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ESG Clauses and Dispute Risks

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In 2022, environmental, social and governance ("ESG") is undoubtedly having a moment, from the cover page of the Economist, to new regulatory schemes in the US and in Europe, not to mention being a headline topic for arbitration conferences from Taipei to Paris, Rio de Janeiro, Singapore, Berlin and Hong Kong. Many reported ESG disputes to date have taken place in the public sphere in the form of strategic litigation, shareholder activism, or investment arbitrations that touch on environmental or human rights issues. But what can ESG mean for private commercial disputes brought to international arbitration?

ESG ratings, disclosure and reporting requirements are on the rise globally. For over a decade, the OECD, the UN, and others have been recommending in their soft law guidance that companies "influence suppliers through contractual arrangements" to maintain and improve sustainability and responsible business conduct.[1)] In addition, ESG has become a reputational issue, with public pressure for real change in terms of ESG impacts not only by companies themselves but impacts caused across corporate groups, supply chains and value chains.

In this context, contractual clauses that contain disclosure and reporting obligations, benchmarks, compliance assurances or targets on ESG issues are increasingly inserted into agreements between contractual partners. This practice will soon become hard law in the European Union ("EU"), as the EU's proposed Corporate Sustainability Due Diligence Directive will require large companies to conduct human rights and environmental due diligence, which includes measures to identify, prevent and mitigate actual and potential adverse human rights and environmental impacts. Companies will also be required to seek contractual assurances from business partners to ensure compliance with the company's code of conduct for corporate functions and operations, as well as "contractual cascading" of such assurances across the value chain.[2)]

Making ESG operational by way of contractual clauses inevitably leads to disputes over interpretation and application of the clauses, as some practitioners have already begun to see. Where the contract contains an arbitration agreement, these disputes will be resolved through arbitration, and such disputes are likely to proliferate together with the increasing use of ESG clauses.

Model Clauses

A quick search online will reveal legal boilerplate ESG clauses, which often take a catch-all or

umbrella-style approach to compliance, e.g., by way of a broad representation or warranty.

Several initiatives have already developed more sophisticated model contractual clauses addressing ESG issues, which may provide inspiration to companies seeking to reach voluntary ESG targets or comply with new regulatory requirements. For example, in 2018 a Working Group of the American Bar Association Business Law Section released a set of model contractual clauses ("ABA MCCs 1.0"), updated with alternative clauses in 2021 ("ABA MCCs 2.0").[3] The aim of the clauses is to assist in the protection of workers' human rights in the supply chain by creating "legally effective and operationally likely" human rights protections.[4] They are drafted on the basis of US law and the United Nations Convention on Contracts for the International Sale of Goods (CISG).[5] The clauses are to be inserted into supply contracts, purchase orders, or similar documents for the sale of goods.[6]

As an example of clauses addressing environmental issues, the Chancery Lane Project is a collaborative initiative that has, since 2019, provided contractual clauses under the law of England and Wales ready to incorporate into agreements.[7] It provides more than 100 model clauses for various kinds of contracts, tailored to the type of contract and to specific climate-related goals.[8]

Other model clause initiatives can be anticipated. In this regard, Article 12 of the EU's proposed Corporate Sustainability Due Diligence Directive provides that the European Commission will adopt guidance about voluntary model contract clauses to support compliance with obligations under the Directive, which notably would address both environmental and human rights impacts.

Dispute Risks and Challenges

The relative novelty of ESG clauses and challenges associated with their drafting allows us to identify some potential issues in future disputes. Here we highlight just a few:

- Interpretation

Since the enforcement of ESG clauses is a relatively new phenomenon, there are likely to be disputes over how to interpret them, and what concrete action is required to comply in a specific case. This is especially the case for broadly drafted clauses or those with imprecise language. It further remains to be seen what will be considered to constitute a material breach of an ESG clause, where this would give a party a right to terminate an agreement.

- Regulatory Proliferation

In circumstances where ESG requirements may be derived from the law applicable to the parties at their seat, the law at the place of performance of a contract, the law governing the contract, and others, identification of the applicable requirements may prove challenging. Where those requirements are mandatory law, arbitral tribunals may further have to consider the impact of such mandatory law in proceedings that are governed by another law.

- Measurability

Where a contract requires ESG benchmarking or third-party verification of ESG compliance, a big

question is how to measure ESG impacts. While efforts are underway to improve this area, there is currently a lack of standardisation and consistency in ESG metrics, large divergences in the rankings of different providers, and a lack of transparency about the data used to arrive at ratings. ESG auditing is likely to become a significant area for compliance, and a matter of expert evidence in arbitral proceedings.

- Supply chains

Ensuring ESG compliance across a supply chain is a potentially onerous obligation on companies. While businesses who have not already adapted become more accustomed to knowing what is going on in their supply chain, the sheer size of the task is likely to lead to disputes. It may also be unclear how far due diligence obligations extend. For example, the EU's proposed Corporate Sustainability Due Diligence Directive imposes obligations where a relationship with a contractual partner "is expected to be lasting, in view of its intensity or duration and which does not represent a negligible or merely ancillary part of the value chain" (proposed Art. 3(f)). It will be necessary for decision-makers to give content to these standards in the circumstances of the specific case and under the applicable law.

Where the assessment of third-party conduct is an issue for ESG compliance (e.g., an environmental or human rights impact caused by another entity in the supply chain), this also brings typical challenges associated with third parties to arbitration, including the lack of jurisdiction over non-parties to the arbitration agreement, difficulties gathering evidence, and the potential for parallel proceedings.

- Causation and Remedies

ESG issues bring into play new types of contractual remedies and requirements that affect existing remedies, which arbitral tribunals will have to assess. Causation also stands out as a complex matter, for example, where it is necessary to determine whether and how specific activities will be considered as a matter of fact and law to have caused environmental harm or an adverse human rights impact. There may be an additional layer of complexity when the entity that allegedly caused the harm is not a party to the proceedings, but it is argued that their adverse impact caused loss to the party bringing a claim.

It may be necessary to consider whether and how typical contractual remedies interact with more novel ESG remedies. ESG clauses that take a due diligence approach (such as the ABA MCCs 2.0, and the proposed Corporate Sustainability Due Diligence Directive) emphasise remediation to address and restore an adverse ESG impact. Remediation may take the form of apologies, restitution, rehabilitation, or financial or non-financial compensation.[9)] Where adverse impacts are not prevented or adequately mitigated, the proposed Corporate Sustainability Due Diligence Directive requires companies to refrain from entering into new relations with a partner in connection with which the impact has arisen. They must also temporarily suspend commercial relations while pursuing prevention and minimisation efforts and terminate the business relationship if the potential impact is severe. EU Member States will be obliged to provide for an option to terminate the business relationship in contracts governed by their laws.

Other potential remedies provided under the ABA MCCs 2.0 include, in the event of breach of human rights standards: (i) demanding appropriate assurances; (ii) obtaining an injunction with respect to non-compliance; (iii) requiring a supplier to terminate an agreement or affiliation with a

specific factory, terminate a subcontract or remove an employee; (iv) suspending payments pending remedial action; (v) avoiding or cancelling the agreement; and (vi) obtaining damages. Worth noting in the ABA MCCs 2.0 is a potential waiver of privity of contract in relation to beneficiaries of the contract (which may include all buyers and suppliers in the supply chain), who may enforce human rights protections against the contractual parties.

These remedies give rise to novel considerations for parties and arbitral tribunals in deciding how they may play a role in arbitral proceedings, including monitoring or enforcement where relevant.

Conclusion

There is plenty of room for disagreement about how ESG clauses will be performed and enforced. As use of ESG clauses continues to increase, we are likely to see this play out in contractual disputes in arbitration. The way an ESG clause is drafted will have a significant impact on likely disputes, in terms of the precision of the language, the inclusion of specific obligations, whether those obligations are easily measurable, and how broadly the obligations extend down a company's supply chain or value chain.

This post is based on the author's presentation of a paper at the Taipei International Conference on Arbitration and Mediation during the Taiwan Arbitration Week on 5 October 2022. The paper is entitled "Under my Umbrella: Seeking Shelter under an ESG Clause".

References

?1 See, e.g., OECD (2011), OECD Guidelines for Multinational Enterprises, OECD Publishing, https://dx.doi.org/10.1787/9789264115415-en, p. 24.

?2 Proposed Corporate Sustainability Due Diligence Directive, Art. 7(2)(b).

?3 See https://www.americanbar.org/groups/human_rights/business-human-rights-initiative/contractual-clauses-project/; David V. Snyder, Susan Maslow and Sarah Dadush, American Bar Association Section of Business Law, Working Group to Draft Model Contract Clauses to Protect Human Rights in International Supply Chains, Balancing Buyer and Supplier Responsibilities: Model Contract Clauses to Protect Workers in International Supply Chains, Version 2.0 (19 April 2021), 77 Business Lawyer (ABA, Winter 2021-2022), American University, WCL Research Paper No. 2021-15 ("ABA Report").

?4 https://businesslawtoday.org/2018/11/human-rights-protections-international-supply-chains-protecting-workers-managing-company-risk/.

?5 ABA Report, pp. 2, 19.

?6 ABA Report, p. 19.

?7 https://chancerylaneproject.org/about/; The Chancery Lane Project, Climate Contract Playbook, Edition 3, p. 9 https://online.flippingbook.com/view/527128/8/.

?8 See https://chancerylaneproject.org/climate-clauses/.

?9 ABA MCCs 2.0, Clause 2.3(b).

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