ESG in private equity transactions: practical considerations

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This note explains how environmental, social and governance (ESG) issues can be addressed in private equity merger and acquisition (M&A) transactions.

Scope of this note

This note explains how environmental, social and governance (ESG) issues may arise and be addressed in transactions. While the focus is on private equity mergers and acquisitions (M&A), similar considerations may arise in a range of general corporate, infrastructure, trade and other deals.

This note considers the main parties involved in a private equity transaction and why ESG is likely to be a key concern for them. It offers practical guidance (from a lawyer's perspective) on ESG due diligence and the negotiation of ESG protections in transactional and equity documents.

For:

- A fuller discussion of the concept of ESG and its relevance in an investment context, see *Practice note, Environmental, social and governance (ESG): an introduction*.
- Additional materials on specific ESG issues, see the *Environmental, social and governance (ESG) toolkit*.
- Materials on other matters relating to private equity transactions (including due diligence, acquisition and equity documents more generally), see *Practice note, A guide to Practical Law's private equity and venture capital materials*.

Main parties in private equity transactions

As well as the variance in ESG terminology (see *ESG and related terminology* below) different terms are used for the various actors in a private equity structure. In this note, we generally refer to:

- The institutional asset or investment manager (that is, in a fund typically structured as a limited partnership, the general partner and its management entities, who manage the funds of the underlying investors) as the "private equity house" or "house".
- Those contributing investment capital to those managed funds (that is, the limited partners in a typical fund structure) as the "underlying investors" or "investors".

ESG and related terminology

ESG has arguably finally arrived as the accepted terminology, at least in the private equity sphere. However, the language used in this area remains fluid (particularly outside of private equity).

Similar (albeit not necessarily identical) objectives, processes and concerns may also be referred to as responsible investment, impact investment, green finance, or sustainable business, among other terms.

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Whatever the terminology used, the ultimate concern lies in the wider set of environmental, ethical, behavioural and social issues that are taken into account in investment decision making, with a view to an investment not only making a positive societal impact, but also protecting its commercial return in light of emergent risks.

Why ESG is becoming more of a feature in private equity transactions

ESG considerations will be relevant to any M&A transaction. Outside the investment sector, ESG may not form an express, dedicated work stream on a deal, but in the private equity sphere it is now commonly a key area of focus. It can feature in all stages of the investment process, as follows:

- Sector and investment selection (usually before any lawyers are involved), where the house will establish the areas of the market where it believes value can be generated for its investors (increasingly, having regard to wider sustainability factors) and identify particular target businesses within those areas.
- Once a particular target business has been identified, through due diligence, and the key transaction documents (including the purchase agreement and the investment agreement).
- In the investment case, whereby the rationale for the investment (which will now often include how the house's expectations on ESG matters have been dealt with) is presented for internal approval.
- Increasingly, post-close during the lifecycle of the investment.

This is because ESG will be a key issue for several stakeholders in a private equity transaction:

- The private equity house will increasingly have its own ESG in-house experts, policies, procedures and commitments. To date, these will typically have been designed, in part, to meet the expectations of the house's (actual or targeted) investors and will be a key driver for the ESG work-stream. In future, there will be an increase in direct regulatory incentives or obligations influencing the house's approach, such as *Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector* (EU Disclosure Regulation) (most of the provisions of which apply from March 2021) (for further detail, see *Practice note, Sustainable finance: Disclosure Regulation: overview*).

- The limited partner investors are likely to have their own specific ESG requirements. For example, pension funds will often have relatively stringent ethical investment criteria. In the past these often emerged late in a transaction (with the deal lawyers sometimes asked to comment retrospectively based on their diligence), but increasingly they are front-loaded to form a key part of the overall approach to the transaction (see *General approach to ESG due diligence*).
- Any banks providing debt finance for the transaction may also have their own set of ESG or similar requirements.

Besides purely ethical concerns, there are several reasons for these parties to focus on ESG, including that:

- ESG risks may affect the sustainability and longer-term profitability (and even viability) of the investment. For example, ESG diligence may assess risks surrounding stranded carbon assets in a proposed oil and gas investment. Concerns of this nature may be particularly important to a pension fund looking to safeguard the longer-term income of its members.
- Poor ESG performance may mean an increased risk of legal liability or a direct loss in the value of a business. For example, poor governance may mean there is a heightened risk of bribery or sanctions breaches, which could lead to significant fines, market access restrictions and reputational damage.
- Often, ESG issues do not respect corporate boundaries and, in limited circumstances, could pose a direct liability risk for a parent (potentially even the house, although in a properly thought-through private equity structure this risk should be low) (see *Parent liability for ESG issues*).
- ESG issues may present opportunities to realise upside, which may be particularly important for private equity investors with shorter investment cycles looking for quick value realisation. For example, if deficient safety performance can be improved, this may rapidly reduce the business's insurance premiums, legal spend and staff turnover. Indeed, COVID-19 demonstrates how a strong safety culture and business resilience can transform value.
- Poor ESG performance may make it more difficult for the business to raise finance, or to attract a buyer on exit.
- Given the above, NGOS such as ClientEarth and others argue that ESG matters need to be addressed for the house (and other institutional actors, such as a pension fund investor) to meet their fiduciary duties to their shareholders and investors. This argument is gaining increasing traction with regulatory bodies such as the *Pensions Regulator*.
- Direct regulatory requirements are now emerging. For example, the EU Disclosure Regulation will effectively require integration of ESG into regulated investors' decision-making (see *Practice note, Sustainable finance: Disclosure Regulation: overview*).
- Increasingly, ESG is a key reputational concern. A house that is not able to evidence a robust approach on ESG may find it more difficult to raise funds, especially given the potential impact of the COVID-19 pandemic in 2020.

- The house will increasingly have commitments (often entered into in light of the above considerations) under voluntary initiatives to consider and address ESG risks in its deal processes. For example, it may be a signatory to the *UN Principles of Responsible Investment*. For further discussion of these voluntary regimes, see *Practice note, Corporate responsibility (CR) and environmental, social and governance (ESG) guidance: tools for companies and investors*.

The COVID-19 crisis may give greater urgency to many of these concerns. Investors are likely to be keener than ever to understand how target investments ensure that their business (and, importantly, their supply chain) is resilient enough to deal with future environmental, safety and social crises, and that they are able to maintain positive relationships with their own workforce, customers and wider stakeholders in doing so.

It is critical that the deal lawyer acting on a private equity transaction has a meaningful understanding of these concerns, so that they can properly advise their client on all legal aspects, including diligence and deal documents, and ensure the client's interests are protected appropriately.

General approach to ESG due diligence

Factors affecting approach to ESG due diligence

The approach to due diligence on any transaction will differ depending on certain key factors. These include:

- Availability of budget and time.
- Degree of seller engagement.
- Nature of the business.
- Requirements of funders and insurers.
- The degree of contractual comfort being offered.

As formal ESG diligence in transactions is a comparatively recent development, and ESG itself is such a broad concept, the approach taken in this sphere is especially variable. It is an area that continues to evolve as new approaches, best practice and technologies emerge.

Historically, ESG diligence was all too often a last minute "tick-box" exercise (and, on increasingly rare occasions, it remains so). If it came up at all in the legal workstream, it may have been limited to a deal lawyer (particularly in environmental and employment teams) being asked at a late stage to confirm that no legal liabilities or claims relating to ESG-type concerns had been identified, or that higher impact infrastructure projects had undertaken environmental impact assessments in accordance with due process.

Three approaches to ESG diligence in private equity transactions

A more methodical approach is now emerging, as awareness of the importance of ESG develops (see *Why ESG is becoming more of a feature in private equity transactions*). Many private equity houses will seek to carry out formal diligence on ESG matters and integrate this into their investment decision-making at an early stage (possibly as part of investment selection).

This has led to the development of three, often overlapping, approaches to specific ESG diligence in a private equity transactional context:

- **Assessments undertaken by the internal team within the private equity house**. These assessments often use one of various standardised methodologies or tools to help integrate ESG into investment decisions and to ensure that investor criteria are met by any proposals (see *Practice note, Corporate responsibility (CR) and environmental, social and governance (ESG) guidance: tools for companies and investors* for more detail on these). These will often be produced at an early stage of the process, possibly to aid selection of an investment target;
- **Dedicated ESG reports produced by external consultants, based on direct engagement with the target investment company.** While these have on occasion been led by lawyers or accountancy firms, they are more often provided by environmental or technical consultants who have expanded their traditional review of safety and environment matters (typically a Phase 1 report) to also consider the wider risk management of the business and how, for example, issues such as employee welfare (rather than just safety) are managed by the company and its supply chain. Often, these reports will be less focused on the governance aspects of ESG (for example, consideration of board structures, anti-bribery and corruption, and trade compliance and risk management). They should therefore be closely co-ordinated with the legal diligence and management work streams. These reports will generally be produced at a more advanced stage of the transaction as their production will usually require engagement with the target business. For information on traditional Phase 1 and 2 reports, see *Practice note, Phase 1 environmental and compliance assessments and Phase 2 intrusive environmental investigations*.
- **Data-focused reports produced by search providers or analytics specialists based on publicly available information.** Screening tools have long been used in procurement and client on-boarding (for example, to check a commercial partner (and key management) against global sanctions lists or criminal prosecution records). Providers are now offering ever more sophisticated reports that present this information in a transactional context. The information often includes press searches and data mined from financial reports and other public sources. Given the regulatory trend in the UK and the EU towards transparency and reporting on ESG matters, the amount of related information in the public domain is increasing, and we are likely to see a commensurate growth in the use and utility of these data-led reports. These reports also have the key advantage of being able to be produced rapidly and without input from the target business, making them particularly useful for early screening processes.

The above list is not exhaustive and it is necessarily a simplification of the approaches seen in the market. In practice, there are many variations and hybrids of these approaches.

The recent growth in publicly available information on businesses provides valuable additional opportunities to understand the business and to address risk, but also brings challenges, when it comes to ESG diligence. While traditional diligence tends to be limited to information disclosed by the target company in data rooms and in response to focused enquiries, ESG diligence is less easily scoped and will often leverage swathes of information in the public domain. Additional deal process and expense may be required to close-out the various loose ends that result. For example, a global financial crime search on a major global corporate will often return a number of hits for financial investigations in far-flung jurisdictions. This may make it difficult to distinguish a false positive from a material risk.

This is further complicated by the fact that the traditional monetary thresholds and liability analysis of legal diligence may not be readily applicable to wider ESG or reputational concerns. An overseas labour dispute in a company's supply chain may have no legal liability risk for a business, but could be critical from a reputational and supply chain perspective. This brings further scoping challenges, for example how many tiers down the supply chain should diligence go? Increasingly, legal advisers are being called on by their client to help navigate this information, identify the real risks and, where possible, protect against them.

Additionally, ESG should not only consider downside risks, but also areas for opportunity and potential positive impact. These do not naturally fit within traditional approaches to deal diligence.

The lawyer's role in ESG diligence

While the above approaches to ESG diligence may appear client or consultant led (and on occasion they are carried out in isolation from the legal team), deal lawyers have an important role to play in a well-managed and effective ESG transactional diligence process. This will vary depending on the transaction, consultants and client involved. Key considerations include:

- **Early input from the legal team.** Ideally the legal team would input into the approach to ESG diligence at the outset, and liaise closely with the client and the consultant on the structure of this. While the house will often have their own pre-determined approach, the lawyer may be asked to recommend the appropriate approach or consultant, based on their experience of the market, the consultants involved, and the sector and geographic location of the target business.
- **Ensuring scope of third party consultant appointment includes traditional risks as well as higher level ESG approach.** High on the lawyer's list of priorities when appointing third party consultants will be ensuring that sight of traditional risks is not lost through a focus on upside ESG considerations. For example, if the environmental consultant on a transaction is providing an ESG report rather than a Phase 1 report, care needs to be taken to ensure that it will still consider (in appropriate detail) issues such as soil and groundwater contamination, and compliance with permits (see *Practice note, Phase 1 environmental and compliance assessments and Phase 2 intrusive environmental investigations*). Often, an ESG-focused report will be a higher-level review that is lighter touch in these areas. As well as the risks this can pose to the investment, this can lead to issues when banks and insurers scrutinise the level of diligence undertaken.
- **Investigating the "governance" element of ESG diligence.** This includes anti-bribery, sanctions and other financial crime matters. Again, if the ESG report is being provided by an environmental consultant, there is unlikely to be a detailed focus on these areas (if any) given they are more legal in nature. There may therefore need to be an additional level of co-ordination with the legal due diligence here.
- **Focusing on the liability aspects of the environment and social elements of ESG diligence.** This includes, for example, claims and enforcement action. This reflects (or arguably has helped create) a change in legal diligence in the private equity sphere, with a move from a narrow legal liability focus, to seeking a broader understanding of how a target business identifies and manages its compliance and wider ESG risk. As such, the legal and ESG reports should be aligned, or (more rarely seen) a combined reporting approach could be considered (but see *Practical pointers on ESG diligence* for health warnings on this).
- **Reviewing house or third party ESG reports.** House or third party ESG reports are also a valuable source of information to the legal team. They will inform and help scope the legal diligence workstream and can also shape the transactional documents (see *ESG and deal documents*). The lawyer will also be able to offer valuable perspective on an ESG report to the rest of the deal team, based on their previous experience of the market and sector, in analysing the array of information referenced above and distilling the key points of concern from a legal perspective.
- **Ensuring that due diligence package is appropriate.** The lawyer should help to ensure that the full package of diligence is appropriate to facilitate the transaction. For example, if there is a warranty

and indemnity insurer, they will want to ensure that environmental and safety risks have been properly investigated and disclosed. The insurer will typically be more focused on traditional liabilities, as these are what it will (for the most part) be most directly exposed to under the warranties it is insuring (see *ESG warranties*). If those have been primarily analysed in the context of an ESG workstream, care needs to be given to ensuring this can be presented in a way that meets the insurer's requirements. Presenting extraneous information relating to wider ESG matters may be unhelpful in this context.

Similar considerations will apply in relation to banks or other third-party funders looking to understand the level of downside risk and potential liability posed by an investment. These parties may also want to rely on the output of any diligence. This may be difficult to negotiate in the context of broadly scoped ESG diligence (with significant areas of risk), where a consultant will wish to limit their potential exposure carefully. Again, the deal lawyer's experience of what is achievable in the market, and what will be acceptable to banks and insurers, will be important.

Practical pointers on ESG diligence

- Where formal ESG diligence is undertaken, there is likely to be overlap between technical and legal workstreams. It is important to align scoping and responsibilities at the outset.
- Consider the purpose with your client. Does the ESG diligence form part of the investment case? Or is the focus on identifying post-transaction improvements? This will inform the approach and structure.
- Consider the form of reporting. Will legal and technical reports contain the respective elements of ESG diligence, or will there be a separate ESG due diligence report?
- Identify the audience. This report may be a tool for future investment management (rather than just liability risk identification and mitigation) and so disclosure to financing banks and insurers may not necessarily be appropriate.
- Interviews with senior management are typically an important part of any ESG exercise; and can be a valuable way for lawyers to understand the target business and risks more generally. However, attendance of legal representatives may change the perception of the meeting, and the degree of transparency within it.
- Pay attention to the supply chain. This can be particularly difficult to diligence, and presents risk across each of the environmental, social and governance aspects. Consider depth and location of the supply chain to inform a risk-based approach (for example, will diligence of tier 1 suppliers suffice? Are specialist consultants needed for overseas factory visits? To what extent will existing contractual provisions protect the target?
- Have regard to the wider liability implications of what is being reported. Claimants in recent UK cases have sought to hold parent companies liable based on their corporate social responsibility (CSR) commitments and public statements, what they allegedly knew, and what actions they failed to take (see *Parent liability for ESG issues*).
- Consider close-outs. Traditional deal mitigation (price chips, warranties and indemnities) will often not be effective for ESG issues, where defining price impact, loss or trigger events can be difficult.
- Don't lose sight of traditional legal liability risks.

ESG and deal documents

ESG warranties

The use of ESG-specific warranties in share purchase agreements has, to date, generally been limited for the reasons discussed below.

Certain aspects of ESG relate to direct legal compliance matters and will typically be covered in a standard, comprehensive set of warranties. For example, warranties in relation to compliance with environmental or anti-bribery and corruption laws, reporting regimes (such as gender pay gap or modern slavery reporting), or maintenance of financial risk policies and procedures will commonly be sought by a well-advised private equity buyer. These matters may also (to a degree) be covered by a general warranty on the target's compliance with laws. As these warranties ultimately relate to legal compliance, they should be sufficiently certain to be able to be given by a seller or management, and disclosed against meaningfully.

The private equity buyer's lawyer may be able to tailor or expand these narrow ESG-related warranties in light of the target company, its sector, and the findings of ESG diligence. Examples of areas where tailored warranties may be sought include:

- A buyer acquiring a timber business may wish to seek specific warranties in relation to compliance with the voluntary requirements of the *Forest Stewardship Council* or other similar schemes (in addition to compliance with mandatory legal obligations); or more broadly that all wood is ethically sourced in accordance with recognised international standards, given that this may be central to the value of the business.
- Businesses in areas with higher risks of impact to safety or the environment may maintain a management system that is certified to voluntary international standards (such as ISO 140001 or OHSAS 180001) (see *Practice note, EMAS, ISO 14001 and other environmental management systems*). It is not unheard of (albeit still unusual) for the buyer to require warranties that management systems have been maintained to these standards.
- A buyer may seek broader warranties relating to policies and procedures in relation to financial crime or social matters, which go beyond strict legal obligations (particularly given that, in areas such as anti-bribery and corruption, there is not a strict legal requirement to maintain an anti-bribery policy).

However, even these limited extensions to traditional legal compliance warranties present challenges (so far as they go beyond compliance with laws). Difficulties can arise in demonstrating breach of voluntary standards or requirements or in demonstrating what loss flows from this. Where the warranties relate to policies, standards or management systems contained within a data room, a seller may also seek to argue that these have been disclosed, and so qualify the warranty. These difficulties increase when it comes to any proposed ESG warranties relating to the broader ethical or sustainable conduct of the business. Careful thought would be needed to construct the warranty in such a way that a breach can be identified, and losses flowing from that can be demonstrated. The seller or management may resist any warranty that requires them to make an overly-subjective judgment on disclosure.

This is further complicated by the growing prevalence of warranty and indemnity insurance (W&I insurance). An underwriter will wish to have a definable trigger event and losses for any claim, allowing it to model and price risk (and respond to claims appropriately). This will make it difficult to obtain insurance cover for ESG specific warranties, particularly if they are new to the underwriter. It may also have a negative impact on the ability to get coverage for the more traditional areas, which, if combined into a consolidated ESG set of warranties, may be excluded more generally. For background information, see *Practice note, Warranty and indemnity insurance*. For an analysis of the use of warranty and indemnity insurance in private equity and private M&A transactions, see *Private M&A trends report: Warranty and indemnity insurance*.

This is not to say that broader ESG warranties cannot be sought or obtained. But the approach will need to be carefully judged, to provide a package that is robust and enforceable, and facilitates disclosure of information in a way that is informative (see *Practical pointers on ESG warranties*). The deal lawyer also needs to remain aware of wider developments in ESG-related practices. As further regulatory regimes emerge, and consensus grows around what businesses should be expected to do in the ESG sphere, the approach to warranties has become a constantly evolving area.

For more information on:

- Traditional environmental warranties in M&A transactions, see *Practice note, Environmental warranties: overview*.
- Using warranties in M&A transactions in general, see *Practice note, Warranties and indemnities: acquisitions*.

Practical pointers on ESG warranties

- Consider coverage in ESG areas provided by existing warranties (including compliance with laws).
- Have regard to the ESG diligence report. This will inform drafting of traditional legal warranties, as well as any more bespoke ESG protections that the private equity buyer may wish to seek.
- Consider enforceability and recourse for any proposed ESG bespoke warranties. Where there is a known concern, the warranty should be as specific as possible and you should consider what the trigger event for a claim would be. Be prepared to justify the warranty to the seller with reference to diligence findings.
- More general ESG warranties could still be useful for disclosure purposes, even if they may be difficult to enforce in practice.
- If the transaction is backed by W&I insurance, discuss the approach with the appointed broker at an early stage. An overly aggressive approach to ESG warranties could undermine cover for traditional warranties (for example, warranties for environmental liabilities).
- Remember that warranties on compliance with specific mandatory reporting regimes (such as modern slavery) may be worthwhile, even if covered by a compliance with laws warranty. This is both to encourage disclosure, and as the binding legal requirements can be quite narrow.
- Consider who is in the knowledge group for any warranties qualified by awareness. Different members of management may have additional responsibility or oversight in this area. The supply chain may be particularly important here.

ESG provisions in investment agreements

Ultimately, many ESG concerns are neither liability nor definable loss issues. They relate more to the overall sustainability, performance and wider commercial and reputational risk profile of the business. Such future-looking issues should be identified in diligence, possibly priced into the deal, and then managed, rather than being matters to be warranted. This is where the investment agreement will be important.

See *Practice note, Equity finance aspects of private equity transactions* for a detailed discussion of the role of the investment agreement in private equity transactions.

In essence, the investment agreement governs the relationship between the private equity investor and the management team of the portfolio company, and (among other things) lays out the ground rules for the operation of the acquired business going forward.

Often, a private equity house will have a set of standard ESG provisions that it requires to be included in the investment agreement. These have two key functions:

- Ensuring that the portfolio company is managing its own risks, and monitoring (and seeking to improve) its performance in certain key areas of concern from an ESG perspective.
- Providing the house with ESG-related data. This will allow the house not only to ensure risk is being managed and value is being generated (possibly with a view to exit) but also provide the house with the information it requires for its own ESG reporting (including to its investors).

Typically, the ESG provisions will require the portfolio company to develop and implement ESG-related policies and procedures. These may include a general ESG or sustainability policy (which may be required to align with a general ESG policy of the house), as well as more specific policies around matters such as anti-bribery or modern slavery. The portfolio company will then need to regularly report its progress in meeting these; as well as against agreed ESG performance metrics more generally. Usually the ESG metrics will not be fixed within the investment agreement, not least as this could necessitate changes to the agreement as they evolve. Instead they will typically be proposed by the company periodically, and approved by the investor.

It is the lawyer's duty to ensure that the legal risk of its client is protected in these structures; while ensuring that their intent (as set out above) can be fulfilled. In the light of recent case law (see *Parent liability for ESG issues*) the general partner should be wary of assuming too much control through the ESG provisions (or indeed wider operation) of the investment agreement. While the house communicating its own policies and expectations in relation to ESG matters to the portfolio company, and being privy to high level strategic ESG-reporting, should not in itself imply control, if there is too much direct operational oversight a future claimant may argue a duty of care has been assumed. Although currently more theoretical in the private equity context, the structure within the investment agreement of the reserved powers, board rights and the role and duties of nominee directors will need to be carefully considered in this light.

Protecting against the assumption of additional legal risks such as these, while allowing for a transparent and meaningful ability for investors and managers to understand and improve the ESG performance of the target business, is a difficult legal balancing act that applies throughout the transactional process. It is therefore more important than ever that the ESG and legal workstreams work in harmony, and that lawyers stay abreast of the fast-moving changes in hard law (that is, mandatory legal requirements that aim to directly require or prohibit certain actions or behaviours) and soft law (that is, legal requirements which focus on reporting and transparency only, or non-binding or unenforceable requirements, such as in guidelines or codes of conduct), and stakeholder expectations in this area.

Parent liability for ESG issues

There have been a series of claims brought before the UK courts against UK parent companies (in many cases, listed companies in higher-risk sectors such as oil and gas) relating to the environmental, safety or social impacts of their overseas operating entities. Claimants (keen to establish the applicability of UK legal standards or to access deeper pockets of a UK parent) have sought to rely on statements in a parent's accounts, reports and policies in this area to imply a degree of control by the parent over its subsidiary's related policies and procedures, including their implementation. Claimants have used this to argue that the parent has assumed a legal duty of care for the acts of its subsidiaries.

While these cases have not been in the context of a private equity structure (where typically the investor will not have the same degree of control as a parent company in a conventional corporate structure), they nevertheless have profound implications for the approach to ESG in the investment sector. They are an important reminder that a parent or investor who makes far-reaching ESG commitments may be vulnerable to claims if they do not deliver on them (particularly where a commensurate degree of control has been assumed).

For a discussion of the issues in *Vedanta Resources Plc v Lungowe [2019] UKSC 20*, see *Article, Parent company liability: your place or mine?*.

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