

ESG CONSIDERATIONS IN M&A

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Environmental, social, and governance (“ESG”) considerations in M&A transactions are becoming increasingly important. Stakeholders, including large institutional stockholders, are requiring greater transparency and accountability from companies on ESG factors, and this unprecedented level of engagement is creating both risk and opportunities that are financially material to companies. Mitigating ESG risk and maximizing ESG-related synergies in M&A transactions is now an important consideration for M&A practitioners.

This article explores how to address ESG considerations in the context of an M&A transaction, including conducting ESG-focused due diligence, allocating ESG risk in transaction documentation, and implementing post-closing ESG integration. Many of the elements discussed in this article are not new. Understanding ESG risk and opportunity has

been an important part of the board of directors’ agenda at many companies. It is also a fundamental component of impact investing and sustainable investment strategy.

The Value of ESG

A successful ESG strategy promotes positive stakeholder engagement and is increasingly viewed as a significant driver of value. Also, the financial consequences to a company of miscalculating ESG risk can be severe. These positive and negative value components are discussed below.

Positive Stakeholder Engagement

ESG is now a mainstream focus for investors. In Larry Fink’s recent letter to

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CEOs, he predicts a fundamental reallocation of capital towards investment strategies that place sustainability at the center of the investment approach. BlackRock, State Street, T. Rowe Price, Vanguard and other large fund managers have stated that ESG-focused companies create long-term value for stockholders and ESG risk will be assessed with the same rigor as traditional measures such as credit and liquidity risk. T. Rowe Price has stated that “we believe that environmental, social and governance issues can influence investment risk and return and, therefore, incorporate ESG risk considerations into our fundamental investment analysis.” Similarly, State Street announced that “addressing material ESG issues is good business practice and essential to a company’s long-term financial performance.”

Institutional commitment to sustainable investing has grown dramatically in recent years. Institutional investors with over \$80 trillion of assets under management have signed up to The Principles of Responsible Investment (the “Principles”) and over 100 investors have adopted

IFC’s Operating Principles of Impact Management, including buyout funds such as KKR. More than 90 banks and financial institutions have adopted the Equator Principles, which are based on IFC’s Performance Standards. Approximately one-quarter of assets under management (approximately \$12 trillion) are now ESG-rated investments, with climate change, human rights, and labor standards being given particular priority by investors.

Increasing engagement on ESG matters is not limited to investors. Social activism is on the rise and a company’s position on ESG can now be a significant factor in attracting talent, with millennials being particularly focused on metrics such as diversity and inclusion when making employment decisions. Companies with higher ESG scores have been shown to have better employee morale, productivity and retention, correlating with improved financial performance and equity returns. Customer engagement can also be enhanced by offering more sustainable products and services and can provide new market opportunities. A demonstrated commitment to

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ESG can fundamentally drive brand value and, in some cases, customers are willing to pay more for sustainable products.

Financial Performance

A majority of over 2,000 studies indicate that companies focused on ESG metrics have performed better over time. This is the case in both developed markets and emerging markets, as well as across different industries. A recent IFC report (*Moving Toward Gender Balance in Private Equity and Venture Capital, 2019*) explored the link between financial returns and gender balance in emerging markets. The report revealed that PE and VC funds with gender-balanced general partners generated up to 20% higher returns compared with funds that have a majority of male or female leaders. Furthermore, portfolio companies with gender-balanced leadership teams outperformed their peers with less diverse teams and their median valuation increased by as much as 25%. Evidence is also emerging that, on average, companies with higher ESG scores have up to a 10% lower cost of capital than companies with lower ESG scores due to an overall lowering of operational risk.

ESG Risk

A company's failure to understand and properly address key ESG factors in its business is increasingly viewed as a significant risk to the company's long-term value (what can be called "ESG risk"). ESG risk can take different forms, including regulatory non-compliance, shareholder activism or litigation and reputational harm, as discussed below.

Regulatory Risk. There is a rising tide of regulatory reform in the EU and U.S. focused on ESG factors, such as climate change and carbon

emission standards, as well as ESG-focused disclosure requirements. In Europe, the EU has required disclosure of non-financial statements on corporate social responsibility for listed companies since 2018. Further ESG reform in the EU contemplates standardization of ESG reporting for large companies and integration of ESG factors in banking, insurance, and asset management industries. While the ESG disclosure regime in the U.S. is currently voluntary, an SEC investor advisory committee has recommended updating public company reporting to include material ESG factors. Major stock exchanges are also considering requiring ESG-specific disclosures and there is global reform towards mandatory human rights disclosures. Companies must consider both the risk of non-compliance with ESG regulation and the potential disclosure risk of material misstatements or omissions on ESG matters, including in connection with any forward-looking statements a company has made about achieving ESG goals within specified time periods.

Shareholder Activism. For a third year in a row shareholder activism in the form of ESG proposals represented a majority of all shareholder proposals in the 2019 U.S. proxy season, with climate change and emission controls being the most significant focus points. Major asset managers, including BlackRock, have publicly stated that they will not vote for directors who have a poor track record on promoting sustainability. The enormous demand among investors for clear ESG metrics has resulted in the growth of an ESG data services industry, with over 100 rating agencies now reporting on company ESG performance. Increasing uniformity in ESG measurement and standards and overall improved disclosure will result in greater

transparency. Companies that fall short in their approach on ESG compared to their peers are likely to be targeted by stockholders and other stakeholders for not doing enough.

Litigation and Reputational Risk. Every industry faces ESG-related litigation risk, including in relation to environmental non-compliance, product safety violations, employee misconduct, and data privacy claims. However, with the rise in social activism, particularly focused on climate change, employee misconduct, and gender and race bias, ESG-related litigation by aggrieved stakeholders can be seen with greater regularity. These trends are also accelerated by an increasing number of ESG-focused NGOs whose very purpose is to ensure that companies comply with ESG standards. Failure to properly address material ESG risk can result in major reputational harm and damage to business valuations. In addition, stockholders continue to focus on the governance prong of ESG. Some institutional stockholders view governance as a major driver of the other aspects of ESG. Accordingly, companies with weak governance or companies ignoring how ESG risk may impact their business face exposure to stockholder lawsuits, including for breaches of fiduciary duties.

Assessing ESG Value and Risk in the M&A Context

Determining the accretive or dilutive impact of ESG factors on the valuation of a target company or the pro forma ESG impact of a transaction on an acquiror is not straightforward. Some of the challenges in making this assessment in the context of an M&A transaction are discussed below.

Difficult to Quantify. ESG risk can be latent

and difficult to quantify in financial materiality terms, particularly within the time and procedural constraints of an M&A transaction. While there is no one-size-fits-all approach to stakeholder engagement, the target's industry is a key factor and ESG standards within specific industries are developing. Carbon emissions in the oil and gas industry, environmental and social risk in agriculture and drug testing and safety in the pharmaceutical industry are just some of the areas where industry standards are forming. The stage of economic development is also important. In emerging markets, where the regulatory landscape and law enforcement may lag behind more developed countries, ESG risk is generally heightened. For this reason, emerging markets investors such as IFC have placed ESG evaluation and performance at the heart of their investment strategy.

No Unified Metrics. While a majority of large companies report on a variety of ESG factors, the lack of clear standardized metrics and the widespread use of inconsistent data make an accurate assessment of the materiality of ESG factors difficult. A number of leading ESG reporting frameworks have emerged in an effort to provide standardised reporting. The Sustainability Accounting Standards Board (SASB) has developed a set of sustainability standards for 77 different industries. These standards are based on sustainability risks and opportunities that are deemed to be potentially financially material to companies in those industries. Other non-industry-specific frameworks include the Task Force on Climate-Related Financial Disclosures (TCFD), which publishes recommendations for climate-related financial risk disclosures that are complimentary to SASB standards, the Global Reporting Initiative (GRI) and the metrics proposed in the World Economic Forum International Business Coun-

cil's consultation paper. Many companies provide ESG disclosure based on one or more of these standards. Over time, we are likely to see convergence in reporting standards and disclosure, driven in significant part by global asset managers, regulators, securities exchanges, and ESG rating agencies. However, until there is more transparency, companies will need to make their own qualitative and quantitative assessments using their own criteria.

Access to Information. Accessing relevant ESG information from the target during M&A due diligence may be very difficult. The target may not be forthcoming with accurate and quantifiable information. Also, a different, but equally valid, approach to ESG may mean a lack of alignment between an acquiror and target in assessing ESG risk and therefore its impact on value. A target company with a poorly developed ESG strategy will also struggle to meet the informational requirements of a sophisticated acquiror with a best in class approach to ESG. However, the mere fact that a target does not or cannot provide adequate ESG information may be a red flag in and of itself.

Assessing "ESG Compatibility." Merger partners that are incompatible on key ESG metrics are less likely to be a good "cultural fit" and more likely to raise integration difficulties for the acquiror. There would certainly be a cost to bringing the target into compliance with the acquiror's own ESG standards. Conversely, an investor or acquiror that can bring ESG expertise and guidance in helping the target or investee company elevate its ESG compliance may be viewed as a significant plus. However, until there are more unified standards and transparency on ESG, it will be difficult for M&A practitioners to

accurately assess the ESG integration costs and potential synergies arising in a potential combination.

Fiduciary Duty Considerations

The increasing focus on ESG, including from public companies' long-term institutional stockholders, as well as the current societal discussion on the purpose of the corporation (particularly put in the spotlight by the Statement on the Purpose of a Corporation of the Business Roundtable signed by 181 CEOs), have raised the question of how to reconcile stakeholder interests with corporate law and the fiduciary duties of directors. In many European countries, corporate law not only allows but requires the board of directors of a public company to take into account interests of stakeholders other than stockholders and even broader community interests. A number of states in the U.S. have also enacted in their corporate statutes the right of the board of directors to consider broader stakeholder interests. Delaware, home jurisdiction to most U.S. public companies, has not adopted the stakeholder doctrine in its statutory corporate law, and Delaware courts have emphasized primacy of stockholder value in a board decision-making process. So does this mean that a board of directors of a Delaware corporation should not, or even cannot, take ESG factors into account?

The answer is that a board of directors can and should take ESG factors into account and many boards have been doing so. A Delaware board, in addition to a duty of care, has a duty of oversight over the corporation (which is part of the duty of loyalty). Several recent Delaware courts' decisions have focused on this duty. Both the duty of care and duty of oversight require the board to

understand the risks that the business may be facing and to implement a system of information flow and controls that enables it to monitor and oversee the company's operations. Whether business risks are addressed on a timely basis directly relates to creation or destruction of stockholder value. ESG risk is a real risk to the business that a board needs to understand and consider and the board should develop a strategy to address such risk.

The board of directors of a Delaware corporation may consider a broad set of stakeholder interests. Looking closely at the Statement of the Business Roundtable, the concepts of taking into account interests of employees, customers, suppliers, etc. directly relate to the success or failure of a business and accordingly to stockholder value. Stating the obvious, how a corporation treats its employees goes directly to employee engagement, productivity, recruitment and retention, delivering value to customers is key to the level of satisfaction and loyalty of customers, and both have a direct positive or negative impact on stockholder value. The same is true for other constituencies. Even before the Statement of the Business Roundtable, the Delaware Chancery Court has held that when the board makes a rational business decision, and the decision is “reviewed under the business judgment rule, this Court will not question rational judgments about how promoting non-stockholder interests—be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture—ultimately promote stockholder value.” (*eBay Domestic Holdings, Inc. v. Newmark et al.*, No. 3705-CC, Del. Ch. (2010)).

Aligning M&A and ESG Strategies

An acquiror should have a clear understanding of the key ESG risks and opportunities in the target's business. This assessment should be evaluated against the acquiror's ESG policies to ensure alignment with its ESG strategy, including acquiror's applicable disclosure regime. As noted above, there is no one-size-fits-all to stakeholder engagement on ESG matters. The acquiror may use existing frameworks such as TCFD, SASB, GRI, or the Principles as a baseline approach or develop its own scorecard and measurement criteria.

As an example, IFC has developed a set of eight Performance Standards that define the approach and criteria to be used by IFC investee companies for addressing environmental and social (“E&S”) risk and opportunities.¹ Together, these eight Performance Standards establish the E&S standards that each IFC investee company is expected to meet throughout the life of an investment by IFC. Performance Standard 1, which requires IFC investee companies to have an established policy that defines E&S objectives and principles that apply to them, emphasizes the importance of having (i) integrated assessment to identify E&S impacts, risks, and opportunities; (ii) effective community engagement through disclosure of project-related information and consultation with local communities on matters that directly affect them; and (iii) the management of E&S performance. Performance Standards 2 through 8 establish objectives and requirements to avoid, minimize and, where residual impacts remain, to compensate/offset for risks and impacts to workers, affected communities and the environment. While all relevant E&S risks and potential impacts should be considered

as part of the assessment, Performance Standards 2 through 8 describe potential E&S risks and impacts that may require particular attention. Where E&S risks and impacts are identified, the company is required to manage them through an Environmental and Social Management System, consistent with Performance Standard 1.

ESG Due Diligence

Approach

Given the constraints typically imposed by a target on the conduct of buy-side due diligence in terms of timing, access to information, ability to conduct site visits etc., it is important at the outset for an acquiror to have a clear understanding of the ESG framework being applied and an informed view of what the key ESG risks and opportunities may be. The acquiror may have in place a dedicated ESG officer to lead this effort or an ESG team. Alternatively, an acquiror may rely more on external resources and consultants to undertake its ESG evaluation. Where appropriate, training should be given to team members on ESG matters to build awareness and align the approach of the M&A team with the overall ESG strategy.

The extent of any desktop analysis will depend on the nature of target's ESG reporting and disclosure, including adoption of existing frameworks. Physical ESG diligence, including site visits and interviews, should be conducted to the extent possible. Again, external providers can assist with identifying industry-specific ESG risk and what ESG criteria are most important to key stakeholders of the target. In any event, the information provided should ideally be qualitative and measurable. Key considerations from a diligence perspective include the following:

- Does the target have an ESG strategy? Has the target adopted any ESG framework?
- What is the target's approach to ESG governance?
- What ESG procedures, policies, and processes does the target have in place?
- How has the target board been involved in understanding, developing and implementing the ESG strategy, including requiring accountability from target management?
- What management incentives are in place to promote ESG?
- What ESG factors are relevant to the target's ability to operate its business?
- How do ESG factors influence key stakeholder decisions in relation to the target and their assessment of the target's business?
- Does the target have a stakeholder engagement strategy? What is the history of stakeholder engagement?
- What ESG disclosures has the target made?
- Has the target prepared internal or external ESG reports?
- What measures has the target taken to reduce ESG risk?
- Are there sufficient personnel and other resources to properly handle ESG matters and how are they deployed in the target business?

Setting Materiality

An assessment of which ESG factors are material will be based on understanding the target's

industry and the impact of the target's business on its key stakeholders. As noted above, certain reporting frameworks such as SASB focus on ESG factors that are considered to be financially material to companies in the relevant industry (*i.e.*, reasonably likely to impact the financial condition or operating performance of the company). Frameworks such as GRI determine materiality based on those opportunities and risks which are most important to key stakeholders. Certainly, risks that are significant to the target's stakeholders or to the target's ability to achieve its business goals or ability to operate its business should be considered material. Until a clearer framework exists, the acquiror should develop its own assessment of materiality as informed by its own rubric, relevant industry standards, the target's own reporting criteria and what the acquiror believes to be material to important stakeholders of the target based on its diligence.

GAP Analysis

Through the diligence process, acquiror should develop a GAP analysis assessing the pro forma ESG performance of the target and the related impact on the acquiror. As part of its analysis, the acquiror should also develop a proposed action plan to mitigate identified ESG risk and achieve any positive valuation outcomes. The key value components, both in terms of potential risk and opportunities, should be taken into account in the valuation models, including the cost of effecting any ESG integration and implementing any ESG action plan. Key ESG risk should be considered at the level of the board of directors or appropriate committee, as part of the acquiror's overall risk assessment of the transaction.

ESG Contractual Protection

Where material ESG risk has been identified, an acquiror may consider seeking contractual protection in the acquisition agreement. A standard warranty package which includes customary representations and warranties on matters such as legal and regulatory compliance, accuracy of securities filings, and environmental and employee matters, should offer significant protection. However, more specific ESG-focused warranties may also be considered, including:

- target's compliance with applicable ESG policies, including standards such as SASB and TCFD if the target has committed to comply with such standards;
- misconduct that implicates material ESG concerns, including allegations of sexual harassment and misconduct (or "Weinstein clauses"), and complaints on matters such as discrimination;
- any other social, labor, health and safety, security or environmental incident, accident or circumstance with respect to the target's business and operations that could reasonably be expected to have a material adverse effect, including the existence of communications from governmental authorities, NGOs or other third parties relating to such incidents, accidents or circumstances.

Post-Closing Considerations

Where acquiror's GAP analysis has identified areas of ESG risk or opportunities for value enhancement, the acquiror should develop an action plan to address them. Achieving buy-in from target management is key and acquiror should consider establishing ESG KPIs for senior man-

agement where appropriate, including integrating ESG metrics into performance measures, performance goals, and vesting conditions. A number of factors have led to the increased use of ESG metrics in incentive compensation plans. These include stakeholder activism (as discussed above) and the repeal of the performance-based exception to Section 162(m) of the tax code. The change to Section 162(m) provides companies with greater latitude to include qualitative (or subjective) performance metrics in their incentive compensation programs.

Shearman & Sterling's soon to be released 18th annual survey of the Top 100 U.S. Companies (based on revenue and market cap) reveals that 36% of surveyed companies incorporate ESG metrics into their executive compensation program. Approximately 80% of these companies include these metrics in their annual, as opposed to long-term, incentive plans. This reflects the long-held view that long-term plans should focus on financial and stock-return metrics, as opposed to operational metrics. For all but two of the companies, diversity was included among the ESG metrics, while energy companies also typically included environmental and safety metrics.

ESG metrics are typically factored into a holistic qualitative review of individual performance, which typically constitutes between 15% and 30% of the total bonus opportunity. Approximately 20% of surveyed companies set forth a specific weighting related to ESG, usually about 10%. These qualitative measures should be included among the performance measures used on performance evaluations and scorecards, many of which already include governance issues. A common design question for companies incorporating ESG metrics is whether to measure

success against internal targets, or targets set by third parties, such as SASB.

Conclusion

The ESG landscape is evolving rapidly. While it is still too early to know what impact “stakeholder capitalism” will ultimately have on corporate decision making, it is clear that ESG factors now represent important risk and value components in M&A transactions. Until there is greater transparency of ESG reporting and more unified measurement frameworks, M&A practitioners should take particular care in understanding and addressing ESG risk in transactions and companies should ensure that the existing ESG framework is well integrated into their M&A strategy and execution.

ENDNOTES:

¹The IFC Performance Standards are available on the IFC website at https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/Policies-Standards/Performance-Standards.

A DEALMAKER'S GUIDE TO THE FINAL DOJ/FTC VERTICAL MERGER GUIDELINES

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