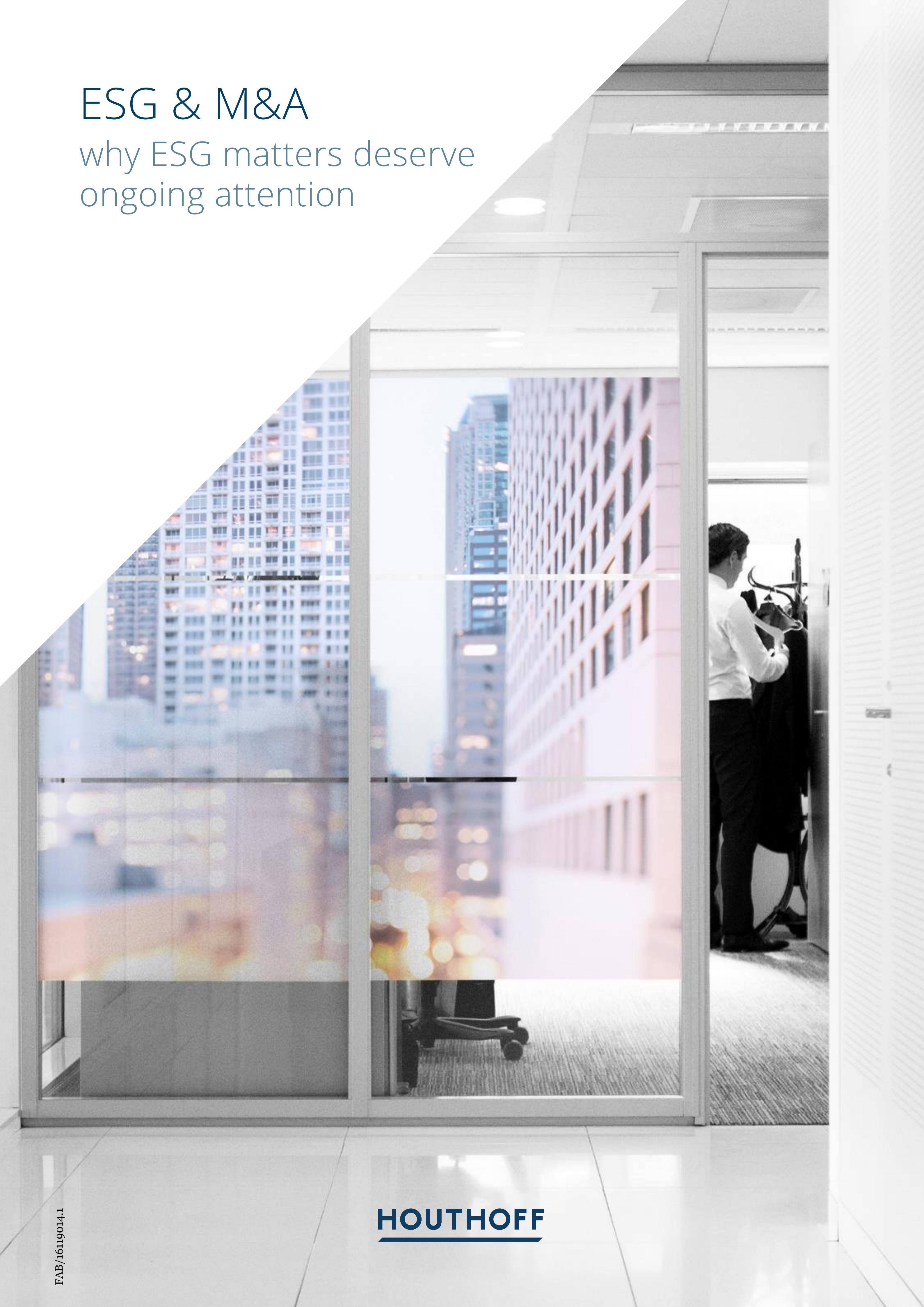
ESG & M&A

why ESG matters deserve ongoing attention



HOUTHOFF

1.Introduction

ESG is currently *on the rise* within the M&A world, is a statement often heard.[1] ESG stands for Environmental, Social & Governance. Within M&A, the term implies that factors such as energy consumption, availability of raw materials, environmental impact of operations, diversity within the company, compliance with human rights, safe working conditions and good corporate governance are taken into account in the selection and management of investments. Whereas ESG investments cautiously emerged in the 1960s - under the label Social Responsible Investing (SRI)[2] - it seems that today investors and companies can no longer afford to ignore ESG.[3] Moreover, there is consensus within the literature and practice that ESG investments and ESG objectives are of added value.[4] Added value that is endorsed and driven by regulatory developments that (will) oblige companies to report on ESG (compliance) (CSRD, CSDD). In short, against this background ESG no longer seems just *on the rise* within M&A but also *here to stay* and will take a more prominent role within M&A strategy and M&A processes.[5] Reason why, in my view, ESG matters also deserve ongoing attention.[6]

In this article, I aim to clarify the role of ESG issues within M&A processes in two ways. First by briefly explaining ESG generally stands for withing M&A (section 2) and what role ESG issues currently play within M&A processes (section 3). Then by discussing how this role will become more important in the near future given two major European legislative initiatives (CSRD & CSDD) (section 4). Against this background, I finish of with some concluding remarks endorsing the importance of continued attention to ESG issues (section 5).

[1] O.A, Emmerich, S.T. Norwitz, '2021's Most Interesting Developments in M&A', *The International Comparative Legal Guide to: Mergers & Acquisitions, Global Legal Group Ltd,* Sixteenth ed. 2022, Chapter 1, pp. 1-5; V. Barros, P. V. Matos, J. M. Sarmento, P. R. Vieira, 'M&A activity as a driver for better ESG performance', *Technological Forecasting and Social Change*, 2022, Vol. 175 pp. 160-169; E. Teti, A.Dell' Acqua, P. Bonsi, 'Detangling the role of environmental, social, and governance factors on M&A performance', *Corporate Social Responsibility and Environmental Management*, 3 June 2022, pp. 1- 14; T. Koller, T. Nuttal, W. Henisz, 'Five ways that ESG creates value', *The McKinsey Quarterly*; *New York*, 14 November 2019; Latham & Watkins LLP, 'ESG on the Rise in M&A Transactions', 11 January 2022, (accessed from: www.latham.london/2022/01/esg-on-the-rise-in-ma-transactions/).

[2] B. Townsend, 'From SRI to ESG: the Origins of Socially Responsible and Sustainable Investing', *The Journal of Impact and ESG Investing*, Fall 2020, issue 1, pp. 10-25.

[3] S. Doron Avramov, A. Si Cheng, L. Abraham, T. Andrea, 'Sustainable investing with ESG rating uncertainty', *Journal of Financial Economics*, 2022, Vol. 145, No. 2, Part B, , pp. 642-664; R. Steel, 'The Elevated Economy: Why Investors and Company can't ignore ESG', *Forbes Business Council,* 28 December 2021 (accessed from: https://www.forbes.com/sites/forbesbusinesscouncil/2021/12/28/the-elevated-economy-why-investors-and-companies-can-ignore-esg/?sh=38b0a1244d30); O. Hart & L. Zingales, 'Serving shareholders doesn't mean putting profit above all else', *Harvard Business Law Review,* 12 October 2017, p.1-6.

[4] See, for example, O.A, Emmerich, S.T. Norwitz, '2021's Most Interesting Developments in M&A', *The International Comparative Legal Guide to: 'Mergers & Acquisitions', Global Legal Group Ltd,* Sixteenth ed. 2022, Chapter 1, p.3; T. Koller, T. Nuttal, W. Henisz, 'Five ways that ESG creates value', *The McKinsey Quarterly;New York*, 14 November 2019; F. Gunnar et al, 'ESG and Financial Performance: Aggregated evidence from more than 2,000 empirical studies', *Journal of Sustainable Finance & Investment,* October 2015, Vol. 5, issue 4, pp.210-233.

[5] See also: O.A, Emmerich, S.T. Norwitz, '2021's Most Interesting Developments in M&A', *The International Comparative Legal Guide to: Mergers & Acquisitions, Global Legal Group Ltd,* Sixteenth ed. 2022, Chapter 1, p.3.

[6] See also: A.R. Brownstein, C.X.W.L.U, 'ESG and M&A in 2022: From Risk Mitigation to Value Creation', *Harvard Law School Forum on Corporate Governance*, 4 January 2022 (accessed at: https://corpgov.law.harvard.edu/2022/01/24/esg-and-ma-in-2022-from-risk-mitigation-to-value-creation/); J. Franklin, 'ESG now a key factor in M&A', *International Financial Law* Review, 18 September 2018; O.A, Emmerich, S.T. Norwitz, '2021's Most Interesting Developments in M&A', *The International Comparative Legal Guide to: Mergers & Acquisitions, Global Legal Group Ltd,* Sixteenth ed. 2022, Chapter 1, p.3.

2. Meaning of ESG

The term ESG was first used in a United Nations report on the impact of financial markets on sustainable development in 2004.[7] Although none of the three elements of ESG has a well-defined meaning, I briefly explain below what they are is broadly understood by each element. Where companies are mentioned in this context, this always refers to companies that are the subject of M&A transactions, investments or divestments. Reporting to shareholders and local communities on what companies are doing on ESG is important to ensure that companies maintain a good reputation and support for their activities.[8]

Environmental

The E, *Environmental*, generally revolves around how a company contributes to and performs on environmental challenges.[9] These include carbon emissions, waste management, possible pollution or deforestation, biodiversity and compliance with environmental legislation.[10] Companies that do well on environmental issues regularly evaluate and manage potential environmental risks that the company faces or will face in order to reduce its environmental and climate impact.[11]

Social

The S, *Social*, mainly concerns topics such as the company's relationships with its employees, customers and (local) communities . For example, human capital management, diversity and equal opportunities within the company, safe and healthy working conditions and good data protection. The external application of the social criterion mainly looks at the company's (or its suppliers') compliance with human rights and integration within local communities. A strong focus on the social pillar raises the level of corporate responsibility and leads to an improvement in the quality of life of a company's most important asset: its people.

Governance

In particular, the G, *Governance*, looks at how the company incorporates rules, principles, methods, expectations and responsibilities between different stakeholders into its way of governance. Consider board members' remuneration, conflicts of interest, tax practices and strategy and policy on corruption and bribery. Adequate governance helps harmonize the interests of different stakeholders within the company and can also serve as a tool to support the company's long-term strategy. [12]

[7] United Nations (2004), 'Who Cares Wins. Connecting Financial Markets to a Changing World', (accessed from: https://www.ifc.org/wps/wcm/connect/de954acc-504f-4140-91dc d46cf063b1ec/WhoCaresWins_2004.pdf?MOD=AJPERES&CVID=jqeE.mD).

[8] M. Orlitzky, D.S. Siegel, & D.A. Waldman 'Strategic corporate social responsibility and environmental sustainability', *Business and Society*, 2011, vol. 50, issue 1, pp. 6-27.

[9] R. Indahl & H.G. Jacobsen, 'Private Equity 4.0: Using ESG to Create More Value with Less Risk' *Journal of Applied Corporate Finance*, 2019, vol. 21, issue 2, pp. 34-41.

[10] E. Markopoulos, I.S. Kirane, E.L. Gann & H Vanharantta, 'A democratic, green ocean management framework for Environmental, Social and Governance (ESG) compliance', in: Ahram, T and Taiar, R and Gremeaux-Bader, V and Aminian, K, (eds.) Human Interaction, Emerging Technologies and Future Applications II: Proceedings of the 2nd International Conference on Human Interaction and Emerging Technologies: Future Applications (IHIET - AI 2020), April 23-25, 2020, Lausanne, Switzerland. (pp. 21-33), Springer: Cham, Switzerland.

[11] K. Babiak & S. Trendafilova, 'CSR and environmental responsibility: motives and pressures to adopt green management practices', *Corporate social responsibility and environmental management*, 201, vol. 18, issue 1, pp. 11-24.

[12] A.J. Ward, J.A. Brown & D. Rodriguez, 'Governance bundles, firm performance and the substitutability and complementarity of governance mechanisms', *Corporate Governance*: *An International Review*, 2009, vol. 17, issue 5, pp. 646-660.

To that extent, ESG consists of separate elements. In practice, however, these elements are often intertwined. For instance, the social element overlaps with the environmental and governance elements when companies seek to comply with environmental laws and broader sustainability objectives. And so, a company that excels in governance will often comply not only with the letter of the law but also with its spirit, for instance by ensuring transparency and ongoing (preventive) dialogues with regulators and local communities.

3. Current role of ESG within M&A processes

Now that we have a rough idea of what ESG means, the question follows: what role do ESG issues currently play within M&A processes? This can be well illustrated by dividing a standard M&A process into four phases: 1) the preliminary phase, 2) the due diligence phase, 3) the closing phase and 4) the post-deal phase.[13] In each phase, both the position of the buyer (*buy-side*) and the seller (*sell-side*) are briefly explained.

3.1 Preliminary phase

Buy-side; positive screening and picking the right targets

Companies that do well on ESG are becoming more desirable.[14] Especially now that investors are *screening* their portfolios more frequently for ESG aspects in a positive sense, meaning they are seeking to strengthen their portfolios by investing in companies that do well on ESG.[15] Potential buyers and investors will therefore want to form a picture of how ESG-compliant the company operates more regularly in the preliminary phase of the M&A process. This by formulating (possibly with the help of advisers) an overall answer to questions such as: How does the company contribute to and perform on environmental challenges? How are the company's relationships with its employees, customers and affected (local) communities? In what way does the company incorporate

[13] The choice of this subdivision is arbitrary insofar as it rests on the fact that, in my view, it clearly illustrates the role of ESG issues within M&A processes. It should be noted that in the 'M&A literature' many different subdivisions of the M&A process are made. See for example; T.J. Galpin, M. Herndon, *The complete guide to mergers and acquisitions: Process tools to support merger and acquisition integration at every level,* San Francisco: John Wiley & Sons, 2014; P. Howson, *Due diligence: The Critical Stage in Mergers and Acquisitions*, Burlington: Gower Publishing 2003; G. Picot, *Handbook of international mergers and acquisitions: Preparation, Implementation and Integration*, New York: Palgrave Macmillan, 2002. Whereas Picot divides it into three phases: preparation, implementation and integration, Galpin and Herndon, on the contrary, opt for a division into four phases and Picot even five phases: 1) formulation of strategy and M&A criteria, 2) identification of target companies, 3) examination of the target, 4) negotiation of the deal and 5) post-deal integration. The consensus is that the M&A process can be seen as a start-to-finish process that revolves around fully managing and guiding the transaction and not just certain individual components within the course.

[14] A, Emmerich, S.T. Norwitz, '2021's Most Interesting Developments in M&A', *The International Comparative Legal Guide to: Mergers & Acquisitions, Global Legal Group Ltd,* Sixteenth ed. 2022, Chapter 1, p.1-5, p.3; SS&C Intralinks Report 'Temperature's Rising: The Growing Importance of ESG to EMEA M&A', (accessed from: https://www3.intralinks.com/growing-importance-of esgreport?utm_source=Eloqua&utm_medium=email&utm_campaign=2022.Analytics.Publication.M&A.IntralinksESG). In the first quarter of 2022, Mergermarket conducted a survey of 150 leaders working in M&A-related functions, including 75 M&A corporates and 75 PE/multi-strategy funds. Respondents were evenly split between France, U.K., Germany, Nordics, Benelux and Iberia. 97% of respondents said they were actively engaged with ESG within their M&A processes and even 41% said their deals were ESG driven during Q1 of 2022 (table 1 report).

[15] I. Jin, 'Systematic ESG Risk and Passive ESG Investing', *The Journal of Portfolio Management*, April 2022, vol. 48, no. 5, p. 71-86. A. Amel-Zadeh & G. Serafeim, 'Why and How Investors Use ESG Information: Evidence from a Global Survey, *Financial Analysts Journal*, 2018, vol. 74, issue 3, pp. 87-103.

rules, principles, methods, expectations and responsibilities between different stakeholders in its way of governance?

Sell-side; negative screening

Sellers are also experiencing the increasing influence of ESG issues on the preliminary phase of their M&A processes and their investment / divestment decisions.[16] They screen their portfolios negatively for ESG issues, which means that portfolio companies or stakes are sold or, on the contrary, intended investments are abandoned because they do not fit (anymore) within the seller's ESG strategy. This affects not only traditional investors; large *energy corporates* like Shell and British Petroleum (BP) have also made commitments (under social pressure) to divest *brown assets in favour of green assets*.[17] BP, in support of its strategic shift to *renewables*, has pledged to divest $25 billion worth of brown assets by 2026.[18] Shell, partly as part of its commitment to invest between two and three billion dollars a year in *renewables and energy solutions*, recently bought Indian renewables platform Sprng Energy Group for one and a half billion dollars.[19] The downside of this is that it may leave a more polluting part with an owner who is less ESG-focused.

3.2 Due diligence phase

Buy-side; how ESG-compliant are you really?

During the due diligence phase, a buyer's research will try to flesh out the picture of the company formed in the preliminary phase. M&A advisers will therefore bombard the company's management with Q&A questions during this phase. Consider questions such as: Does the company have and maintain an environmental policy that includes clear commitments and targets to improve the company's environmental footprint? Does the company have and follow procedures for the safe use, handling, storage and disposal of hazardous/toxic chemicals and substances? Does the company have and maintain a policy that includes clear commitments and targets to support gender equality, diversity and equal opportunities and pay in the workforce? Are ESG issues regularly discussed at board level? Are there any pending and/or threatened ESG-related claims and/or lawsuits?

The answers to the Q&A questions and other due diligence findings[20] often result in ESG chapters in the relevant due diligence reports. These identify the material ESG risks and make concrete recommendations on how to deal with them legally. These include recommendations to apply for an additional or review license, to establish a concrete policy on diversity after the transaction to comply with applicable regulations[21] and/or to include specific ESG guarantees and indemnities in the transaction documentation. In an extreme case, it may even be advised to abandon the transaction entirely, for example if the estimated remediation costs of a groundwater surpass the transactional added value, and the seller is unwilling to foot (part of) the bill for it.

[16] T. Verheyden, R. G. Eccles, 'A. Feiner, 'ESG for All? The Impact of ESG Screening on Return, Risk and Diversification', *Journal of Applied Corporate Finance*, Spring 2016, vol. 28, no. 2, p. 47-55.

[17] A, Emmerich, S.T. Norwitz, '2021's Most Interesting Developments in M&A', *The International Comparative Legal Guide to: Mergers & Acquisitions, Global Legal Group Ltd,* Sixteenth ed. 2022, Chapter 1, pp.1-5, p.3.

[18] https://www.offshore-technology.com/news/bp-sale-assets-renewable-investment/.

[19] https://www.shell.com/media/news-and-media-releases/2021/shell-accelerates-drive-for-net-zero-emissions-with-customer-first-strategy.html; https://www.shell.com/media/news-and-media-releases/2022/shell-completes-acquisition-of-renewables-platform-sprng-energy-group.html.

[20] For example, search results based on research into public sources.

[21] Consider the Act of 29 September 2021 amending Book 2 of the Civil Code in connection with balancing the ratio of men and women on the management and supervisory boards of large public and private limited companies (*Stb. 2021,495*).

Sell-side; windowdresser or front runner of real change?

Sellers, partly in the knowledge that buyers increasingly value ESG, may choose to have their M&A advisers (pre-emptively) prepare a *vendor diligence report* or *legal factbook* that (partly) focuses on identifying and describing ESG issues.[22] The underlying due diligence exercise then usually serves two purposes. First, as on the buy side, to identify ESG-related risks that might have a value-decreasing effect on the company to be sold. However, and unlike with buy-side due diligence, precisely with the idea of eliminating these ESG-related risks before the intended buyer investigates and/or makes an offer. In addition, the due diligence exercise serves to identify value-creating elements to bring them to the attention of potential buyers. For example, in the case the envisaged sale of a group that operates various car washes, by highlighting in the vendor diligence report or legal factbook that by using biodegradable soap and recycling the used wash water, future environmental legislations are complied with.

3.3 Deal phase

Buy-side; what are my options?

How does the buyer safeguard its ESG position during transaction documentation negotiations? Essentially, the buyer has several options to do so, which can be traced back to what the buyer intends to protect itself against: (A) a known problem or (B) a potential risk.

Protection against known problem or potential risk?		
A. Known problem		**B. Potential risk**
Not resolvable (in time)	Resolvable (in a timely manner)	
i. Waiver of transaction	i. Condition to Signing	1. Warranties and indemnities sufficiently covered or ESG extensions needed?
ii. Carve-out/Ring-fencing	ii. Condition to Closing	2. Insured (W&I)?
iii. Purchase price reduction	iii. Undertaking	3. Holdback / Escrow?
iv. Indemnification	iv. PMI	4. Pre-closing covenants?

Suppose the buyer aims to protect itself against a problem of the company that has been noted in the context of ESG due diligence (scenario A). In that case, the buyer should ask whether the problem can be resolved (in a timely manner). If not, the buyer has four options: (i) abandon the transaction, (ii) try to keep the problem outside the transaction perimeter (via a carve out/ring fencing[23]), (iii) negotiate a direct discount on the purchase price or (iv) ask for an indemnity. If the issue can be resolved in a timely manner, the buyer again has four options: (i) make the signing of the purchase

[22] See also: M. Brink, Due diligence: a consideration of due diligence under Dutch law, The Hague, *Boom Juridische uitgevers*, 2009, p. 39-41. In short, the vendor diligence report and legal factbook are reports in which the seller's advisers (favourably) describe the company to be sold from a legal perspective, partly with the aim of simplifying the (top-up) due diligence investigation for prospective buyers and thereby accelerating the sales process.

[23] Ring fencing refers to ring-fencing a particular asset or group of assets using a structural technique that protects them from the financial instability or bankruptcy of the owner (the acquirer of the assets) or an affiliate of the asset owner. Ringfencing is usually achieved through the creation of a special purpose vehicle (SPV) by a parent company to which the assets to be ringfenced are transferred.

agreement conditional on the resolving of the problem (condition to signing), (ii) include the resolvement as a condition precedent (condition precedent, CP) to completion of the transaction (condition to closing), (iii) include an obligation for the seller to resolve the problem without the transaction being conditional to it (undertaking) or (iv) address the problem itself upon the integration of the company after completion of the transaction (post-merger-integration, PMI).

If it is not a known problem but rather the buyer is trying to protect itself against a potential risk (scenario B), then four questions are important. First (B1), do the current warranties and indemnities provide sufficient coverage or are specific ESG enhancements needed? Examples include indemnities that cover (soil) pollution or guarantees that the company has properly complied with the diversity legislation applicable to it or that there is no awareness of impending ESG (claim) proceedings (think of the Shell climate case[24]).[25] In addition (B2), is the risk perhaps insurable at an acceptable price? Warranty & Indemnity (W&I) insurance policies can (increasingly) offer a solution when they cover the intended ESG guarantees and indemnities. Thirdly (B3), can it be agreed that part of the purchase price is withheld (via a holdback or in escrow)? This portion can be released to the seller if the identified ESG risk does not materialize within a certain period after completion or, conversely, remain in the buyer's pocket if it does. If deal certainty is more important to a seller than price, this option can certainly be considered as an alternative to the aforementioned conditions. Fourth (B4), can the buyer hold a grip on ESG issues at the company by including *pre-closing covenants* in the purchase agreement? These are covenants that require the seller and/or the company to coordinate certain actions with the buyer between signing and closing or to keep the company running in a similar manner (*ordinary course*) during that period. Think of covenants requiring the buyer to report to the buyer on ESG issues between signing and closing or regulating that public statements about how climate-friendly the company's products are must first be coordinated with the buyer.

Sell-side; 0-recourse?

On the sell-side, there is usually little need to issue indemnities, a comprehensive set of warranties, CPs or a long list of pre-closing covenants. Particularly when it comes to an *exit* from a private equity fund, where the aim is a sale with minimal to no contingencies and no residual liability (0-recourse).[26] Sellers will therefore often find it difficult to accept that they are increasingly faced with ESG issues. In any case, they will want clear agreements on maximum liability but will also want to lay down the *do's & don'ts* regarding the issue in question. For example, by conforming to strict but above all clear pre-closing covenants or, in the case of the selling private equity party, by requiring buyers to take out S&I insurance that also covers the intended ESG guarantees and indemnities.

3.4 Post-deal phase

Post-Merger-Integration (PMI)

The post-deal phase is mainly about integrating the company into the buyer group. Research shows that buyers would do well to oversee the integration of ESG issues and take into account any

[24] Rb Den Haag 25 June 2021, ECLI:NL:RBDHA:2021:5337, *JOR* 2021/208 m.nt. S.J.M. Biesmans.

[25] ESG is increasingly the subject of litigation. In the Urganda judgment (HR 20 December 2019, ECLI:NL:HR:2019:2006, *NJ* 2020/41 mnt J. Spier), the Supreme Court ruled that the Dutch state is obliged to take measures to prevent further climate change. And in the Shell climate case (see footnote 26), the District Court of The Hague also ruled that companies may be obliged to do so.

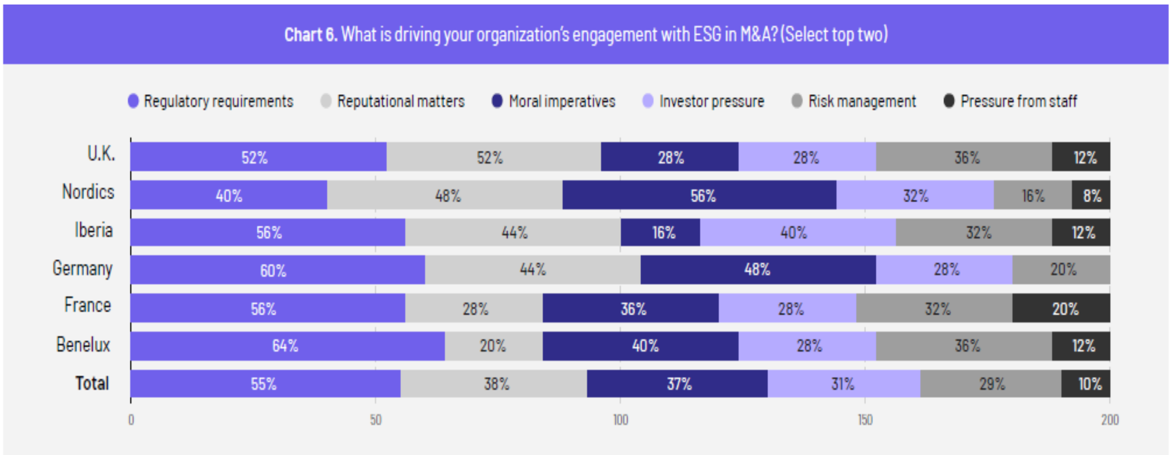
[26] See e.g. H.L. Kaemingk, 'Towards the exit: on private equity divestment', *Business Law* 2007/62, paragraphs 3 and 5.

consequences of the transaction in this regard.[27] Suppose H&M decided to acquire a tech wearables company in order to offer H&M smartwatches in addition to its regular clothing products. In that case, H&M would be wise to pay close attention to the risks identified during (ESG) due diligence when integrating the acquired company. Think of risks around correct and honest processing of personal data or around working conditions in the production plant or processing of production waste. In addition, H&M will have to monitor that the ESG reporting of the purchased (subsidiary) company is properly integrated with that of the H&M Group (see also section 4.2).

4. Impact of upcoming regulations?

4.1. What does the market say?

Will ESG issues become more important within M&A processes in the near future? It is to be expected, particularly due to upcoming regulations. A recent survey of 150 European leaders within the M&A industry by Mergermarket and Intralinks also shows that their ESG engagement during the first quarter of 2022 was mostly driven by regulatory requirements, especially in the Benelux. [28]



(Source: SS&C Intralinks Report 'Temperature's Rising: The Growing Importance of ESG to EMEA M&A') [29]

Against that background, I explain below two European legislative initiatives (CSRD & CSDDD) that can be expected to affect ESG issues within M&A processes. I note that there are more relevant regulatory developments, but a description of all of them is beyond the scope of this artcile. [30]

[27] I. Tampakoudis & E. Anagnostopoulou, 'The effect of mergers and acquisitions on environmental, social and governance performance and market value: Evidence from EU acquirers', *Business Strategy and Environment*, 2020; 29, pp. 1865-1875; E. Martirosyan & T. Vashakmadze, 'Introducing Stakeholder Based Frameworks for Post-Merger Integration Success', *Global Business Conference Proceedings*, 2013, pp. 169-175.

[28] Mergermarket and Intralinks are a reputable parties collecting data (analysis) related to the global M&A market.

[29] Available at: https://www3.intralinks.com/growing-importance-of esgreport?utm_source=Eloqua&utm_medium=email&utm_campaign=2022.Analytics.Publication.M&A.IntralinksESG.

[30] From a Dutch perspective, one of the most notable initiatives is the update of the Dutch Corporate Governance Code (NCGC).

4.2 Corporate Sustainability Reporting Directive (CSRD)

Purpose and timing

On 21 April 2021, the European Commission (EC) adopted a proposal for a Directive on Sustainability Reporting by Companies, the Corporate Sustainability Reporting Directive (CSRD). The European Parliament and the Council of the European Union reached a provisional agreement on the CSRD on 30 June 2022.[31] Following a final agreement, the CSRD will have to be implemented in national legislation within two years. Companies falling within its scope are likely to have to comply with the regulatory obligations in 2025, when they report for the 2024 financial year. [32]

Scope of application

The CSRD aims to expand the scope and material obligations of the previous Non-Financial Reporting Directive (NFRD)[33] now that, according to the EC, it has not led to sufficient improvement.[34] Thus, not only public-interest entities are no longer covered - as was the case under the NFRD - but the CSRD also covers all large and (almost) all listed companies. Large companies in this context are those that exceed at least two of the following three criteria on the balance sheet date: (a) a balance sheet total of €20 million; (b) net turnover of €40 million; and (c) an average workforce during the financial year of 250. [35]

Outline CRSD

The CSRD concretizes the sustainability information that companies must disclose.[36] Companies should: (i) report on sustainability in a detailed and standardized manner, (ii) make these reports available digitally in such a way that they can be included in a central access point for relevant publicly available information on companies (the European Single Access Point, ESAP) and (iii) obtain and publish an assurance *opinion*[37] on sustainability reports. The company's governance report must also include a description of its business model and strategy, including plans by which the company contributes to the transition to a sustainable economy and the limitation of global warming to 1.5°C compared to pre-industrial levels, in line with the UN Paris Climate Agreement.[38]

[31] https://www.consilium.europa.eu/en/press/press-releases/2022/06/21/new-rules-on-sustainability-disclosure-provisional-agreement-between-council-and-european-parliament/.

[32] See also L.J.M Bak, L.K. van Dijk and J.B.S. Hijink, 'Giant steps in the field of sustainability reporting: The European CSRD and creation of the ISSB', *Business Law* 2022/36, pp.219-227; L.K. van Dijk & J.B.S. Hijink 'Corporate Sustainability Reporting: on the European impetus for the foundation of sustainability reporting', *FR* 2021, no. 8/9.

[33] Directive 2014/95/EU of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large companies and groups. The NFRD was implemented in the Netherlands by introducing the Decree of 14 March 2017, laying down rules implementing Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large companies and groups. The NRFD concerned an amendment to Directive 2013/34/EU of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of companies.

[34] Explanatory memorandum (explanatory *memorandum*) to the proposed CSRD directive, p. 4.

[35] The only listed companies excluded are micro-enterprises, as defined in the Accounting Directive. So companies that on the balance sheet date do not exceed the limit amounts for at least two of the three following criteria: (a) a balance sheet total of €350,000; (b) a net turnover of €700,000; and (c) an average workforce during the financial year of 10.

[36] Art. 1(3) CSRD.

[37] It is obvious that the external auditor will take on this audit in addition to his already existing role in the statutory audit of the annual accounts. This way, both audits remain in one hand (Art. 2:393 of the Dutch Civil Code). Initially, only limited assurance needs to be provided. However, the European Commission already hints that at some point reasonable assurance will have to be given, in line with the audit of financial information. Institutional investors also expect a lot from the auditor in this context (https://www.eumedion.nl/clientdata/215/media/clientimages/Audit-Firm-Letter-2022.pdf?v=220217205415).

[38] Art. 1(3) and (7) CSRD.

The CSRD further provides for three levels of sanctions in case of breaches: (i) a public statement naming the responsible persons and the nature of the breach orders, (ii) an order requiring the responsible person to cease the breach, (iii) statutory fines (the levels of which are not yet known at the time of finalizing this article). [39]

Impact of CSRD on M&A processes

With the advent of the CSRD, it can be expected that more companies will report on sustainability in a detailed and standardized manner. This information will also become more publicly accessible and insightful through the ESAP. This may further encourage ESG screening, both positively and negatively (section 3.1 - preliminary stage). It also stands to reason that the requirement for an *assurance opinion* adds to the need for ongoing and careful evaluation of ESG issues within a company. After all, the audit requirement means that many companies will soon face verification on their sustainability reporting for the first time and thus need to make timely preparations to enable this verification.[40] This in turn leads to an increased interest in thorough due diligence on ESG issues (section 3.2 - due diligence phase). All the more so as various sanctions can be imposed when breaches are found. A prospective buyer will therefore want to negotiate protection against known issues and potential risks, for example by negotiating a guarantee and/or indemnity that the company has complied with its obligations under the CSRD (section 3.3 - deal phase). Finally, even after the transaction, the buyer will be wise to monitor that the company continues to comply with its obligations under the CSRD as part of the buyer group (section 3.4 - PMI phase).

4.3 Corporate Sustainability Due Diligence Directive (CSDDD)

Purpose and timing

On 23 February 2022, the EC also published a proposal for a Directive on Corporate Sustainability Due Diligence, also known as the Corporate Sustainability Due Diligence Directive (CSDDD).[41] Companies falling within its scope will be required to identify (potential) negative human rights and environmental impacts of their business operations on an ongoing basis and to prevent and mitigate them (where possible).[42] The proposed directive is currently being submitted to the European Parliament and the Council for approval. As a rule, this will take several months, and given the subject matter of this proposal, it is to be expected that there will be a robust (public) debate on its content. Once the proposed directive is adopted, EU member states will have two years to transpose the CSDD into national law.

[39] Art. 1 (12) CSRD, with reference to Art. 52 Accounting Directive.

[40] See also: B. Baaijens & L.A. van Amsterdam, 'The Corporate Sustainability Reporting Directive: reporting, auditing and socially responsible legal advice', *Bb 2022/30*.

[41] Proposal for a Directive on due diligence in corporate sustainability and amending Directive (EU) 2019/1937.

[42] See, for example, the definition in the OECD Guidelines, Chapter II. General principles for corporate policies, Recommendation 145.

Scope of application

The proposed scope of the CSDDD is quite broad[43] and covers companies that fall into three groups.

1. Companies formed in accordance with the law of a Member State with an average of more than 500 employees[44] and a worldwide net turnover[45] of more than €150 million in the last financial year for which annual accounts have been drawn up (group 1); [46]

2. Companies incorporated in accordance with the laws of a Member State with an average of more than 250 employees and a global net turnover of €40 million, of which at least 50 per cent is generated in one of the following high-risk sectors (Group 2):
   - production of textiles, leather, clothing and related products (such as footwear), and wholesale of textiles, clothing and footwear;
   - Agriculture, forestry, fisheries, food products production, and wholesale of agricultural raw materials, live animals, wood food and beverages;
   - mining of mineral resources, production of metal products, and wholesale trade in mineral resources, mineral raw materials and semi-finished products; [47]

3. Companies incorporated in accordance with the laws of a third country with net sales of more than €150 million in the EU or with net sales of more than €40 million, 50 per cent of which are in one of the high-risk sectors (Group 3).[48]

'Companies' in the aforementioned sense primarily include NVs and BVs in the Netherlands.[49] It also includes the VOF and CV when all partners of these legal forms consist of NVs, BVs or similar entities from other jurisdictions.[50] Regulated financial enterprises, such as credit institutions, investment firms and insurers are also still covered, regardless of their legal form. [51]

Outline CSDD

Companies falling within the scope of the CSDDD must conduct ongoing human rights and environmental due diligence by performing six steps (see next page) in short (Articles 5-11 CSDDD).[52]

[43] The EC expects the CSDD to cover around 13 000 EU and 4 000 third-country companies (Proposal for a Directive on due diligence in corporate sustainability and amending Directive (EU) 2019/1937, p. 19).

[44] The number of employees is determined by taking the average of the number of employees in the last financial year for which financial statements have been prepared.

[45] Art. 3 (m) CSDDD - turnover is determined by reference to worldwide net sales in the last financial year for which annual accounts have been prepared.

[46] Art. 2(1)(a) CSDD.

[47] Art. 2(1)(b) CSDD.

[48] Art. 2(1) CSDD, Art. 3(a)(i) CSDD.

[49] Art. 3(a)(i) CSDD.

[50] Art. 3(a)(iii) CSDD.

[51] Art. 3(a) (iv) CSDD.

[52] See art. 4(1) CSDD. See also J.E.S. Hamster, 'The European Commission's proposal for a Directive on Corporate Sustainability Due Diligence: a critical exploration'¸ *MoD* 2002/5.4, pp. 150-159; C.H.A. van Oostrum, 'Weighted by comparison: the CSDDD and second-generation binding chain regulations', *O&F* 2022-2, pp. 29-4; S.F. Ter Brake, 'The proposal for the Corporate Sustainability Due Diligence Directive', *TvOB* 2022/3, pp. 75-85; S.B. Garcia Nelen, 'The proposal for a European Corporate Sustainability Due Diligence Directive', *Business Law* 2022/41, pp.261-273.

Step	Content (business as usual)
1	**Policy** - integrate human rights and environmental due diligence into all facets of their corporate policies and establish a separate due diligence policy on those topics to be reviewed and revised, if necessary, on an annual basis.[53]
2	**Identification** - taking appropriate measures to identify (potential) adverse human rights and environmental impacts of their own activities or those of their subsidiaries and, if related to their value chains[54] , of their business relationships[55] .[56]
3	**Prevention and minimization** - to, with respect to potential consequences, (i) develop and implement a prevention plan; (ii) negotiate certain contractual guarantees with direct business relationships; (iii) make necessary investments; (iv) provide support to SMEs with which the company has an established business relationship[57] if compliance with the code of conduct or the prevention plan would jeopardize the viability of those businesses; and (v) cooperate with other entities to eliminate adverse consequences.[58] With regard to actual consequences, the same obligations apply, but in this case 'correction plan' should be read instead of 'prevention plan' and companies are also obliged to neutralize the adverse consequences or reduce their extent, including by paying compensation.[59]
4	**Complaints procedure** - establishing a complaints procedure that can be used when there are legitimate concerns about (potential) adverse human rights and environmental impacts of their operations, the operations of their subsidiaries or their value chains.[60]
5	**Monitoring** - monitoring the effectiveness of their due diligence policies (steps 1 to 4) and taking action where necessary to adjust them. [61]
6	**Reporting** - reporting and communicating on the process as described in steps 1 to 5.[62]

[53] Art. 5 (1)-(2) CSDD. The due diligence policy should include at least the following: (a) a description of the company's chosen approach to doing due diligence, including a long-term approach, (b) a code of conduct describing the rules and principles to be followed by employees and subsidiaries, and (c) a description of the processes put in place to implement the due diligence policy, including the measures that will be taken to monitor compliance with the code of conduct and extend its application to established business relationships. Integrating due diligence into corporate policies will practically create a lot of work for companies. The CSDDD places the responsibility for this on directors, who should take into account input from stakeholders and civil society organisations.

[54] The 'value chain' includes the activities related to the production of goods or the provision of services by an enterprise, including the development of the product or service and the use and disposal of the product, as well as the related activities of established business relations of the enterprise. Although the CSDDD does not directly affect micro-enterprises and small and medium-sized enterprises, they may be indirectly affected if they are part of the value chain of enterprises covered by the scope.

[55] A 'business relationship' is a relationship with a contractor, subcontractor or other legal entity (i) with whom the company has a commercial agreement or to whom the company offers financing or (re)insurance, or (ii) who carries out business activities for or on behalf of the company in relation to the company's products or services (Art. 3(3) CSDDD).

[56] Art. 6 CSDD.

[57] Whether there is a 'permanent' business relationship depends on whether the relationship is 'perpetual', looking at the intensity and duration of the relationship, and whether the relationship does not represent only a negligible or non-essential part of the value chain (Art. 3(f) CSDD). The company should assess this periodically and at least every 12 months (Art. 1(1) CSDD).

[58] Art. 7 (2) CSDD.

[59] Art. 8 (3) CSDD. However, neutralisation or mitigation must be proportionate to the importance and extent of the adverse effects and the extent to which they are attributable to the company.

[60] Art. 9 CSDD.

[61] Art. 10 CSDD.

[62] Art. 11 CSDD.

Impact of CSDDD on M&A processes

The reporting requirement (step 6) will help make information around ESG compliance more publicly available and understandable. Like the reporting requirements under the CSRD (section 4.1), this may encourage ESG screening and thus influence the preliminary phase of the M&A process (section 3.1). However, the biggest impact will be felt at the due diligence stage (section 3.2). In light of the CSDD, it will become (even) more important to conduct thorough due diligence on companies' compliance with ESG regulations and their business relationships. After all, under the CSDDD, there is an obligation on companies to continue to do so on an ongoing basis. Thus, ESG should no longer be a tick-the-box exercise, but rather a central part of due diligence.[63] Moreover, the ongoing ESG due diligence obligation under the CSDDD means that it becomes more important to include detailed pre-closing covenants at the deal stage. This allows the buyer to ensure that the company to be bought continues to meet these obligations even between signing and closing. These ongoing ESG due diligence and reporting obligations (steps 1 to 6) work equally well in the PMI phase (section 3.4), where it will become more important for buyers to also oversee proper integration in this (ESG) area.

5. Concluding remarks: continued focus on ESG issues

Against this background, ESG issues seem to be not only *on the rise* within M&A processes but also *here to stay*. They already take up an important role within the various stages of an M&A process (section 3) and it is expected that this role will become even more important given the influence of the CSRD and the CSDDD (section 4). M&A advisers and companies would therefore do well, in my view, to give ESG issues ongoing attention. Timely awareness of the various (upcoming) ESG (reporting) obligations and the (European) sources to consult (such as the ESAP) (section 3.1) will already pay off during the preliminary phase of the M&A process. After all, this allows better decisions to be made on which companies to buy and sell from an ESG perspective. For due diligence, it is advisable to update the Q&A lists such that they include targeted questions that address (compliance with) the current applicable ESG regulation(s) and the company's plans to comply with future regulation(s). Please refer to Invest Europe's "ESG Due Diligence Questionnaire for Private Equity Investors and their Portfolio Companies" now which contains useful sample questions.[64] For the deal phase (section 3.4), the increasing regulatory pressure on companies (sections 4.2-4.3) is likely to translate into (more) detailed(er) ESG provisions in transaction documentation. Useful in this regard is The Chancery Lane Project, a website with examples of contractual provisions on climate targets.[65] Finally, for the PMI phase (section 3.4), one would do well to pay attention to compliance with ongoing ESG due diligence and reporting obligations under the CSDDD (section 4.2). All the more so as responsibility for implementing and monitoring these actions under the CSDDD has been placed on directors. [66]

[63] See also J.E.S. Hamster, 'The European Commission's proposal for a directive on appropriate due diligence in the field of sustainability: a critical exploration', *MoM* 2002/5.4, pp. 150-159.

[64] Available at: https://www.investeurope.eu/media/1777/invest-europe_esg_dd_questionnaire.pdf.

[65] Available at: https://chancerylaneproject.org/.

[66] Cf. Articles 25 and 26 CSDD.