ESG in M&A transactions – what's the trend…?

ESG has long formed part of any M&A process, with most deal documents including a range of standard warranties around environmental issues and compliance with laws and reporting obligations. But historically, the focus has come at a late stage, or even by accident, by dint of standard wording in precedent SPAs.

The market has shifted significantly over recent years, with ESG factored in at a much earlier stage of the process, informing initial investment strategy and target identification long before heads of terms are considered. That shift has been driven by an increased awareness amongst acquirers, funders, insurers and sellers that environmental, ethical and cultural issues directly affect risk, and therefore commercial return. Many stakeholders now have their own ESG policies which effectively sift out potential targets at a very early stage.

Once a target has been identified, it's not 'one size fits all' when it comes to due diligence of ESG issues. What's appropriate will depend on a number of factors including the nature of the business, time, and budget, as well as the requirements of any funders or insurers. Due diligence will then be dealt with across a number of different work streams: the buyer will focus on the impact of ESG on commercial and reputational issues; the legal team will focus on 'hard law' (where compliance is mandatory) and technical experts will often be involved to advise on 'soft law' (compliance with codes of practice and the like). Contrast with only a few years ago when reliable information around ESG issues was patchy at best, there is now a vast pool of data available as a result of increased regulation and consumer pressure; it will be essential to agree at the outset which resources will be used, what needs to be investigated in the context of the deal, who will be responsible for what and how the resulting information will be collated and reported.

Translating the results of the due diligence exercise into the transaction documents can also be challenging. The traditional warranties around environmental and regulatory compliance will cover off some risks, but others such as reputational issues will be harder to tie down. How is loss proved and quantified? Would the disclosure of an ethics policy, for example, undermine the ability to bring a claim if that policy is not in reality embedded in the culture of the target or its supply chain? Legal and technical advisers will need to work hand in hand to ensure warranties are tailored in such a way that a breach can be easily demonstrated, and loss accurately assessed.

It's worth remembering that the purpose of warranties is not solely to ensure a contractual remedy for breach. Their primary function is to set out a common foundation of understanding (with a claim for loss being the necessary consequence if that foundation is flawed). Seen in that light, a full suite of tailored warranties, however challenging to enforce, may still have intrinsic value.

Finally, the 'net' when it comes to disclosure against ESG warranties is also becoming increasingly wide. Historically, 'knowledge' would rarely take into account the thoughts of any key individuals outside the board; but with reputational risk at the heart of ESG, that knowledge base is becoming increasingly wide. It's not unusual to extend the net to include sales managers well below the senior executive, and even key players in the supply chain of the target entity.

ESG is not a new theme, but it is increasingly driving change in the context of an M&A transaction. Our advice is: embrace the challenge – not only to minimise risk and maximise value, but also to make a positive and lasting difference to market practice.

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