Top 10 Checklist – ESG issues in M&A transactions

For businesses and investors, navigating the risks and tapping into the opportunities created by environmental, social and governance (ESG) issues are now key to financial performance, reputation, and sustainable value creation. In M&A transactions and private equity investments, acquirors and targets are increasingly expected to demonstrate their ESG credentials.

This note includes the top ten ESG issues to consider when preparing for a transaction or investment.

ESG risks

1. Have you thought about how ESG risks affect the longer-term profitability of the company? Due diligence investigations are and warranty coverage is increasingly focused on ESG risk areas and so a deal process may uncover material ESG risks which could be a concern for a potential acquiror or investor or may require significant spend to remediate.
2. Be aware that poor ESG performance may mean an increased risk of liability or a direct loss in value, e.g. poor governance may mean there is a risk of bribery or sanctions breaches, which could lead to fines, market access restrictions and reputational damage.
3. Are management prepared to engage with investors and stakeholders to demonstrate how ESG will impact long-term performance and growth prospects? Poor ESG performance may make it more difficult for the business to raise external finance, undertake an IPO or attract a buyer on a future sale.
4. Are there any existing ESG obligations on the company e.g. does it already have B-Corp status? If so, do these obligations impact or fetter your intentions for the business in any way?
5. Have you considered how you will manage post-merger governance and integration? Integration efforts should be sensitive to the existing ESG approach of the company so as to enhance rather than adversely impact the ESG profile.
6. Traditional deal mitigation (price chips, warranties, indemnities etc.) may not be effective for all ESG issues as defining the impact can be difficult to identify and quantify and so alternative protection may need to be considered (including insurance and remedial work taking place pre-completion).

Rules and regulation

7. What regulatory incentives or obligations will affect the transaction? The regulatory trend in the UK, EU and the US towards greater transparency and reporting is clear.

Other players

8. If there is a **limited partner investor** involved, do they have their own specific ESG requirements, (e.g. a pension fund, which may have stringent ethical investment criteria)?
9. Lenders are increasingly considering the potential impact of ESG risks on business' creditworthiness and so if a **Bank providing debt finance** is involved, consideration needs to be given as to whether they have their own ESG requirements, what those requirements are and what action will be required to ensure they are complied with?

Parent company liability

10. ESG issues do not respect corporate boundaries – beware the risk of parent company liability for ESG issues of a subsidiary (including a recently acquired subsidiary). Recent cases emphasise that a parent company of a subsidiary which makes far-reaching ESG commitments is vulnerable to claims if the underlying entity doesn't deliver (even where that underlying entity is based abroad), particularly where a significant degree of control is assumed by the parent.

If you would like to discuss any of these matters please speak to your usual contact.