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Merger Due Diligence Considerations Amid Rising ESG Focus

By **Brad Dragoon and Matthew Flug** (February 10, 2021, 5:41 PM EST)


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The mergers and acquisitions space remains active despite the economic challenges presented by the ongoing pandemic.

In December 2020, 952 transactions were completed — nearly as many as the 1,085 deals closed in December 2019, an indication of a strong rebound despite turbulent times.[1]

Acquisitive firms are dealing with an evolving set of challenges as the corporate landscape continues to shift from its traditional focus on immediate shareholder value to a more holistic paradigm of stakeholder capitalism.

Rather than focus solely on corporate fundamentals and possible legal exposures, buyers must also account for environmental, social and governance factors.[2]

Managing these prospective reputational risks has become as important as mitigating the potential pitfalls — such as legal or regulatory — associated with consummating a transaction.

The Socially Conscious Business Environment

A more formal emphasis on environmental, social and governance facts began in 2006 with the issuance of the six core principles of the Principles for Responsible Investment, an international network of investors.

The investor network was launched by the U.N. and the New York Stock Exchange, and signatories to its mandate pledged to "incorporate ESG [environmental, social and governance] issues into investment analysis and decision making."[3]

Since then, signatories have increased from 100 to more than 3,000 corporations and global institutions.

The trend toward a more socially conscious business environment was fostered by a disaffection with traditional shareholder-centric capitalism following the Great Recession in 2008.

Over the past decade, sustainable and socially motivated decision making has been incorporated into most major firms, and studies have found that companies which place at least some emphasis on environmental, social and governance factors tend to financially outperform those that do not.[4][5]

Emergence of Reputational Risk

Socially responsible investing and operations may prove beneficial. However, failing to account for environmental, social and governance factors, especially within an M&A context, can have significant repercussions for all parties involved in a forthcoming acquisition.

In any transaction, acquiring parties are expected to obtain a full suite of diligence.

At a minimum, due diligence historically and presently includes a core legal, financial and tax review.

Given the current political climate and proliferation of information through news and social media, reputational risks should be analyzed with the same priority as financial and legal considerations.

Large classes of consumers are genuinely concerned about the environmental impact and ethical principles of organizations from which they purchase goods and services.[6]

While environmental diligence is not new, it is typically geared toward regulatory requirements or historical incidences of contamination, as opposed to public scrutiny arising from environmentally sensitive activities.

Similar to shareholder activists, consumers are leveraging their collective influence, which can have a determinative impact on profitability, in what some are now deeming M&A activism.[7]

Always Check Under the Hood

The rapid transmission of information in the 21st century, which produces vast amounts of publicly available data, is a double-edged sword.

It makes it nearly impossible to avoid the scrutiny of disclosure.

Alternatively, the accessibility of information allows parties transacting M&A to better understand and assess the risks posed by their counterparties and investment targets.

To mitigate reputational risks, purchasers need to be keenly aware of sellers they are engaging and targets they hope to acquire.

The know-your-customer verification process in customer due diligence has become a pillar of financial crimes prevention in consumer and commercial banking.

However, conducting investigative due diligence to understand who or what is behind an acquisition target is not always standard practice.

A holistic review of a target company's operations and ownership structure is especially critical in multinational transactions. Traditional legal due diligence does not always account for the political exposure of transactional counterparties, whether a company's owners hold political influence, or whether a company is considered a state-owned enterprise.

Identifying these connections is critical both from a reputational perspective and to mitigate impending legal and regulatory concerns. Transactions involving non-U.S. investors can trigger a review by any number of federal agencies,[8] most notably the interagency Committee on Foreign Investment in the United States.[9]

This panel, which reviews cross-border transactions to identify national security threats, may impose harsh remediation measures; it terminated eight deals in 2019.[10]

Beyond the Target: Third-Party Risks

In addition to knowing who the owners and key stakeholders of an acquisition are, gaining a deeper understanding of the acquisition's operations and material supply chain partners, including third-party vendors or suppliers, is important and carries its own set of unique challenges.

Determining if a target's vendors operate in jurisdictions known for high levels of corruption can prevent potential violations of the U.S. Foreign Corrupt Practices Act or U.K. Bribery Act.

Third-party vendors may have relationships with entities operating in countries subject to comprehensive sanctions, including those issued by the U.S. Department of the Treasury Office of Foreign Assets Control.

Checking a company's customers against OFAC's Specially Designated Nationals list only scratches the surface.

Violations of OFAC rules by an acquired entity or its third-party partners can result in significant fines or require costly remediation and review, even if the violations occurred before the commencement of the acquisition.

Beyond civil penalties, the negative reputational impact of such violations may harm relationships with material vendors or suppliers.

Meeting New Expectations

Labor and human rights expectations are not new as prominent factors when considering M&A activities.[11]

However, due dilligence can still be difficult to perform and these areas are still sometimes overlooked in the throes of deal negotiation.

Representations known as #MeToo or Weinstein clauses included in purchase agreements are representations that no sexual harassment or assault allegations have been made against a company's senior employees or officers within a specified period of time.[12]

Of course, despite such provisions, there may be allegations that a seller is unwilling or unable to disclose.[13]

Discreet source inquiries conducted by investigative professionals may unearth allegations of sexual misconduct not identified through self-disclosure.

Due diligence in this area is important because while Weinstein clauses may indemnify buyers against direct financial loss, they don't protect or prepare them for intangible blowback from a more conscientious consumer populace.

Sourcing of raw materials, another well-known example, has also come under scrutiny in recent years. New legislation prohibiting trade in minerals extracted in conflict zones went into effect in the European Union in January 2021,[14] and the U.S. Congress has proposed a law banning the use of cotton harvested through forced labor.[15]

Understanding the global supply chain of a prospective acquisition target may help promote environmental sustainability and accountable governance and may prevent violations of nuanced regulatory regimes and significant financial impositions.

Expanding the Scope of M&A Due Diligence

It is no longer sufficient to focus solely on the historically fundamental aspects of diligence.

The cost of a robust suite of reputational and investigative due diligence, complementary to, and not in lieu of, a full-scope corporate legal review, is a small price to pay for a complete picture of the exposures that may be inherited through M&A.

While commercial due diligence may cover topics such as internal synergies or market competition, they rarely purport to assess consumer perception of a company, the likelihood of a key customer walking away from a contract because of reputational risks, or even some regulatory scrutiny and subsequent enforcement actions.

These issues are not simply a fad that will fade away but growing and important aspects of conducting business — especially M&A — and indicative of an active consumer class.[16]

Ignoring reputational risks and emerging compliance concerns can be costly.

When considering engaging in M&A, the scope of diligence needs to account for a globalized economy that is becoming more socially aware.

Prospective acquirers must consider the evolving nature of risk by looking beyond financial fundamentals and legal requites. Corporate social values of a prospective target may soon require the same consideration as its balance sheet.

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