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Increased ESG Emphasis Finds Its Way Into M&A Process

By **Benjamin Horney**

Law360 (February 18, 2022, 6:52 PM EST) -- Investors and regulators alike are paying more attention to environmental, social and governance issues, and while it's still uncommon for such considerations to take precedence over economics, mergers and acquisitions attorneys are feeling the ESG focus in the form of increased due diligence and disclosure burdens.

ESG matters encompass a wide range of topics, such as environmental sustainability, climate change, sexual harassment, and board and employee diversity. For a long time, ESG issues, while considered important, didn't factor heavily into mergers and acquisitions, mostly because deal-makers were focused on the financial bottom line.

But the tide has been turning in recent years, and nowadays, nearly every deal requires significant ESG-related work, beginning with the due diligence process.

Emily Huang, a corporate partner at Debevoise & Plimpton LLP who is a member of the firm's M&A group, told Law360 that ESG is "changing how investors evaluate deals and choose to deploy capital, from the rise of impact funds to increased and more standardized ESG reporting."

"This puts more emphasis on getting it right at the diligence stage in assessing businesses from an ESG perspective," she said. "I think we can expect social issues of equality and diversity to have increased emphasis, as well as continued attention to carbon emissions and climate change generally."

Law firms have noticed the increase in attention being paid to ESG matters, and some are even taking action to ensure they are properly prepared. Sidley Austin LLP, for instance, has put together a team of lawyers that is tasked with analyzing and thinking through ESG developments so the firm and its attorneys can be better prepared to advise on ESG issues and effectively manage associated due diligence, according to Brien Wassner, a partner and co-leader of the private equity practice at Sidley. The group consists of partners across multiple practices, offices and industries.

"The group is built to conduct ESG diligence as a diligence line for our clients on deals," Wassner said. "That's definitely been a development, ESG as a diligence item. Today, you have to understand the value proposition of ESG considerations. It's not just a check-the-box item."

Underscoring that point are the results of a recent survey from SRS Acquiom, which provides analytics and software aimed at helping deal parties manage mergers and acquisitions. The 2021 SRS Acquiom Barometer on ESG Factors and Their Influence on M&A Activities surveyed a total of 85 law firms, strategic buyers, investment banks and private equity firms, asking questions such as "How important to your current M&A strategy are ESG factors?" and "Are ESG factors impacting your M&A deal dynamics? If so, in what way?"

On the first question, nearly 52% of respondents said that ESG factors are either "very important" or "somewhat important." For the second question, respondents were allowed to choose more than one answer. Of the 85 total respondents, about 52% said ESG issues are causing there to be "additional steps" in the due diligence process and 44% said they are resulting in new representations or warranties. Notably, only 1.2% of the respondents said they would "materially sacrifice" economics on a deal to support ESG, compared with 42.2% that said they wouldn't be willing to sacrifice on economics "at all."

"This kind of market data to reflect what is actually happening is important," said Carl Valenstein, a partner at Morgan Lewis & Bockius LLP who co-chairs the firm's ESG group. "The SRS survey results are very consistent with my own experience doing transactions. We're beginning to see movement on the diligence front, and slightly when it comes to contractual language, but almost nobody is sacrificing economics for ESG."

It's not surprising that such a survey would show people not wanting to make major economic sacrifices just to ensure certain ESG issues are being supported. But the idea that supporting ESG and obtaining the best financial outcome are mutually exclusive doesn't have the same support it once did. Many modern investors are convinced that, when it comes to certain ESG issues, it's actually better for a company's long-term financial outlook to make sure there are proper policies in place. And the boards of directors for some companies have started to agree.

"It's not ESG for ESG's sake," said Elizabeth Bieber, a counsel at Freshfields Bruckhaus Deringer LLP who heads the firm's shareholder engagement and activist defense practice in New York. "It's ESG as a strategic consideration that is fundamentally tied to financial returns."

"The way companies should be thinking about it is this: Incorporating ESG oversight, execution and policies can be additive from a financial perspective," she added.

As an example, a company might be doing well today, but if it hasn't considered how environmental issues might impact its business in the future, then today's rosy financial projections won't be tomorrow's actual results.

"Some companies haven't considered environmental impacts on their future business and how they are going to shift to a world where there's less demand for their product or business because the world is changing," she said.

The momentum toward more ESG consideration in M&A is also being pushed by regulators. For instance, there's been an increased focus from the U.S. Securities and Exchange Commission on greenwashing, which is the term for when asset managers misrepresent their own sustainability practices or the sustainability features of their investment products. At this point, most of that focus is on the private funds side, as opposed to the corporate side, Valenstein noted.

"The SEC, under this administration, has been focusing on investigating whether funds are really doing what they are telling investors they are doing," he said.

The SEC hasn't issued any formal rules or guidance as yet, although in March it announced the formation of a Climate and ESG Task Force that sits within the Division of Enforcement and is charged with developing initiatives to identify "ESG-related misconduct."

The ESG movement also exists elsewhere in the world. In Europe, for instance, private equity sponsors have to report to their investors under the EU Sustainable Finance Disclosure Regulation, or SFDR, while large publicly listed corporations must provide ESG-related information under the EU Corporate Sustainability Reporting Directive. Sidley's Wassner noted that the U.K. is also in the process of putting together sustainability disclosure requirements.

"There's the potential for the SEC to build into reporting functions disclosures around ESG considerations," Wassner said. "We're already seeing that movement in Europe ... and the U.K. has also just introduced its requirements, so it's only natural that we'd see something develop in the U.S., too."

--Editing by Orlando Lorenzo and Jay Jackson Jr.