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Mitigating ESG Risks in M&A Transactions

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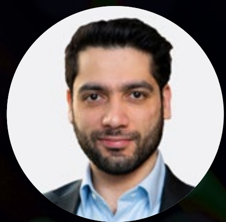

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Key Takeaways

- ESG considerations have become part of the new normal in corporate culture and their importance is expected to continue rising for the foreseeable future.
- ESG factors are now frequently a value driver in M&A deals. However, even though the rise of ESG brings along new business opportunities it also introduces a new spectrum of risks.
- In addition to standard due diligence on issues such as privacy and data security, labour practices, tax, environmental, compliance and bribery/corruption, there are additional key considerations for buyers as part of an ESG due diligence exercise.
- There are various insurance solutions available in the market and it is expected that the insurance industry will remain attuned to investors' needs in this area and either develop new products or adapt its existing offering to help investors navigate their risks in the ESG space.

Introduction

In recent years ESG issues have become really important considerations for companies due to increasing regulatory requirements, employee considerations and public and shareholder activism.

Unlike some other topics that are temporary in nature, ESG has proved that it is not a 'trend' but rather a topic that will only continue growing in importance for the foreseeable future. This can be seen from the increased focus it is receiving from investors and taking into account the impact of COVID-19. Existing and emerging ESG-related legal requirements highlight the growing desire from governmental authorities for increased transparency at a corporate level. There is also pressure from shareholders for greater transparency as an increasing number of rating agencies now provide ESG ratings that allow investors to get an indication of a company's exposures to ESG risks.

It is also anticipated that climate change and environmental considerations will receive more attention and public scrutiny as carbon emission reduction targets adopted by governments and corporates start being felt. For example, both BP and Shell have announced plans to reduce greenhouse gas emissions to net zero by 2050 and the UK passed a net zero emissions law, which will require the UK to bring all greenhouse emissions to net zero by 2050. It is therefore, expected that, as time goes by, investors and the public in general will be increasing their focus on how governments and corporates are tracking against their carbon emission reduction targets. It is also anticipated that those corporates and governments that do meet their targets will be perceived in a more positive light from an ESG angle than those who fail to meet them.

Regulators have been revisiting their legislative frameworks and overall policies to steer corporates and investors towards purpose-led corporate governance that takes into account environmental, social and governance concerns:

- In Europe, a regulatory reform initiative[1] prompted by the publication of the European Commission (EC)'s Action Plan on Sustainable Finance in March 2018 has already crystallised into a new regulation on ESG disclosures, which will come into effect in 2021.
- On 15 April 2020, the Council of the European Union adopted the long awaited 'taxonomy regulation' that intends to establish an EU-wide taxonomy on environmental sustainability, and to give corporates and investors a common language to identify which activities and financial instruments may be considered environmentally sustainable.
- On 29 April 2020, it was announced that next year the EC will introduce ground-breaking new EU legislation on mandatory human rights and environmental due diligence for companies.
- On 27 May 2020, the EC put forward its proposal for a recovery plan. The EC aims to create a new EUR 750 billion recovery instrument. Although the proposal is still in a draft form and while the details still need to be honed down and agreed, the focus of investments will be on 'Green Deal' Priorities. Therefore, it is expected that EC investments will focus on a wide range of priorities, including energy projects, clean hydrogen, industrial investment to decarbonise, building renovation, sustainable transport as well as digitalisation.

Stock exchanges are also demanding transparency, either by putting forward a guide to ESG reporting for voluntary disclosure (for example, the London Stock Exchange) or by making ESG reporting required as a listing rule (for example, Euronext France). In the US, the Security and Exchange Commission's (SEC) Investor Advisory Committee released on 14 May 2020 a formal recommendation to urge the SEC to "update the reporting requirements of Issuers to include material, decision-useful, ESG factors".

> "ESG has proved that it is not a 'trend' but rather a topic that will only continue growing in importance for the foreseeable future."
>
> **Laura Gonzalez, Associate - Baker McKenzie**

ESG Regulatory Reform

1 For more details on the ESG regulatory reform, please review Baker McKenzie's article.

COVID-19 Impact

Even before the COVID-19 crisis, it was becoming more evident to corporates that a focus on ESG was no longer a question of marketing, but rather an important element to achieving competitive advantage. Corporates have been forced to look at improving their stakeholder governance, to manage their social and human capital closely and revisit their overall corporate purpose, business model and corporate strategy to make sure they are resilient to social and regulatory scrutiny.

The governance aspect of ESG had been understood for many years as essential for any organisation and 2019 was the year where the environmental aspect of ESG was put in the spotlight due to increased media attention around climate change. However, it is widely acknowledged that the COVID-19 pandemic in 2020 has now brought attention to the societal aspect of ESG. In addition, corporates are increasingly focused not only on how they are perceived by the public with regard to their ESG credentials but also by investors:

- A survey carried out by the Oxford Saïd Business School[2] showed that 3/4 of respondents expect businesses to be more socially responsible and trustworthy after COVID-19, compared with a mere 6 per cent who trusted business to behave in a socially responsible way before COVID-19.
- A survey carried out by the Financial Times (FT) and Savanta[3], showed that almost 9 in 10 wealth managers polled believed that COVID-19 would result in increased interest from investors in ESG investing.
- A poll of UK independent financial advisers (IFAs) by asset manager Federated Hermes referred to by the FT[4], showed that more than 3/4 of respondents "believed investors would be motivated to divest from companies that had not supported their employees or wider society through the crisis".

COVID-19 may also encourage regulators and governments to make the recovery 'green' through ESG-contingent bailouts. This is already starting to be seen not only with the EC proposal for the EU recovery plan which, as noted above, will focus its investments on 'Green Deal' Priorities, but also with certain government measures in Europe. For example, the government in France has set green conditions as part of the bailout package for Air France and the government in Austria imposed sustainability requirements as part of its rescue package for Austrian Airlines.

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2 This survey was conducted on the attendees of the webinar organised by Oxford Saïd Business School and the Financial Times. For further details, please click here to access the survey.
3 For further details, please refer to "ESG passes the COVID challenge" dated June 2, 2020.
4 For further details, please refer to "ESG passes the COVID challenge" dated June 2, 2020.

ESG Impact on M&A Deals: Key Issues to Consider

It is no surprise that ESG factors are now frequently a consideration in M&A deals and will likely have a growing impact on global M&A activity. A global survey conducted by McKinsey & Company on valuing ESG programs, showed that 83 percent of C-suite executives and investment professionals expressed a belief that ESG programs will contribute more shareholder value in five years than today and that they would be willing to pay around a 10 percent median premium to acquire a company with a positive ESG profile over one with a negative one[5].

It is also acknowledged that investing in businesses with good ESG "scores" has the potential to increase a company's ability to deliver long-term sustainable value to its stakeholders and that lack of compliance with ESG may have severe financial or reputational implications for the purchaser after completion. According to a survey conducted by IHS Markit and Mergermarket in 2019, 53% of respondents confirmed that their firms had walked away from an investment or M&A target due to a negative assessment of ESG issues at the target company[6].

Access to Capital:

It is clear that costs and access to capital for corporates are increasingly becoming linked to their ESG performance and it is anticipated that this will continue being the case as time goes by. This is evidenced by strong statements from asset managers such as BlackRock and State Street announcing that their investment decisions will be driven by ESG performance. Lenders such as the International Finance Corporation (IFC) incorporate ESG metrics, such as Environmental and Performance Standards, as part of their initial credit review process.

There is an increasing number of investors wanting to invest in 'clean and responsible' assets. According to a study conducted by the Oxford Saïd Business School and the Erasmus School of Economics in Rotterdam, corporates with good sustainability ratings received 15 percent more investment from wealthy investors between 2016 and 2019, compared to those with a low rating[7]. This means that in practice, it will likely be more difficult for companies with poor ESG profiles to access capital than for those with strong ESG profiles. It is anticipated that the importance of a healthy ESG profile for corporates to access capital will be accentuated post-COVID-19, when many businesses will likely be looking to raise capital to deleverage the debt accumulated during the months of the COVID-19 pandemic.

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5 For further details, please refer to "The ESG premium: New perspectives on value and performance" dated February 12, 2020.
6 For further details, please refer to page 10 of "ESG on the Rise: Making an Impact in M&A" by IHS Markit and Mergermarket.
7 Please refer to research from Associate Professor Amir Amel-Zadech at Oxford Saïd Business School and professors Mary Pieterse-Bloem and Rik Lustermans at the Erasmus School of Economics, in Rotterdam mentioned by the FT on 2 June 2020.

ESG Impact on M&A Deals: Key Issues to Consider

Due Diligence:

In addition to standard due diligence on issues such as privacy and data security, tax compliance, labour practices (including, global talent development and workforce diversity), environmental risks, compliance and bribery/corruption, a more in depth sustainability due diligence is advisable. Depending on the nature of the business, the following are some of the areas buyers should consider as part of an ESG assessment:

1. Assessment of the target's governance framework and associated risk management systems

Buyers need to understand whether the target has a good governance framework in place by reviewing and assessing the target's policies, programs and structures, as well as its stance and approach to ESG matters- how good is its stakeholder governance and related decision-making?. The buyer may want to consider whether the target business has stated its commitment to the United Nations Sustainable Development Goals (UN SDGs) and has aligned its corporate strategy and policies accordingly, as that may be considered an indicator of a healthy ESG profile.

Further, it is key for buyers to assess whether the target has developed an adequate system to manage ESG risks and opportunities, which is proportionate to the location, size and nature of the business activity of the target in order to evaluate, monitor and mitigate any risks, or take advantage of any opportunities, in each case identified. It is important for buyers to understand how the target business is tracking progress and compliance of corporate policies and programs.

With good stakeholder governance practices becoming more critical for companies as a risk mitigation strategy, a good source of understanding of the level of focus of the target on ESG factors is to interview its board members, to review its board minutes and board papers from a stakeholder governance perspective. This will allow the buyer to assess to what extent the target has identified its key stakeholders, to what extent it engages with them and to what extent the target uses the information obtained from such engagement to drive its decision making, to inform its strategy and to define its business model. This will also assist the buyer in comparing the target's approaches with the buyer's, which will help to assess how easy an integration of ESG strategies will be post-closing.

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ESG Impact on M&A Deals: Key Issues to Consider

2. Assessing compliance or potential compliance with ESG standards and disclosure requirements

Buyers should consider conducting an evaluation that goes beyond the assessment of historical non-compliance into future potential risks and opportunities in the ESG space by reference to generally recognized ESG standards, including with a view to future disclosure requirements.

Although there are no ‘single universally accepted’ ESG standards as yet, there are various ESG standards available which include IFC Performance Standards[8], Global Reporting Initiative (GRI) standards[9] and the Sustainability Accounting Standards Board (SASB) standards[10]. Buyers will need to determine whether (i) the target company is subject to any contractual obligations that are linked to ESG standards or (ii) the target company’s revenue and/or access to funding is contingent on a determined performance against ESG standards. In either case, the buyer will want to diligence these assets accordingly and understand whether there is any risk exposure post-sale should any such standards become mandatory or should the rating agencies covering the buyer’s stock (where such buyer is a publicly listed company) use these standards.

Assessment should also be made of the target’s disclosure obligations and its level of compliance with these - does it have in place appropriate assurance for the disclosures it makes? In addition, what is its preparedness as regards recommended disclosures that will likely become mandatory (such as, for example, disclosures pursuant to the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD))?

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8 To access the IFC Performance Standards, please click here.
9 To access the GRI Standards, please click here.
10 To access the Sustainability Accounting Standards Board (SASB) standards, please click here.

ESG Impact on M&A Deals: Key Issues to Consider

3. Supply chain due diligence

Buyers should also understand whether the target incorporates appropriate ESG factors into its selection of suppliers and whether it demands a healthy ESG profile on suppliers as a requisite for an on-going business relationship. It will also be important to assess how the target is monitoring that suppliers remain ESG compliant. It is clear that a non-ESG compliant supplier may adversely affect the brand and reputation of a company and could receive media attention. An illustration of this would be the extensively covered case of a Shanghai supplier of cards to Tesco that allegedly used forced prison labour in its manufacturing process and that led Tesco to suspend the commercial relationship with this supplier. Similarly, if the target company has a poor ESG profile it is likely that key suppliers and customers may reconsider whether they want to continue their commercial relationship with the target company.

As corporates become more aware of the extent of their indirect carbon emissions (such as, for example, those that occur in their supply chains), we anticipate that buyers will want to better understand the indirect carbon emissions of the target as part of the due diligence process.

In addition, the effect of a prolonged pandemic on supply chains, as well as governments' responses thereto needs to be considered. For example, a second-wave of infections could lead to key equipment/materials shortages. A buyer would be well advised to understand the target's strategy to prevent, identify and mitigate the risks of a prolonged pandemic and the measures the target has taken to manage these (for example, has the target stockpiled key inventory to prepare for a second-wave of infections?).

It is also accepted that inadequate working conditions in corporate supply chains can lead to an increase in COVID-19 infections potentially rendering entire facilities and sites non-operational. Consequently, a buyer will want to better understand the employment health and safety policies and procedures that the target and its key suppliers have put in place in response to the COVID-19 pandemic to manage the risk of spread of the virus amidst employees.

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ESG Impact on M&A Deals: Key Issues to Consider

4. Assessment of engagement with customers

Buyers may also want to understand the target's policies, strategies, tools and channels to engage with its customers. Customers in recent years have become more conscientious and knowledgeable around ESG matters. For many companies both brand perception and the use of channels (including social media and advertising) to engage with customers are now more important than ever. There is increasing pressure from customers for corporates to set an example and take a stand by publicly stating their position on key social issues (as an example, brands such as Adidas expressed solidarity with the Black Lives Matter movement by issuing statements and adverts of support).

Corporates are also expected to actively engage and keep up-to-date with customer needs: as an illustration of this, a survey[11] conducted by Nielsen showed that nearly half (48%) of US consumers said "they would definitely or probably change their consumption habits to reduce their impact on the environment". It is therefore, no surprise that leading brands have been diminishing their use of non-recyclables and engaging in circular economy.

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5. Regulatory assessment

Customers and the public in general are seeking greater transparency from companies on how they treat their customers, suppliers and employees.

Regulators have also turned to reporting as a transparency tool for corporates. In the UK, this can be seen with the enactment of the reporting on Payment Practices and Performance Regulations 2017, the Equality Act 2010 (Gender Pay Gap Information) Regulations 2017 and the Modern Slavery Act 2015. The introduction of these regulations aims to ensure that qualifying UK companies report on their practices, policies and performance relating to the payment of their suppliers, modern slavery and gender pay gap. In addition, since the enactment of the Companies (Miscellaneous Reporting) Regulations 2018, which require a large proportion of companies (the thresholds are relatively low) to report how directors have exercised their section 172[12] duties for financial years starting on or after 1 January 2019. Companies that meet the relevant thresholds must include a section 172 statement in their Strategic Report (and also publish it on a website) and include in the Directors' Report a statement on engagement with suppliers, customers, employees and others, and what impact that engagement has had on the principal decisions taken during the year[13]. For very large private companies, a governance statement is also now required[14]. Therefore, a well-advised buyer will want to understand whether the target is compliant with the relevant regulatory framework in this regard.

Well-advised buyers may also want to understand how much work the target has already conducted to evaluate climate-related risks and opportunities that are relevant to their businesses. The TCFD has published

11 Please see further details of the survey conducted in 2018 by clicking here.
12 Section 172 of Companies Act 2006.
13 For further details, please refer to Baker McKenzie's client alert "GC100 Guidance - piecing together the s172 jigsaw".
14 For further details, please refer to Baker McKenzie's client alert "Publication of the Wates Principles - a defining moment for private company corporate governance?"

ESG Impact on M&A Deals: Key Issues to Consider

recommendations[15] to encourage organisations to evaluate and disclose climate-related risks and opportunities as appropriate. While these are non-mandatory, not only are investors regularly expecting companies to assess their climate-related impact but also commentators suggest that regulators will make the TCFD disclosures mandatory for certain companies in the near future.

The TCFD divided the climate-related risks in two main categories: those related to the transition to a lower-carbon economy (which include all the policy, legal, technology and market changes in response to climate change) and those related to the physical impacts of climate change (which include acute risks such as hurricanes or floods and chronic physical risks such as sustained higher temperatures). The TCFD also identified climate related opportunities such as resource efficiency, access to new markets and building resilience along the supply chain. All those climate-related risks and opportunities of the target business have corresponding financial impacts that should be considered by the buyer before an acquisition.

"Regulators have also turned to reporting as a transparency tool for corporates."

Beatriz Araujo, Partner - Baker McKenzie

"Well-advised buyers may also want to understand how much work the target has already conducted to evaluate climate-related risks and opportunities that are relevant to their businesses."

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"GC100 Guidance - piecing together the s172 jigsaw".

"Publication of the Wates Principles - a defining moment for private company corporate governance?"

15 To access the final report on the Recommendations of the Task Force on Climate-related Financial Disclosures, please click here.

ESG Impact on M&A Deals: Key Issues to Consider

6. Health & safety assessment

Buyers should review and understand whether the target has appropriate and sufficient policies, guidelines, systems and procedures in place to manage the risks of accidents at the workplace and to manage temporary employees and contractors. It is also important for buyers to understand how compliance to those policies and measures is tracked and monitored.

In light of the COVID-19 climate, it will also be advisable for buyers to assess the target's risk for exposure to COVID-19 at the workplace and the target's plans for preventive measures to address and mitigate the risk of COVID-19 infections. It will also be particularly important for buyers to understand and evaluate the target's preparedness for its workforce to return to work as organisations shift focus from crisis management to reopening mode.

7. Assessment of community engagement

Buyers may also want to assess whether the target is driving growth and raising its profile through community engagement initiatives such as public activities, campaigns or events. Buyers will likely want to understand what topics or causes (environment, water and sanitation, etc.) are supported by the target through these public activities and assess whether these are a 'good fit' with the buyer's own approach.

Further, buyers may also want to consider whether any portion of the target's profits is being allocated to initiatives that seek a positive impact for its employees, the community and the environment in general.

Insurance Solutions

A Way to Mitigate ESG Risks on M&A Deals

Environmental Compliance

With the World Economic Forum ranking the Top 5 risks as environmental in 2019, it is unsurprising that environmental matters are firmly on boardroom and deal maker agendas. Howden has witnessed an increase in the number of clients seeking affirmative cover for historical environmental risks under traditional W&I insurance policies, as well as the use of standalone environmental insurance policies to cover known matters revealed through in-depth environmental due diligence.

While the W&I insurance market is continuing to grow and offer more cover than ever before, affirmative cover for environmental matters remains difficult to achieve for all but the most environmentally benign transactions. This is partly due to environmental matters being excluded by virtue of the 'disclosed matters' exclusion, but it is also partly attributable to the risk profile environmental matters can carry.

Howden is seeing a dramatic rise in the use of environmental insurance to manage legacy environmental exposures both retained and inherited through a transaction. This can be explained, in part, by a growing reluctance amongst corporates, private equity firms and financial institutions to retain or accept environmental risks as the likelihood, quantum and severity of public scrutiny toward those responsible for environmental damage is continuing to rise.

As demand has increased, insurers have had to keep pace and find innovative ways to insure the exposures faced by clients. We are seeing a sharp broadening of risk appetite to those areas that were previously deemed uninsurable. For example, an asset management company approached Howden after reviewing their portfolio of divested assets and identifying a former mining operation that they sold over 10 years ago. It was revealed that they continued to hold potential liabilities under environmental law even post-sale and we developed an insurance product that transferred that risk to an insurer for the next 10 years.

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Insurance Solutions

A Way to Mitigate ESG Risks on M&A Deals

Insurers have also responded to the ever-growing impact of public opinion and negative media publicity and now offer cover for crisis management costs following an environmental incident. This covers the cost of engaging and retaining a professional crisis management firm to assist the business and its management whilst they navigate the environmental incident and help alleviate the overall impact to a company's public reputation. Whilst not directly insuring financial loss such as a drop in revenue or share price, such assistance can be vital to managing the impact to a company's balance sheet.

Sellers and their advisors are now paying more attention to achieving a 'clean exit', particularly on transactions where pollution is known to exist. To address this issue, working alongside environmental legal professionals, Howden has developed new and innovative insurance products to insure, or even replace, the full suite of environmental warranties provided in a sales agreement. By transferring these risks to a financially secure A+ rated insurer, not only does this achieve a 'clean exit', it also ensures the creditworthiness of a guarantor and reduces the risk of clean-up costs ultimately landing on the public purse.

Looking forward, Howden expect to see increased use of environmental and other forms of specific risk insurance to address environmental matters in increasingly innovative ways to match the rising demand of corporates, investors and financial institutions.

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Insurance Solutions

A Way to Mitigate ESG Risks on M&A Deals

Tax Compliance

The insurance market can also assist and provide cover for any historical tax risks identified that are associated with environmental matters. For example, where a rebate has been claimed from the tax authorities as a result of cleaning up a contaminated site but a risk exists that the tax authorities could challenge that rebate in the future.

With an increased focus on tax compliance matters as a result of a general trend of an increase in scrutiny by tax authorities all over Europe, investors are also now focussing heavily on historical tax compliance issues with respect to the companies they want to acquire/invest in. The increased due diligence focus results in tax risks being raised where there is some ambiguity about the historical tax treatment followed – investors previously would have lived with such risks but are now seeking ways to mitigate any potential liability. With sellers now not willing to stand behind any warranties or indemnities, a specific tax risk insurance policy is increasingly being used to manage such risks. Howden are particularly seeing an increased number of enquiries on permanent establishment and residency based risks where companies could be subject to tax liabilities in jurisdictions other than the jurisdiction of their incorporation. The insurance market has appetite for such risks and can be a useful tool on an M&A transaction where neither the buyer nor the seller is willing to accept any future risk from the identified tax issue.

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> **Abbas Juma, Director - Howden**

Insurance Solutions

A Way to Mitigate ESG Risks on M&A Deals

Insurance Solutions in the Pipeline

Risks associated with ESG issues have risen quickly up the agenda for risk owners globally in recent years. In response to this, the insurance market has adapted to place increasing importance on designing risk transfer products that help build resilience for corporates.

For example, in response to the increasing awareness surrounding environmental exposures, Howden has recently partnered with a number of data and parametric platforms to offer wider access to risk transfer solutions to insure or hedge risks associated with adverse or unexpected weather conditions. It is clear that climate change is influencing weather volatility and therefore, the use of a simple risk transfer solution that does not require a proof of loss but can be priced accurately through sophisticated modelling is going to be of increasing interest globally. To provide a more specific example of products in this space, Howden recently placed its first carbon credit invalidation insurance policy – a solution that will help to drive liquidity in the carbon offset trading market by wrapping carbon offsets with insurance to protect them against fraud exposures. With more of these types of risks in the pipeline this represents an enormous source of opportunity.

Elsewhere, insurers are looking for solutions to insure financial losses arising from non-compliance with pre-determined ESG metrics. A good example of this can be seen in the M&A space, where a breach of a seller's warranty relating to ESG matters may give rise to certain contractual penalties and in turn devalue the business acquired by a purchaser. As lenders place ESG-linked penalties on businesses receiving their funding, insurance may offer a solution to protect the innocent party whilst maintaining social responsibility.

Howden expect company directors to have a marked increase in risk exposure due to governance expectations as a result of higher regulatory expectations surrounding ESG. There are insurance products in this space to address these needs also.

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> **Charlie Langdale, Managing Director - Howden**

Conclusion

ESG considerations have become part of the new normal in corporate culture and their importance is expected to continue rising for the foreseeable future. Corporates and investors with strong ESG profiles are likely to be better equipped to manage not only unexpected crises but also broader risks in the long term. However, even though the rise of ESG brings along new business opportunities it also introduces a new spectrum of risks. In addition to standard due diligence on issues such as privacy and data security, tax compliance, labour practices (including, global talent development and workforce diversity), environmental risks, compliance and bribery/corruption, there are other areas of risk that buyers should consider as part of an ESG assessment. There are various insurance solutions available in the market and it is expected that the insurance industry will remain attuned to investors' needs in this area and either develop new products or adapt its existing offering to help investors navigate their risks in the ESG space.

Baker McKenzie helps clients overcome the challenges of competing in the global economy.

We solve complex legal problems across borders and practice areas. Our unique culture, developed over 70 years, enables our 13,000 people to understand local markets and navigate multiple jurisdictions, working together as trusted colleagues and friends to instill conwfidence in our clients.

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