How ESG Matters Are Influencing M&A Due Diligence Trends

By **Jeremy Kutner, Matthew Triggs and Ben Perry** (June 22, 2022)

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Environmental, social and governance, or ESG, matters are high on governments' regulatory agendas. Topical concerns include, but are by no means limited to, climate and wider environmental sustainability, boardroom diversity and supply chain ethics.

To name a few developments in these areas, the U.K. government continues to pursue its stated intention to make climate disclosures, aligned with the Task Force on Climate-Related Financial Disclosures framework first published in 2017, "fully mandatory across the U.K. economy by 2025."[1]

Work on the U.K.'s Green Taxonomy and Sustainability Disclosure Requirements is also continuing, and in April mandatory diversity targets were introduced for issuers listed on the main market of the London Stock Exchange.[2]

In the EU, February saw the publication of the European Commission's draft directive on corporate sustainability due diligence.[3] If it is adopted, in-scope companies will need to identify and prevent, end or mitigate adverse impacts of their operations and activities on human rights and the environment.

EU member states are also pursuing ESG initiatives. For example, beginning in January 2023, the German Supply Chain Due Diligence Act will require qualifying companies to take due diligence steps to prevent human rights violations in their own business operations and in their supply chains.[4]

This regulatory environment in relation to ESG has implications for corporate practitioners and others involved in M&A transactions, particularly with respect to how they scope and conduct due diligence.

This article identifies current trends in ESG due diligence and examines why an acquirer might carry out an ESG due diligence exercise. It concludes by considering how ESG due diligence is carried out in practice and how the results of this are reflected in contractual documentation.

ESG Due Diligence Trends

Client inquiries regarding ESG due diligence are becoming more common. This is driven by the fast-changing regulatory environment and proliferation of ESG-related laws and regulation.

In some instances, it may also be driven by a desire to comply voluntarily with nonbinding guidance and best practice. Heightened investor and customer expectations in the ESG space may also be contributing factors.

Whatever the cause, it is clear that ESG is front of mind for many clients. A survey of 60

corporate and private equity dealmakers carried out by Baker Tilly International from April to May 2021 found that 84% consider ESG to be important within their organizations, with over two-thirds, 67%, considering it very important. Nearly two-thirds, 63%, believe that ESG is important when considering investments and M&A, and a majority, 52%, believe it to be extremely important.[5]

This said, ESG due diligence is not entirely new; environmental liabilities and anti-bribery and corruption are long-standing due diligence items with an ESG flavor that remain important today.

However, the scope of ESG due diligence is expanding as regulation evolves. Accordingly, as an exercise, ESG due diligence does not stand alone from traditional legal due diligence. Instead, given the extent to which ESG issues commonly — and increasingly — have a legal dimension, there is typically a significant degree of overlap.

In terms of the market for ESG due diligence, a wide range of providers offer ESG due diligence reports. As well as law firms and accounting firms, which typically provide more traditional ESG due diligence reports based on information received from the seller and target, third-party data providers are offering ESG reports based on publicly available information.

As governments around the world expand ESG reporting requirements based on consistent frameworks, for instance, the Task Force on Climate-Related Financial Disclosures, to cover a wider range of public and private companies and seek to improve the quality of ESG disclosure, it is expected that such reports will become powerful tools for evaluating acquisition targets.

Due to the overlap between ESG and traditional legal due diligence, law firms are strongly placed to position themselves as coordinators of ESG due diligence exercises. As a practical matter they will, at the very least, typically wish to have sight of any ESG due diligence procured from an alternative provider.

Why Might an Acquirer Carry Out ESG Due Diligence?

Legal Risk

Over recent years, an increasing number of ESG-related hard law obligations have been introduced that may apply to the acquirer or target and so be relevant for evaluating an M&A transaction.

An ESG legal due diligence exercise can identify which obligations apply to the target, the extent of the target's compliance and penalties for non-compliance. It may also identify which legal obligations of the acquirer will be affected by the deal, for example an acquirer that is required to report on its Scope 1 and Scope 2 greenhouse gas emissions under the U.K.'s Streamlined Energy and Carbon Reporting regime, which came into force in 2019, may want to know how the acquisition will have an impact on its reporting.[6]

An ESG due diligence exercise should also assess the target's governance framework and systems and controls. These may need to be brought up to the same standard as, or otherwise aligned with, those of the acquirer and its group. Moreover, by scanning the ESG regulatory horizon applicable to the target, ESG due diligence can help to assess forthcoming legal risks and so suggest ways in which the target's governance framework and systems and controls can be future-proofed.

Financial Risk

The extent of the target's ESG compliance may be relevant when pricing the target, for example if any customers or suppliers are subject to sanctions, or if supply chains need to be adjusted, this may materially affect the projected financial performance of the target.

Reputational Risk

The reputational risk of an ESG-unfriendly investment can be high. Accordingly, ESG due diligence can set out to identify reputational issues, such as controversial customers or suppliers, workplace culture, or employee dismissals due to sexual harassment, etc. Desktop news searches may be useful sources of information in this regard.

The reputational risks presented by ESG reporting were illustrated in a prominent news story earlier this year. In the U.K., employers with at least 250 employees are required to report on their gender pay gap each year.[7] The reports are published on a central government portal and are easy to access. For International Women's Day, on March 8, a journalist programmed the Gender Pay Gap Bot, which replied to organizations supporting International Women's Day on Twitter by tweeting their gender pay gap figures — often with embarrassing results. Within hours, the bot reportedly had 250,000 Twitter followers and companies with the most stark pay disparities were getting hundreds of retweets.[8]

Assessment of Opportunities

ESG due diligence is not all about minimizing risk. Having the full picture of the target's ESG performance may help identify ways to improve it.

On a subsequent sale or exit, improved ESG metrics may smooth the path and/or underpin a strong valuation. Some studies have suggested that there is a positive relationship between ESG and financial performance.[9]

Legal Requirements Specifically Mandating ESG Due Diligence

There is an increasing trend for lawmakers to specifically mandate regular ESG due diligence, outside of an M&A context, as part of an organization's ongoing compliance obligations. The EU's proposed corporate sustainability due diligence directive, the German Supply Chain Due Diligence Act and U.K. gender pay gap reporting requirements are significant examples, as are the U.K.'s Modern Slavery Act 2015 and the U.K.'s and EU's proposed deforestation due diligence frameworks.[10] [11]

In addition, where the acquirer is a financial services firm, such as an investment fund, it may need to make disclosures on its ESG due diligence policies and processes at entity or product level. For instance, under the EU's Sustainable Finance Disclosure Regulation 2021, in-scope funds are required either to implement and disclose a due diligence policy with respect to the principal adverse impacts of their investment decisions on sustainability factors, or explain the reasons they do not consider such adverse impacts.[12]

Additional disclosures are needed under the Sustainable Finance Disclosure Regulation where a financial product promotes environmental or social characteristics or has sustainable investment as its objective. These disclosures will be informed by the ESG diligence carried out by the fund, as well as its internal policies.

ESG Due Diligence Processes

Practice for ESG due diligence in some respects mirrors that for traditional legal due diligence. The main tools used during an M&A process to obtain information required to conduct an ESG due diligence exercise are as follows.

Publicly Available Information

As with traditional due diligence, the target's annual report may be a good starting point for information on the target's assessment of climate-related risks and other ESG matters. This will be the case where the target or its parent is based in a jurisdiction, such as the U.K., which has mandatory ESG disclosure requirements.

However, the annual report should not be considered in isolation. For example, modern slavery and human trafficking statements required by the U.K. Modern Slavery Act 2015 need to be published on the company's website and there is a central government portal for U.K. gender pay gap reporting.

As mentioned, as governments worldwide expand ESG reporting requirements, desktop searches or reports from third-party data providers are likely to become increasingly powerful diligence tools. News searches are particularly helpful for assessing reputational risks.

Due Diligence Request Lists

Due diligence request lists should specifically ask the seller for information about relevant ESG matters and be adapted to reflect the likely ESG risks arising from the transaction in question. This requires an assessment of the business and risk profile of the target, as well as the ESG law and regulation to which the acquirer is subject or, potentially, to which it may become subject as a consequence of the acquisition.

Sessions with target management are often helpful in providing further color on the seller's responses to the due diligence request lists and in facilitating a discussion around the target's ESG priorities, objectives, policies and procedures. They can provide insight into how existing policies and procedures are implemented in practice.

Contractual Protection

Warranties

As with non-ESG risks, warranties can flush out information and allocate risk between the buyer and the seller. Although some ESG risks may be addressed without specific ESG warranties, typically because they are covered by more general warranties, such as compliance with laws, specific ESG warranties are sometimes necessary or appropriate to flush out key information or to address sensitivity on certain ESG issues such as workplace harassment or supply chain sustainability.

In the wake of the #MeToo revelations, some acquirers, particularly in the U.S., have sought to include a so-called Weinstein warranty to require disclosure of past sexual harassment allegations.

The acquirer may also ask the seller to warrant the accuracy of key due diligence information provided by the seller that has informed the acquirer's ESG risk assessment —

for example a list with the identity and location of suppliers in a complex and high-risk supply chain.

Covenants

ESG considerations will outlast the closing of a deal. After closing, a corporate buyer will likely need to integrate the target business into its own, and a private equity buyer will begin the process of improving the business.

In particular, the internal policies and procedures of the acquirer may necessitate changes to the target's governance framework and systems and controls, in order to bring them up to the same standard as those of the acquirer and its group.

This work is likely to involve updating the policies and procedures of the target group and, potentially, terms of reference for committees of the target board. In addition, ESG deficiencies identified during due diligence may need to be rectified.

Assistance from the target and target management would often help to embed these changes within the organization and to address known issues. The acquisition documentation may therefore contain specific covenants on the target and target management to assist with this process, subject to antitrust and other regulatory limitations, and may set out in detail the specific changes to the governance framework and systems and controls that are contemplated.

Conclusion

Given governments' and market participants' engagement with ESG matters, ESG due diligence has become an area of focus for clients and advisers engaged in M&A worldwide.

In turn, the market and practices for ESG due diligence have developed. These are likely to evolve further with the regulatory environment, particularly in response to the proliferation of mandatory ESG disclosure and due diligence regimes and the development of analytics tools to assess ESG data.

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[1] HM Government, Greening Finance; A Roadmap for Sustainable Investing, October 2021.

[2] Financial Conduct Authority, Diversity and inclusion on company boards and executive management, PS22/3, April 2022.

[3] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, COM/2022/71 final.

[4] *Gesetz über die unternehmerischen Sorgfaltspflichten zur Vermeidung von Menschenrechtsverletzungen in Lieferketten*, Nr. 46, ausgegeben zu Bonn am 22 Juli 2021.

[5] Baker Tilly International, Global Dealmakers series: Deal breakers and opportunity makers, 2021.

[6] The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 (SI 2018/1155).

[7] The UK Equality Act (Gender Pay Gap Information) Regulations 2017 (SI 2017/172).

[8] The Metro, I was fed up with companies using International Women's Day to brag – so I set up a Twitter bot to expose their pay gaps, 14 March 2022.

[9] See, for instance, Stern Centre for Sustainable Business, ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015 – 2020, August 2021.

[10] Department for Environment, Food and Rural Affairs, Implementing due diligence on forest risk commodities, December 2021.

[11] Proposal for a Regulation of the European Parliament and of the Council on the making available on the Union market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010, COM/2021/706 final.

[12] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.