

THE IMPACT OF ESG CONSIDERATIONS IN SUPPLY CHAIN CONTRACTS

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Environmental, Social and Governance ("**ESG**") considerations have emerged as a dominant force reshaping business practices worldwide. While once regarded primarily as corporate social responsibility initiatives, ESG principles are now recognised as integral to managing risk, attracting investment, maintaining regulatory compliance, and preserving reputational value. Increasingly, companies are being held responsible not only for their own operations but also for the conduct of their suppliers and business partners. This broader scope of accountability means that ESG compliance must extend throughout the supply chain, prompting companies to build ESG obligations directly into their contractual arrangements.

Supply chain contracts have become a critical mechanism through which companies implement their ESG compliance obligations and commitments. This strategy is often used by companies in jurisdictions with higher ESG compliance obligations, which usually equates to companies in jurisdictions with higher bargaining power than others.

To illustrate, ESG-related requirements such as anti-modern slavery, sustainability and anti-greenwashing terms (just to name a few) are becoming increasingly common in standard supplier terms and similar contracts provided by larger multinational companies, often headquartered or with core businesses in jurisdictions such as the European Union ("**EU**"), the United Kingdom ("**UK**") and the United States ("**US**").

In doing so, businesses aim to ensure that their entire value chain aligns with their sustainability goals, legal obligations, and stakeholder expectations. Contractual provisions serve as both a tool of risk management (for example, by setting agreed standards of compliance, usually providing audit rights to at least one party over the other to ensure compliance, allocating liabilities and remedies and even allowing for termination), and a means of demonstrating to investors, regulators, and consumers that ESG principles are being meaningfully integrated into business operations. As a result, the negotiation and drafting of supply chain contracts now routinely involve ESG considerations.

This article explores the growing trend of how ESG considerations have influenced the drafting of supply chain contracts, the legal and practical implications for

both buyers imposing ESG requirements and suppliers who are required to comply, and practical approaches for integrating ESG into supply chain governance. It is also intended to assist supplier companies operating in jurisdictions outside of those with more stringent ESG compliance legislation, understand the ESG expectations that may be placed on them by multinational customers based in more heavily regulated markets. As part of meeting customers' stringent ESG requirements, suppliers are generally expected to impose equivalent ESG obligations on their own downstream suppliers, ensuring that compliance is passed through the entire supply chain.

The Drivers of ESG Integration into Supply Chains

In recent years, ESG issues have evolved from being seen as voluntary corporate initiatives to becoming critical, often non-negotiable, components of how businesses operate. This shift has been fuelled by several factors, primarily growing regulatory obligations, stakeholder and investor scrutiny, and an effort by companies to keep up with market trends.

Companies are increasingly using contracts as tools to extend ESG standards beyond their own walls and jurisdictions and into the conduct of their suppliers. Imposing contractual obligations in this manner is a tool in which companies are able to manage, and to a certain extent control, their supply chain.

• Regulatory Developments

One of the strongest drivers has been legislative and regulatory developments that impose obligations not only on a company's own operations but also on its value chain. Governments are increasingly enacting laws that require businesses to monitor and control ESG risks in their supply chains.

For example, the EU's Corporate Sustainability Due Diligence Directive ("**CSDDD**") requires certain companies to undertake human rights and environmental due diligence across their entire chain of activities, including suppliers and subcontractors in jurisdictions outside of the EU.

Germany's Supply Chain Due Diligence Act also imposes obligations on companies to conduct thorough due diligence on their entire supply chains to assess, prevent, and remedy ESG-related risks - not just in their direct operations, but also among indirect suppliers.

Further, the UK's Modern Slavery Act 2015 mandates companies to disclose efforts taken to prevent human trafficking and slavery in their supply chains.

Because these laws create liability for ESG breaches occurring at the supplier level, companies have responded by inserting ESG-specific clauses into their contracts. These clauses are designed to flow down legal obligations to suppliers, making them contractually responsible for compliance and enabling the purchasing company to demonstrate due diligence and even an "exit route" via termination clauses, if regulatory scrutiny arises.

• Investor and Consumer Expectations

Institutional investors and asset managers are increasingly integrating ESG factors into their investment decisions, often requiring portfolio companies to have demonstrable ESG policies extending into their supply chains. Major investors, such as BlackRock and State Street, have published stewardship guidelines emphasising supply chain responsibility as part of corporate ESG performance.

Consumers, too, expect companies to be accountable for the conditions under which their products are made. In industries like fashion, electronics, and food production, supply chain transparency and ethical sourcing are now key brand differentiators. Companies that cannot prove ethical and sustainable supply chains risk losing market share to more socially responsible competitors.

To meet these expectations, there is increasing pressure on companies to keep up with investor trends and demands, and must ensure that their ESG commitments are not hollow. They therefore require not just their own subsidiaries, but also suppliers to adhere to ESG standards through legally binding contractual provisions, ensuring that their commitments are enforceable and verifiable.

• Reputational Risks and Opportunities

Cases of labour exploitation, environmental harm, and governance failures originating within supply chains have the potential to cause significant reputational damage to multinational corporations. Negative media exposure can result in consumer boycotts, investor activism, and even regulatory investigations.

Conversely, companies that demonstrate leadership in ESG compliance (including through responsible supply chain management) can be said to gain reputational advantages in the market.

Given these reputational stakes, businesses are embedding ESG obligations into supply contracts not only as a defensive risk mitigation measure but also as a proactive way to align their brand image with their operational practices.

In summary, the convergence of legal mandates, financial market pressures, consumer activism, and reputational risks has made it commercially and legally imperative for companies to impose ESG standards applicable to them, throughout their supply chains. Supply chain contracts have become the primary vehicle for doing so.

ESG-Related Clauses in Supply Chain Contracts

As companies seek to ensure ESG compliance throughout their operations and value chains, supply chain contracts have become a primary tool for translating ESG commitments into enforceable contractual obligations.

Some ESG-related clauses now commonly included in supply chain contracts can be grouped into several key categories:

- **Compliance with Laws**

Suppliers are often required to comply with all applicable laws, including ESG-specific legislation and regulations in the buyer's home country and the supplier's country of operation. Contracts increasingly go beyond legal compliance, requiring suppliers to meet voluntary industry standards or international frameworks such as the UN Guiding Principles on Business and Human Rights or the OECD Guidelines for Multinational Enterprises.

These clauses effectively extend the scope of compliance obligations to the entire supply chain, ensuring that suppliers are not simply adhering to local minimum standards but are aligning with the buyer's broader ESG objectives.

- **Codes of Conduct and Policies**

Buyers often draft detailed supplier codes of conduct covering labour rights, environmental management, anti-corruption, and health and safety. These codes are typically incorporated into contracts either by reference or as annexes. Suppliers are usually required not just to comply with these codes themselves, but also to impose equivalent obligations on their own subcontractors and suppliers, thus cascading ESG expectations through multiple tiers of the supply chain.

- **Audit and Monitoring Rights**

To verify supplier compliance with ESG obligations, contracts commonly grant buyers the right to conduct audits and inspections of supplier facilities. These may be conducted with or without notice and may include access to documents, interviews with workers, and environmental sampling.

Some contracts also require suppliers to submit regular ESG performance reports, sometimes through digital platforms that allow real-time tracking of compliance indicators such as carbon emissions, water usage, or worker grievance metrics.

- **Warranties and Representations**

Suppliers are often required to make affirmative warranties regarding their ESG compliance. These warranties may cover past conduct (e.g., no history of human rights violations) and ongoing practices (e.g., adherence to specific environmental standards). Such warranties provide a contractual basis for the buyer to terminate the agreement or claim damages if ESG breaches are later discovered.

- **Termination and Remediation Mechanisms**

Contracts typically give buyers the right to terminate the agreement for material breaches of ESG obligations. However, recognising the practical complexities of immediate termination, some contracts incorporate remediation periods during which suppliers are expected to implement corrective action plans. This approach balances the need for strict enforcement with the commercial desire to maintain supply relationships where feasible.

- **Indemnities and Liability Allocation**

Buyers may require suppliers to indemnify them against any losses arising from the supplier's breach of ESG obligations, including regulatory fines, reputational damage, and the cost of remediation measures. Such indemnities not only provide a financial safety net, but also incentivise suppliers to prioritise ESG compliance within their operations.

- **Evolution Clauses**

Recognising that ESG standards and regulatory frameworks are evolving rapidly, some contracts include clauses requiring suppliers to adapt to updated codes of conduct or revised ESG policies issued by the buyer during the term of the agreement.

This ensures that ESG obligations remain dynamic and aligned with the latest best practices and legal requirements, without the need for renegotiating the entire contract.

The Perspective of Suppliers Subject to ESG Clauses

For many companies, particularly those in developing countries or at the lower tiers of a global supply chain, ESG obligations are often not self-imposed, but externally driven. Smaller suppliers may find themselves required to adhere to ESG standards dictated by larger multinational customers based in jurisdictions with more intensive and detailed legal and regulatory ESG requirements.

While these clauses serve important goals, they can also present significant operational and financial challenges for suppliers. Compliance may require investments in new systems, training, audits, or certifications that smaller enterprises may not be equipped to afford. In some cases, there may be tension between the commercial pressure to deliver competitively priced goods and the need to comply with ESG-related expectations.

Moreover, suppliers may not have a clear understanding of what is required of them, particularly where ESG clauses refer to broad international standards or general principles rather than specific obligations. This can lead to confusion, misalignment, or inconsistent enforcement.

The imbalance of bargaining power often means that suppliers are unable to negotiate or modify these obligations, even when they are unclear or burdensome. In some cases, suppliers may feel compelled to sign contracts without fully understanding the consequences of non-compliance.

To improve outcomes, buying companies should adopt a collaborative approach by providing training, guidance, and capacity-building support. Rather than relying solely on punitive mechanisms, a more constructive strategy would involve helping suppliers understand the rationale for ESG obligations and assisting them in meeting those expectations over time.

Practical Approaches for Implementing ESG Considerations in Supply Chain Contracts

To implement ESG obligations effectively, companies may consider the following practical steps:

- **Clarity** - Ensure that ESG clauses are clearly drafted, with specific expectations and measurable requirements.
- **Consistency** - Align contractual provisions with internal ESG policies and public commitments.
- **Capacity Building** - Provide support to suppliers, including training, toolkits, and guidance on compliance.
- **Due Diligence** - Establish robust onboarding and monitoring processes to identify ESG risks.
- **Remediation** - Include mechanisms that allow for corrective actions rather than immediate termination.
- **Continuous Improvement** - Recognise that ESG compliance is an ongoing and continuous process and allow for incremental progress.

Conclusion

ESG considerations are no longer peripheral to commercial transactions. They are now central to the way companies manage their supply chains and contractual relationships. As regulatory and stakeholder scrutiny intensifies, the trend of incorporating ESG obligations into supply chain contracts is set to grow.

While this evolution presents challenges, particularly for suppliers with fewer resources, it also creates opportunities for smaller businesses and those in jurisdictions with developing ESG regulations to strengthen resilience, enhance reputation and be able to compete and remain relevant locally and on a regional and international level. In house counsel advising their internal businesses and stakeholders on supply chain contracts must also be attuned to these developments and help their stakeholders navigate the complex interplay between ESG expectations, legal enforceability, and commercial realities.

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