

A world of difference

Managing ESG
risk in corporate
transactions



1. Introduction

Environmental, social and governance (**ESG**) and climate risks are not just regulatory issues. They are a board level strategic issue - failure to take appropriate steps could leave an organization exposed to material business risks particularly as key stakeholders are now requiring change within companies. Climate risk is getting a lot of attention and understandably so because arguably it has the potential to impact company value the most.



In the months ahead companies will come under increasing pressure to not only report on climate risk, but also to quantify the climate risks and opportunities their business faces,

and document their plans for climate action within the organization and across their supply chains in a proportionate way to the risks they face. Key stakeholders, such as investors, customers, and business partners, will want to see a defined strategy from companies with whom they engage in order to satisfy their own climate risk and decarbonization agenda including whether a particular investment or transaction should be made or whether to exit.

Eversheds Sutherland and KPMG Climate Change and Corporate Value Report, 2020

As ESG takes a more prominent place on the corporate agenda, boards and management will necessarily take more aggressive steps to develop an ESG strategy and implementation plan. This applies equally when undertaking corporate transactions.



ESG strategies should set out key milestones, the achievement of which should be capable of being verified to a reportable standard and reported on as part of a company's reporting process. ESG compliance will likely become an important tool in the delivery of an ESG strategy rather than an end in itself.

Eversheds Sutherland and KPMG Climate Change and Corporate Value Report, 2020

Corporate transactions

The key ESG objective in corporate transactions is to ensure that our clients have full visibility of ESG risk areas, are able to evaluate these and assess the impact they should have, if any, on the transaction structure, terms and pricing. This applies across M&A, private equity transactions, joint ventures and shareholders agreements, as well as fundraisings including Stock Exchange listings and secondary issues.

It is true that some existing standard provisions will by their nature cover ESG but they need to go further to ensure that the modelling, structure and documents are ESG fit for purpose and, so far as possible, ESG future proofed.

In addition, ESG has the potential to create value enhancement which may not have been captured at the time of the transaction. Corporate transactional models need to be capable of identifying this and capturing it for future value enhancement. We believe that this is a huge opportunity and one which must not be missed.

We aim to bring you the three Cs when it comes to ESG in corporate transactions:



Certainty

You can rely on the ESG data to have captured all ESG risk and opportunity.



Clarity

You are clear that the modelling, structure and provisions relating to ESG are correct, understood and have been properly implemented.



Comfort

From knowing that this transaction is aligned with your ESG strategy and will enable your business to continue to grow.



2. Looking at ESG in a corporate context

ESG encompasses many areas that can be relevant on a corporate transaction. Whilst a number of these have been important historically, we are now seeing them brought together under the ESG umbrella so that the target's overall ESG profile can be considered. Examples of ESG considerations include the matters set out below.



Environmental

- ✓ Climate change
- ✓ Greenhouse gas emissions
- ✓ Environmental risks, e.g. hazardous waste and pollution
- ✓ Energy efficiency
- ✓ Changes in land use



Social

- ✓ Business human rights and labour standards
- ✓ Workplace diversity
- ✓ Health & Safety policies and procedures
- ✓ Modern Slavery
- ✓ Investigation of supply chain



Governance

- ✓ Corporate governance and reporting
- ✓ Board composition, structure and executive pay
- ✓ Risk management
 - ✓ Anti-bribery and corruption
- ✓ Tax compliance
- ✓ Sanctions and financial crime
- ✓ Privacy

3. Why does ESG matter in corporate transactions?

The extent of the ESG risks will depend on the nature and sector of the target, but they may include or be affected by the matters set out below.

It is clear that companies will need to have increased regard to the ESG risks as well as opportunities when undertaking corporate transactions.

Risks of non-compliance

A considerable amount of legislation underpins some of the areas that come within the ESG umbrella, for example in an environmental or employment context. Buyers and sellers will be mindful of the business risks that can arise, including litigation. The cost of non-compliance – both financially and reputationally – can be significant. International groups will be mindful of cases where the Courts are being asked to determine the liability of parent companies for pollution and environmental harm from the activities of their overseas operations. Larger listed company buyers will be concerned about the expectations of institutional investor bodies in this area, and the potential for increased shareholder activism.

ESG regulation is increasing and developing rapidly. Moves at an EU level towards new corporate due diligence laws will require companies that want to access the single market to identify, address and remedy areas in their value chain that impact on human rights, the environment and good governance. Companies will have to adapt quickly to comply with new legislation and initiatives such as this.

Access to, and cost of, funding

Investors and funders, for example private equity investors and lenders, may favour companies which perform well in ESG areas.

Covid-19 impact

Whilst the environmental aspect of ESG was put into the spotlight due to the increased emphasis placed on climate change in recent years, the Covid-19 pandemic has seen an increased focus on the 'social' element, e.g. how companies have supported their employees and wider society through the crisis. There is significant pressure on governments and regulators to focus on a green Covid-19 recovery.

ESG disclosure and investor demands

As we highlight below, there have been a number of global initiatives around ESG reporting and disclosure. Companies, private equity houses and funders will need to be aware of their obligations, both existing and those on the horizon, in the context of corporate transactions.

4. Seeing the bigger picture and managing risk:

How Eversheds Sutherland can help

Our global ESG Solutions Team can help you to manage ESG risk in your corporate transactions, including in the areas described below.

Transaction planning

Our experience will help you to understand the significance of ESG to the main players in a corporate transaction, as well as any ESG regulatory obligations they may be subject to, for example in the case of PE houses, funds and listed companies. This may inform the scope of any specific ESG third-party due diligence to be undertaken.

Due diligence and disclosure: understanding the risks

ESG should now be a part of any due diligence, verification or disclosure process. The challenge is knowing what to look for. Understanding which ESG factors have the potential to impact risk or value in the target business is key and this is what our global ESG Solutions Team is able to do and then advise you on how to process and act on this.

Sale and purchase agreements and warranties

Whilst existing standard warranties will no doubt cover many areas of ESG concern, in our view the better approach is to be specific and to consider going beyond a focus on compliance. This is because:

- a company's ESG position has the potential to impact a company's value notwithstanding ESG compliance
- key stakeholder engagement will likely be linked to a strong ESG position
- ESG is not just about risk. ESG can create value enhancing opportunities and these need to be understood

Sellers need to consider their potential liability for legacy ESG issues, and how their exposure can be mitigated.

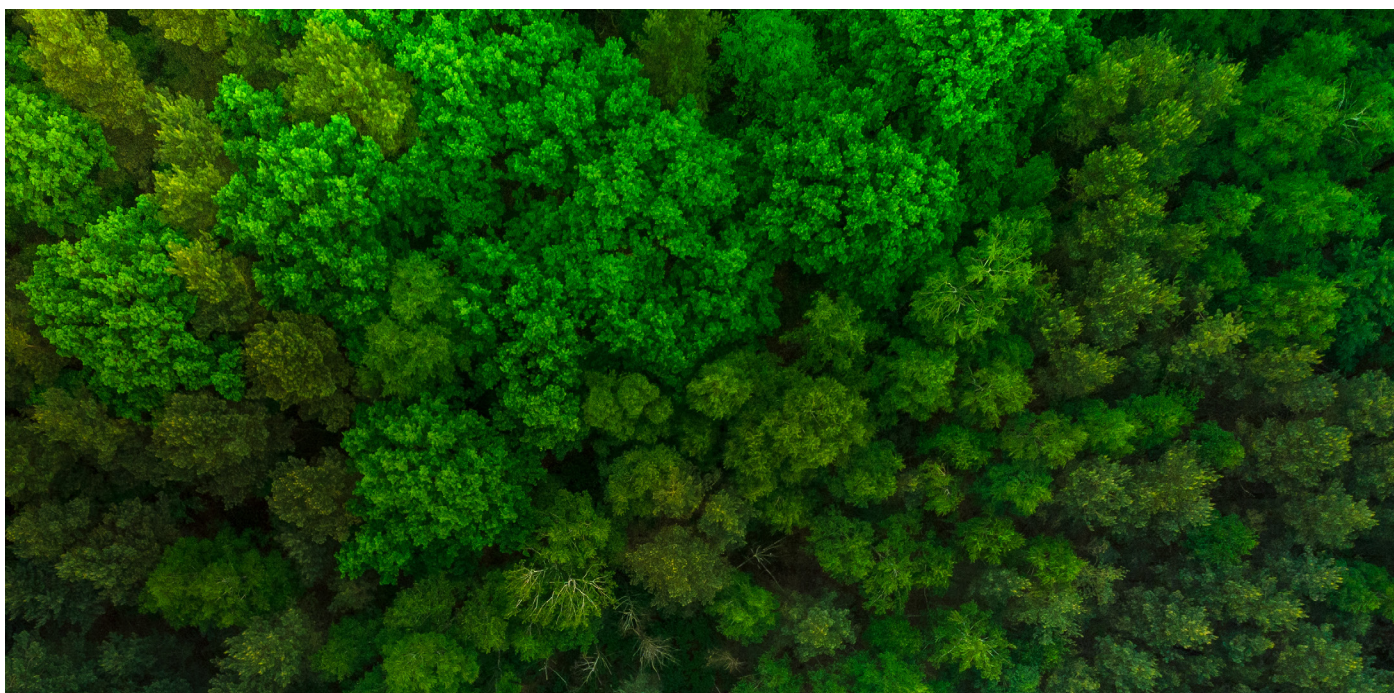
Private equity transactions

ESG may be relevant at all stages of the investment process. It will be relevant to the PE house and the limited partner investors, who may be subject to specific ESG obligations. ESG factors may also affect the sustainability and profitability of an investment. Increasingly PE houses are also establishing dedicated "Impact" funds which only invest with an ESG agenda.

Ongoing obligations

If an investment or joint venture agreement is being entered into ESG coverage may be required in the following areas:

- in relation to existing and ongoing compliance with ESG law and ESG regulation
- to disclose any circumstances that could impact the ESG position of the company
- to protect against ESG driven value deterioration and to focus on ESG driven value enhancement on an ongoing basis
- to establish appropriate access to ESG data and establish appropriate due diligence, monitoring and disclosure protocols
- to share ESG best practices
- to cover the reputational risks of breach



IPOs and fundraisings

ESG factors may be relevant on IPOs and fundraisings. Climate-related risks and other ESG considerations are widely understood to be financially material to the assets and prospects of listed and traded companies and the risks and opportunities they face. For example, listed and traded companies in the UK and the EU are subject to a range of disclosure obligations under the Prospectus Regulation where ESG factors may be relevant. Our dedicated team of lawyers can guide you through the regulation and guidance that applies in the relevant jurisdiction.

It will also be important on a verification exercise to ensure that green credentials and statements made in a prospectus or admission document are backed up by appropriate evidence.

Plc advisory

Reporting and Disclosures

There has been a global shift towards ESG reporting and disclosure, with a focus on climate risk, sustainability and decarbonization. Globally, we are seeing a clear push by governments and regulators to introduce ESG legislation and regulation, such as the EU's Taxonomy and supporting measures and a proposal for a Corporate Sustainability Reporting Directive, and the UK Government making climate-related financial disclosure mandatory through the Task Force on Climate-related Financial Disclosures (TCFD) Framework (see below). Leading framework and standard setting organizations are collaborating on a framework to improve sustainability disclosure.

Progress has been made in relation to climate risk and decarbonization reporting and disclosure. Following the UK, jurisdictions such as Switzerland and New Zealand have also adopted the TCFD framework, with the US and Canada

expected to follow suit, and progress is also being made towards this in France. In the US, the SEC is still considering the best way to implement an ESG disclosure framework for listed companies, but we understand this is likely to be implemented in the near future.

At an EU level, key initiatives that will impact companies include:

- the EU green taxonomy and supporting measures to help investors understand companies' exposure to climate risk
- the EU Sustainable Finance Disclosure Regulation, which requires all financial services participants in the EU to disclose ESG issues, with additional requirements for products that promote ESG characteristics or that have sustainable investment objectives. This is likely to have an impact for investee companies
- a proposal for a Corporate Sustainability Reporting Directive to improve sustainability reporting. This proposal will extend the companies required to report on a range of ESG and sustainability issues to include large non-listed companies established in the EU and listed SMEs on EU markets. Reporting would be against mandatory EU sustainability reporting standards

As mentioned above, the position is more advanced in the UK. Premium listed companies in the UK are now subject to "comply or explain" climate-related disclosure obligations in their annual financial report for financial years commencing on or after 1 January 2021 in line with the TCFD recommendations.

The UK government is also consulting on mandatory climate-related financial disclosures by publicly traded companies (including those on AIM) and certain large private companies and LLPs aligned to the TCFD recommended disclosures being required from 2022.



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Other regulatory and governance obligations

Listed companies are subject to other continuing obligations which may be impacted by ESG factors, for example in the UK and EU under the Market Abuse Regulation and the Transparency Directive in relation to inside information, the prevention of market abuse and other required market disclosures.

We also work with our employment and share incentive teams globally to help you address ESG issues as they impact executive remuneration.

Insurance solutions

Buyers and sellers will need to assess the availability of adequate insurance in relation to corporate transactions, as well as any exclusions that may apply (e.g. under warranty and indemnity insurance policies). Brokers can help identify any specialist insurance policies that may be available for specific ESG risks.

Integration

Post-completion, we can help with:

- alignment of the target's ESG policies and procedures
- a post-completion ESG compliance audit
- addressing and managing ongoing ESG risks
- preparing for enhanced ESG disclosure

5. Key contacts

For further information, please contact:



Herbert Short

*Co-Head of ESG and US
International Partner*

T: +1 404 853 8491
herbertshort@
eversheds-sutherland.com



Marc Rawls

Partner

T: +1 404 853 8058
marcrawls@
eversheds-sutherland.com



Richard Moulton

Head of Corporate (International)

T: +44 20 7919 4593
richardmoulton@
eversheds-sutherland.com



Martin Weitenberg

Partner

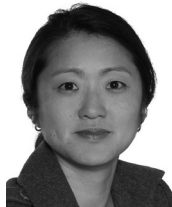
T: +49 2 11 86 46 75 8
martinweitenberg@
eversheds-sutherland.com



Jae Lemin

Partner

T: +852 2186 3215
jaelemin@
eversheds-sutherland.com



Miriam Van Ee

Partner

T: +31 1 02 48 80 26
miriamvanee@
eversheds-sutherland.com



Gaelle Le Quillec

Partner

T: +33 1 55 73 40 47
gaellelequillec@
eversheds-sutherland.com



Luisa Deas

*Senior Marketing and
Business Development Manager*

T: +44 20 7919 0560
luisadeas@eversheds-sutherland.com

eversheds-sutherland.com

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