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ESG and the Supply Chain

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A Practice Note discussing environmental, social, and governance (ESG) trends affecting the supply chain. This Note discusses what ESG is, why it is important, and how it relates to corporate social responsibility (CSR). This Note identifies relevant legislation affecting supply chains in the ESG arena, including the California Transparency in Supply Chains Act of 2010 and the SEC's Conflict Minerals Rules, and outlines the different approaches that companies can take to address ESG issues in their supply chains.

A company risks legal, reputational, and economic damage if its suppliers:

- Engage in illegal or inhumane employment practices.
- Violate human rights.
- Cause environmental harm.
- Engage in bribery or corruption.

Through an emphasis on corporate social responsibility (CSR), consumers have been holding companies accountable for unethical behavior within the companies' supply chains for some time now. More recently, many investors and other corporate stakeholders have been considering environmental, social, and governance (ESG) factors when evaluating a company's performance and long-term viability and making investment decisions.

In addition, governments, legislators, and regulators are now starting to act to require companies to disclose more information regarding their own practices and those of their suppliers. For example:

- In March 2022, the Securities and Exchange Commission (SEC) proposed new and amended rules to enhance and standardize disclosure regarding climate-related risks and opportunities. The proposed rules would require companies to disclose climate-related information in registration statements and annual reports, including:
  - climate-related risks that are reasonably likely to have a material impact on their business, strategy, and outlook;
  - board and management oversight of climate-related risks;
  - the management of climate-related risks;
  - greenhouse gas (GHG) emissions and related third-party assurance; and
  - climate-related financial metrics in the company's audited financial statements.
  - For more information, see Legal Update, SEC Proposes Mandatory Climate Disclosure Rules.
- On March 9, 2022, the SEC proposed new and amended rules to enhance and standardize disclosures regarding cybersecurity risk management, strategy, governance, and incident reporting (see Legal Update, SEC Proposes Enhanced Cybersecurity Disclosure Rules).

Consequently, many large public companies and also private companies doing business in the US have started to:

- Develop and maintain effective, comprehensive, and legally compliant ESG policies and mandates.
- Integrate ESG considerations and objectives into their business operations, including their sales, human resources, compliance, legal, marketing, enterprise risk management, communications, and investor relations functions.

This Note:

- Defines ESG and CSR in the supply chain and discusses how they are related.

- Explains why companies should treat ESG as a priority and imperative.
- Identifies and summarizes enacted, pending, and proposed US ESG-related laws and regulations relating to supply chains.
- Highlights the role of supplier codes of conduct and ESG clauses in supply chain contracts.
- Discusses the main practical steps involved in creating an effective ESG policy or program.
- Does **not** address:
  - international ESG laws; or
  - ESG-related obligations applicable to federal government contracts.

What Is ESG?

Generally, ESG is an umbrella term for a broad range of environmental, social, and governance factors which seek to provide investors with objective, quantifiable performance indicators:

- **Environmental.** Environmental factors relate to issues such as a company's impact on the environment, and include carbon emissions, waste management, water usage deforestation, biodiversity, and pollution.
- **Social.** Social factors generally address how a company treats a wide range of stakeholders, such as its employees, customers, local communities, and society generally, and includes topics such as human rights, diversity and inclusion, health and safety, nondiscrimination, human capital management, privacy and data protection, and how these issues are addressed within its supply chain.
- **Governance.** Governance factors relate to how the company is managed, and include issues such as director independence, board diversity, other board structure and composition issues, executive compensation, anti-competitive practices, bribery and corruption, and business ethics.

Arriving at a standard or universally accepted definition of ESG has been elusive. ESG factors that are relevant to a company differ depending on the industry and jurisdiction. In addition, the prominence of particular factors may vary over time. For example, many companies had to quickly adopt health and safety measures for their employees during the COVID-19 pandemic.

For more information on ESG generally, including a discussion of the various global sustainability organizations and initiatives, such as the United Nations Global Compact, as well as ESG standards, voluntary disclosure frameworks, and ratings, see Practice Note, Environmental, Social, and Governance (ESG): Overview.

What Is CSR?

Often referred to as corporate responsibility, corporate philanthropy, sustainability, business ethics, stakeholder theory, or corporate citizenship, CSR is defined differently by various international organizations and industry groups. The World Business Council for Sustainable Development (WBCSD) and the European Union (EU) published commonly used definitions of CSR:

- The WBCSD defines CSR as "the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large."
- The EU defines CSR as "the responsibility of enterprises for their impacts on society."

In essence, when a company adopts CSR policies and practices, its planning and decision-making reflect the potential impact of its corporate actions on various stakeholders and constituencies.

How Are ESG and CSR Related?

The terms ESG and CSR are sometimes used interchangeably because of the overlap of topics. It may be more accurate to view ESG and CSR as two sides of the same coin. CSR may be summed up as a company's sustainability efforts – company actions aimed at having a positive impact on society and the environment. ESG refers to how investors and other stakeholders measure those sustainability efforts to assess the long-term viability of companies. For more information, see Practice Note, Environmental, Social, and Governance (ESG): Overview: What Are the Differences Among ESG, CSR, and Sustainability?

Why Is ESG Important?

There are several reasons to take ESG seriously, including:

- Investor and consumer sentiment (see Investor and Consumer Sentiment).
- Legislative and regulatory requirements (see Legislative Initiatives).
- Exposure to legal risk (see Legal Risk).

- Reputational capital and competitive advantages (see Reputational Capital and Competitive Advantages).

Recent events have created some headwinds for ESG in the US (see Special Report: ESG Under Strain, Thompson Reuters Institute, October 2022). ESG is becoming increasingly politicized, with a number of states seeking to restrict the use of ESG investing for state funds and prohibiting the use by financial firms of ESG factors (see Article, ESG and State Law in 2022: Conflicts and Trends and Practice Note, Key Developments in State ESG Law: 2022 Tracker). The war in Ukraine and the resulting increases in energy prices may, in the short and medium term, increase the demand for fossil fuels. Despite these challenges, it is likely that ESG-minded investors, consumers, and regulators will continue to drive companies to earn their social license (see Does ESG Really Matter-and Why?, McKinsey & Company, August 10, 2022).

Investor and Consumer Sentiment

Ever since it was first introduced as a term in 2005 at the Who Cares Wins conference, ESG has become increasingly important for investors, and consequently for companies. In 2022, the number of publicly traded companies that published a sustainability report reached an all-time high, with 96% of S&P 500 companies and 81% of the Russell 1000 companies doing so (see the Governance & Accountability Institute website). New investments in sustainable funds reached $87 billion in the first quarter of 2022 and the total value of global sustainable assets was $2.5 trillion after the first half of the year (see Does ESG Really Matter - And Why?, McKinsey Quarterly, August 10, 2022).

Consumers also continue to be an important driving force for ESG with many companies touting their sustainability efforts and ESG programs as part of their marketing and advertising efforts. In some cases, companies have been overstating those efforts or making misleading claims about the environmental impact of their products or services, a practice referred to as greenwashing, and regulators are starting to hold them accountable for greenwashing (see, for example, Legal Update, SEC Charges Company with Making False Statements in Sustainability Reports and Public Filings).

Legislative Initiatives

Certain existing and pending legal requirements impose disclosure obligations intended to encourage companies to address ESG-related issues in their operations.

These requirements do not mandate that companies take affirmative steps to adopt particular policies regarding their own supply chain practices or their suppliers' practices. Rather, affected companies are required to disclose their policies regarding certain activities that have been deemed offensive to human dignity. These disclosures include:

- Supply chain verifications.
- Information on supply chain audit activities.
- Supplier and third-party certifications.
- Training provided to affected employees and contractors.
- Information on compliance with local laws and the company's ESG policies.

For more details on these requirements, see Relevant Legislation Impacting the Supply Chain.

Legal Risk

With an effective ESG policy that is carefully drafted and properly enforced, a company can better:

- Comply with emerging ESG-related laws and regulations.
- Preempt costly lawsuits and non-compliance actions.
- Address the source of non-compliance by installing cultural mechanisms and fostering corporate alignment around the relevant issues.

(See Relevant Legislation Impacting the Supply Chain.)

In addition, an effective ESG policy has a positive effect on relations between the company and its shareholders and other corporate stakeholders, employees, regulators and government authorities.

Reputational Capital and Competitive Advantages

A company that defines its corporate culture with reference to ESG imperatives can leverage that commitment to forge powerful and lasting relationships with important stakeholders. ESG policies can differentiate a company's brand, culture, and corporate identity and positively influence the decision making of consumers, partners, investors, and talent. With reputational capital, a company can:

- **Aid its business development.** Both activist and retail investors as well as customers and other partners are

increasingly including ESG criteria in their investment and screening processes.

- **Earn consumer loyalty.** Consumers increasingly rationalize buying decisions with reference to the corporate values of the manufacturer and its supply chain and other ESG practices.
- **Attract top talent.** A company's commitment to ESG can be a selling point to executives and other job candidates who increasingly demand a committed and coherent culture of concern for ESG-related issues.
- **Strengthen employee morale and commitment.** Staff can be rallied to common causes to improve morale, efficiency, and loyalty in the midst of a highly mobile talent market.

Relevant Legislation Impacting the Supply Chain

In contrast to other jurisdictions such as the UK and EU, there are no overarching laws that specifically regulate ESG in the US to date. However, a number of ESG-related laws have been enacted at the federal and state levels that affect the supply chain.

Existing Federal Regulation

The Conflict Minerals Rules

In 2012, the SEC adopted final rules implementing the conflict minerals disclosure requirements (Conflict Minerals Rules) set out in Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (15 U.S.C. § 78m(p)). The Conflict Minerals Rules are intended to reduce trade and exploitation of conflict minerals believed to be financing violent conflict in the Democratic Republic of the Congo (DRC) and the adjoining countries of:

- Angola.
- Burundi.
- Central African Republic.
- The Republic of Congo.
- Rwanda.
- South Sudan.
- Tanzania.
- Uganda.
- Zambia.

Section 1502 added new Section 13(p) to the Securities and Exchange Act of 1934 (Exchange Act), which directs the SEC to adopt rules requiring reporting companies to disclose information regarding the use of conflict minerals that originate from the DRC or an adjoining country in the products they manufacture or contract to manufacture. The final rules require all affected companies to conduct due diligence and make annual disclosures on SEC Form SD by May 31 of each year, except that if that day falls on a Saturday, Sunday, or holiday, then the first business day following (Exchange Act Rule 0-3(a)). Note that Section 13(p) has been the subject of a legal ruling (see DC Circuit Ruling on the Conflict Minerals Rules).

The minerals covered by the rules, which are included in many common products but are particularly common in electronics components, include:

- Cassiterite.
- Columbite-tantalite (coltan).
- Gold.
- Wolframite.
- Derivatives of these minerals (including tin, tantalum, and tungsten).
- Other minerals the US Secretary of State may designate in the future.

Under the final rules, if conflict minerals are necessary to the functionality or production of a product that a company manufactures or contracts to manufacture, the company (affected company) must conduct a reasonable country of origin inquiry to determine whether the conflict minerals both:

- Originated in the DRC or an adjoining country.
- Did not come from recycled or scrap sources.

If so, the affected company must perform heightened due diligence on the source and chain of custody of the conflict minerals that conforms to a nationally or internationally recognized due diligence framework. If the affected company determines otherwise, it must describe its reasonable country of origin inquiry and results thereof on Form SD.

If the affected company's heightened due diligence reveals **either** that its conflict minerals did **not** originate in the DRC or an adjoining country **or** that the conflict minerals came from recycled or scrap sources, it must still describe its reasonable country of origin inquiry, its due diligence efforts, and the results of both on Form SD. If

the affected company's heightened due diligence reveals otherwise, the affected company must file a Conflict Minerals Report as an exhibit to Form SD.

The Conflict Minerals Report must:

- Include an independent private sector audit.
- Include a company certification.
- Describe the measures the company has taken to exercise due diligence on the source and chain of custody of the conflict minerals.

For more information on complying with the Conflict Minerals Rules, see Practice Note, Conflict Minerals Diligence and Conflict Minerals Disclosure Requirements Checklist.

DC Circuit Ruling on the Conflict Minerals Rules

On August 18, 2015, the US Court of Appeals for the District of Columbia Circuit Appeals issued an opinion reaffirming its 2014 ruling that Section 13(p) and Section 1502 violate the First Amendment to the US Constitution to the extent they require companies to report to the SEC and state on their websites that any of their products have "not been found to be 'DRC conflict free.'"

For more information on the August 18, 2015 ruling, see Legal Update, Conflict Minerals Challenge: DC Circuit Reaffirms Decision on Rehearing. For a discussion of the practical implications of this litigation, see Practice Note, Conflict Minerals Diligence: Final Judgment in the Conflict Minerals Rule Litigation and Subsequent SEC Guidance.

The Foreign Corrupt Practices Act of 1977 (FCPA)

The FCPA (15 U.S.C. § 78dd-1 to 15 U.S.C.§ 78dd-3) prohibits subject companies from offering or paying anything of value to any person while knowing that any portion will be offered, given, or promised to foreign government officials to assist in obtaining or retaining business. For more information on the FCPA, see Practice Note, The Foreign Corrupt Practices Act: Overview.

The Trade Facilitation and Trade Enforcement Act of 2015 (TFTEA)

President Obama signed the TFTEA on February 24, 2016. Among other things, the TFTEA amended the Tariff Act of 1930 and eliminated the long-standing "consumptive demand exception" to the prohibition against importing goods produced by convict labor, forced labor, or indentured labor. Previously, this exception allowed such goods to be imported in order to meet the U.S. consumptive demands.

Countering America's Adversaries Through Sanctions Act of 2017 (CAATSA)

President Trump signed CAATSA on August 2, 2017. Among other things, CAATSA creates a rebuttable presumption that forced labor was used in products made by North Korean nationals or citizens, wherever located.

The Uyghur Forced Labor Prevention Act (UFLPA)

President Biden signed the UFLPA on December 23, 2021. The US enacted the UFLPA to support the prohibition on import of goods made with forced labor in the Xinjiang Uyghur Autonomous Region (XUAR or Xinjiang) of China. The UFLPA took effect on June 21, 2022.

California Legislation

California has enacted two pieces of legislation affecting supply chains in the ESG arena:

- The California Transparency in Supply Chains Act of 2010 (Supply Chains Act) (see Supply Chains Act).
- California Senate Bill 861 (see California Senate Bill 861).

Supply Chains Act

The Supply Chains Act (Cal. Civ. Code § 1714.43) applies to a company if it meets all of the following criteria:

- It is a retail seller or manufacturer as indicated on its California tax return (see Practice Note, The California Transparency in Supply Chains Act: Overview: Manufacturers or Retail Sellers).
- It does business in California (see Practice Note, The California Transparency in Supply Chains Act: Overview: Doing Business in California).
- It has worldwide gross receipts in excess of $100,000,000 (see Practice Note, The California Transparency in Supply Chains Act: Overview: Gross Receipts).

A business covered under the Supply Chains Act must disclose to what extent, if any, it:

- Verifies product supply chains to evaluate and address risks of human trafficking and slavery, and specifies if the verification was not conducted by a third party.
- Audits suppliers to evaluate compliance with the company's standards for trafficking and slavery in supply chains, and specifies if the verification was not an independent, unannounced audit.
- Requires direct suppliers to certify that materials incorporated into the product comply with laws

regarding slavery and human trafficking of the country or countries in which they are doing business.

- Maintains internal accountability standards and procedures for employees or contractors failing to meet company standards regarding slavery and trafficking.
- Provides training to company employees and management (those who direct responsibility for supply chain management) on:
  - human trafficking and slavery; and
  - mitigating risks within the supply chains of products.

The information must be disclosed either:

- On the **homepage** of the company's website. On its face, the statute does not permit the information to be placed on a CSR-related landing page.
- In written copies within 30 days of receiving a written request from a customer, if the company does not have a website.

(See Practice Note, The California Transparency in Supply Chains Act: Overview: Required Location of Disclosure.)

A California Attorney General's action for injunctive relief is the exclusive remedy for a violation of the Supply Chains Act. While private plaintiffs have no right of action under the Supply Chains Act, they may be able to bring claims under other statutes, such as the California Unfair Competition Law or the Consumer Legal Remedies Act (see Practice Note, The California Transparency in Supply Chains Act: Overview: Supply Chains Act Exclusive Remedy).

California Senate Bill 861

California's Senate Bill 861 (2011 CA S.B. 861 (NS)), which became effective on August 22, 2012, requires any public company contracting with the State of California to comply with the Conflict Minerals Rules (see Section 1502 of the Dodd-Frank Act).

Maryland Legislation

Like California, Maryland's House Bill 425 (2012 MD H.B. 425 (NS)), which became effective on October 1, 2012, prohibits state agencies from obtaining supplies or services from companies that violate the Conflict Minerals Rules.

Pending Federal Legislation: BSCTTSA

The Business Supply Chain Transparency on Trafficking and Slavery Act of 2020 (BSCTTSA) is the federal version of the Supply Chains Act. If passed, the BSCTTSA would amend Section 13 of the Securities and Exchange of 1934 (15 U.S.C. § 78m) to mandate reporting companies to disclose their efforts to address forced labor, human trafficking, slavery, and the worst forms of child labor within the companies' supply chain.

Supplier Codes of Conduct

Led by large retailers with considerable bargaining power, companies have been establishing standards for how their suppliers treat their workers and the environment. These minimum standards are often set out in a supplier code of conduct that the vendor must observe to do business with the company (see Standard Document, Supplier Code of Conduct Policy). Supplier codes of conduct, also referred to a vendor codes of conduct or responsible sourcing standards, are usually posted on company websites and sometimes incorporated by reference into the company's supply chain contracts. Companies also require their suppliers to place posters in supplier facilities informing their workers of these minimum standards (see Standard Document, Supplier Code of Conduct Poster).

ESG Clauses in Supply Chain Contracts

Companies with the requisite bargaining power have also been increasingly including ESG-related representations and covenants directly into their commercial contracts with their suppliers and vendors. For example, companies may require their vendors to:

- Represent that the vendor's goods do not contain conflict minerals (see Standard Clause, General Contract Clauses: Conflict Minerals Representations and Warranties).
- Covenant that the vendor's goods have not been made using any form of forced labor (commonly referred to as modern slavery in the UK and other jurisdictions) (see Standard Clause, General Contract Clauses: Forced Labor Covenant).

While clauses requiring suppliers to reduce their GHG emissions are still rare, the SEC's pending climate disclosure rules may provide public companies with an increased incentive to impose obligations on their suppliers to help them comply. For more information, see Article, ESG Clauses Increasingly Incorporated In US Supply Chain Contracts.

Creating an ESG Supply Chain Policy

A comprehensive ESG program generally includes policies and procedures to address various ESG risks and opportunities. This Note only considers the creation of an ESG policy for a company's supply chain.

At a high level, when establishing a new ESG policy for the supply chain or reviewing an existing policy, a company should:

- Identify the appropriate legal and operational leaders within the company (see Team).
- Articulate its objectives (see Objectives).
- Recognize the potential challenges (see Challenges).
- Commit to decisions made (see Commitment).

Team

Any company that wishes to establish a new ESG policy or to review its existing policy should first assemble a working group composed of the appropriate legal and operational leaders. Companies often establish such working groups to manage and oversee their ESG program, including establishing appropriate disclosure controls and procedures for collecting, verifying and reporting ESG information. Members may include, key operations executives, communications executives, risk management executives, human resource professionals, and in-house counsel. In time, and depending on the size of the company, the working group may also establish committees and sub-groups at various levels of the company.

The working group or a subset of the working group should be involved in the drafting or approval of any supply chain policy. The working group should also oversee the process of communicating the policy internally, including to senior management and the board of directors. While the board will typically not be involved in approving the policy, it should be notified of the policy's existence and understand its role in helping the company meet its ESG objectives.

Objectives

A company's ESG supply chain program should be shaped by legal requirements, corporate values, market, industry, and societal norms, and the commercial context in which the company operates. The working group should have a clear understanding of existing and proposed ESG-related legislation affecting the supply chain (see Relevant Legislation Impacting the Supply Chain).

The team should also be familiar with voluntary sustainability reporting frameworks developed by global sustainability organizations and initiatives (see Practice Note, Environmental, Social, and Governance (ESG): Overview: ESG Standards and Frameworks). As there is currently no standardized mandatory ESG disclosure framework in the US, companies can look to organizations and initiatives such as the United Nations Global Compact (UNGC), the Global Reporting Initiative (GRI), and the Sustainability Accounting Standards Board (SASB) for guidance (for more information, see Practice Note, Environmental, Social, and Governance (ESG): Overview: Sustainability Organizations and Initiatives).

The working group should also consider existing and current:

- Governance policies, corporate values, mission statements, and goals. It is particularly important that an ESG supply chain policy adhere to other ESG-related policies, such as environmental and corporate governance policies (for example, codes of conduct, FCPA policies, and data security policies).
- Budget, resources, management, and accountability structures.
- Prevailing thoughts, opinions, activities, and commitments of employees and other stakeholders.
- ESG-related operational goals set by the company.

Synergies can be obtained from coupling the development of an ESG program with marketing, branding, communications, financial reporting, and investor-relations efforts. The working group should regularly analyze the ESG areas that pose the most risk and present the greatest opportunity to the business. The working group should be particularly alert to identifying and prioritizing activities that could potentially:

- Help retain or win clients and contracts.
- Expose the company to unacceptable levels of risk if not addressed.
- Improve relations with major stakeholders, including investors, customers, suppliers, regulators, employees, and non-governmental organizations.

Challenges

When complying with legislation and developing and implementing ESG programs for the supply chain,

companies often face obstacles that can be time-consuming or expensive to overcome. These include:

- **Conflicting legislative mandates.** With the politicization of ESG in the US, companies with ESG programs that operate in multiple states are confronted with conflicting state laws on ESG, where being in compliance in one state may mean violating the law in another (see Article, ESG and State Law in 2022: Conflicts and Trends and Practice Note, Key Developments in State ESG Law: 2022 Tracker).
- **Supply chain complexities.** Supply chains are often long, complex, and difficult to define. In most cases, a manufacturer purchases goods and services from many suppliers (direct suppliers), who in turn may have their own suppliers (indirect suppliers). Even where voluntary or legal obligations apply only to direct suppliers, companies can face significant logistic and legal challenges, for example, with respect to oversight, audit, and enforcement, especially in the context of international sales.
- **Implementation difficulties.** It may be difficult for companies to impose ESG reporting obligations on their existing direct and indirect suppliers. Doing so may require companies to amend existing vendor contracts, which in turn may require renegotiation of economic or other terms of the relationship.
- **Challenging supplier audits.** It is challenging for a company to determine whether its direct and indirect suppliers are complying with ESG reporting obligations. Supplier audits can be costly and unsuccessful because of limited record access, transparency, consistency, and clarity.

Commitment

A company must be prepared to commit to the ESG policies it establishes at every level. As with other corporate policies, a commitment to ESG demands:

- The buy-in of senior leadership and the board of directors and the communication of that buy-in to internal and external constituents. For a template briefing for in-house counsel to give business executives to educate them on ESG, see Standard Document, ESG Issues in US Supply Chains: Business Briefing.
- Realistic procedures that are well-tailored to achieve implementation of set goals.
- Effective and ongoing communication, staff motivation, and training programs.
- A system for setting, measuring, and publicizing specific targets.
- Readiness to provide adequate responses to internal and external investigations and audits.
- Regular review.

For more information on developing an ESG supply chain compliance program, see Practice Note, Developing an ESG Supply Chain Compliance Program.