rule passes with Scope 3 intact, every publicly listed company will be required to look back into its supply chain for emissions data, and businesses in those supply chains will, in turn, be called upon to deliver that data.

Even the SEC's rules aside, the pressure is on for businesses in supply chains to level up as ESG frameworks coming online elsewhere already include Scope 3 emissions. The biggest news in the U.S. on this front is California's passing its own emissions reporting rules. Governor Newsom signed SB253 into law in October. That rule will require all reporting entities (i.e., all businesses "doing business" in California that meet the specified $1 billion revenue threshold) to disclose Scope 3 emissions.

Pressure from outside the U.S. is also mounting. The E.U.'s Corporate Sustainability Reporting Directive (CSRD) went into effect in January. Its reach is sweeping, extending reporting obligations from 11,000 companies to more than 50,000. The related first set of European Sustainability Reporting Standards (ESRS) adopted in July include disclosures as to Scope 3 emissions (as well as other supply chain issues).

The recently finalized International Sustainability Standards Board standards also require Scope 3 disclosures. And while those are a voluntary framework, many jurisdictions worldwide have already indicated they will adopt those standards into law. In fact, the International Organization of Securities Commissions has called on its member jurisdictions (all 130) to consider incorporating those standards into their regulatory frameworks, and the U.K. Department for Business and Trade announced it would create standards-based thereon.

4. Direct Supply Chain Reach

In addition to frameworks reaching into supply chains as a practical matter, others are doing so with express intention. The German Supply Chain Due Diligence Act came into force in January and requires that in-scope companies make efforts to ensure there are no violations of human rights and environmental obligations in their supply chains.

Likewise, the E.U.'s Corporate Sustainability Due Diligence Directive (CSDD) adopted in February applies to the entire supply chain of in-scope companies and is aimed at violations of human rights and environmental-related violations along those supply chains.

5. Federal Government Procurement

Under a proposed Federal Acquisition Regulatory Council rule issued in August, federal U.S. agencies could be required to purchase "environmentally preferable" sustainable products and services to "the maximum extent practicable," with limited exceptions.

6. "Amazonian" Upstream Demands

In July, Amazon released its 2022 sustainability report. The opening letter from Kara Hurst, vice president of Worldwide Sustainability for Amazon, announced that starting next year, Amazon will update its supply chain standards to require regular reporting and emissions goal setting on behalf of its suppliers. The report that follows Hurst's letter is evident in its emphasis on Amazon's supply chain as a critical component in Amazon's ESG efforts.

The move by Amazon is particularly notable given Amazon's sheer size and breadth. Given how far, and varied Amazon's supply chain extends, one might ask whether Amazon has effectively stepped in to fill any void that might be left by regulators anywhere as to supply chains.

7. Evolving Contract Terms

Last but not least, The Chancery Lane Project (TCLP) and cooperating U.S. attorneys have announced 10 climate clauses for use in contracts under U.S. law. Included among those are clauses specific to supply chain contracts:

1. The first, addressing deforestation and land use, includes a questionnaire about environmental impacts relating to land use within supply chains.
2. And, the second, addressing renewable energy requirements, requires suppliers to procure energy from renewable sources.

The TCLP is a global network of lawyers and business leaders promulgating climate-oriented contract clauses, glossary terms, and other tools for public use with the determined aim of decarbonizing contracts.

Takeaways

Against this backdrop of market and legal demands, any entity delivering goods or services upstream would be well-served to prepare for ESG.

Whether as a consequence of the interconnected and cumulative impact of supply chains on ESG factors and related scrutiny, consumer demand for ESG products, legal frameworks coming online in the U.S. and overseas, rules for federal government procurement, behemoths like Amazon establishing their own baselines for ESG efforts from their suppliers, or even evolving discussion around including ESG issues in contracts, supply chains are increasingly within the ambit of ESG.

The indicia covered here signal ESG reaching far enough into supply chains that every business along those chains would do well to prepare.

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