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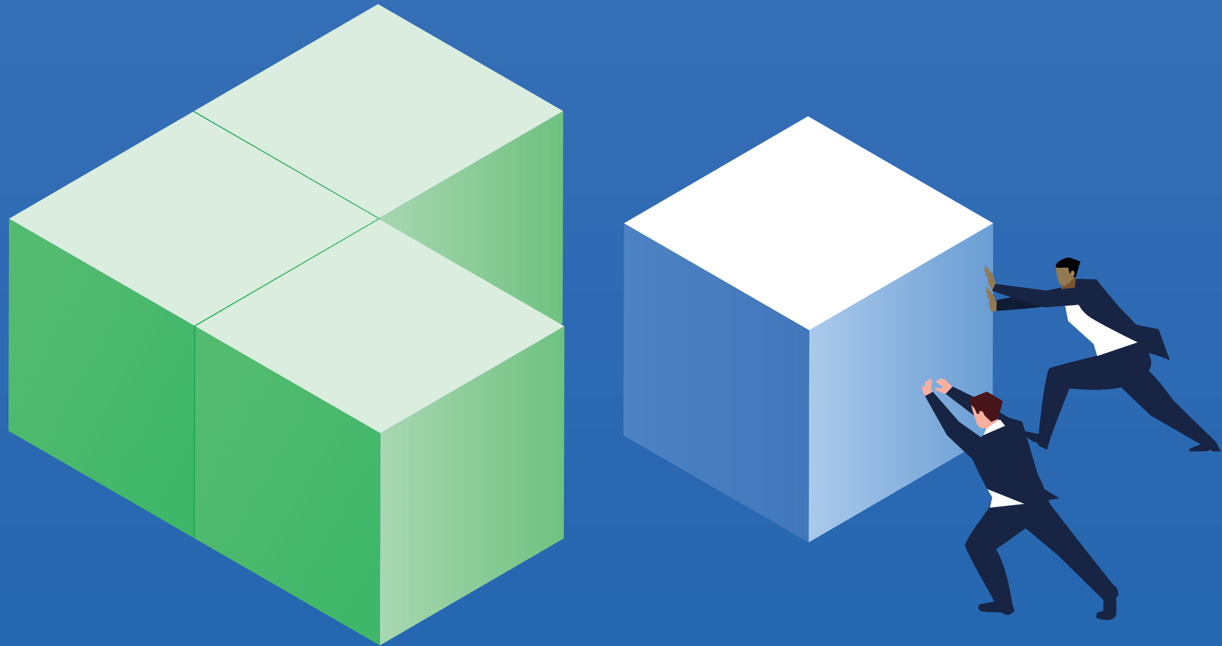
# In Practice



NACD ELEVATE BOARD PERFORMANCE

## When M&A Runs Into ESG

By Helene R. Banks and Kimberly C. Petillo-Décossard

Eighty-three percent of business leaders say that environmental, social, and governance (ESG) factors will be increasingly critical to merger and acquisition (M&A) decision-making in the next 12 to 24 months, according to a 2020 McKinsey & Co. survey. That represents a sea change from just a few years ago. And since the survey was conducted, interest and concern over ESG matters have only continued to surge.

Not long ago, M&A due diligence focused primarily on the potential for pending lawsuits to generate unexpected financial liabilities. Today, however, whether your company is a potential buyer or seller, you should be ready for a wide-ranging inquiry that includes questions tied to the ESG events of the past few years—the #MeToo movement, the COVID-19 pandemic, the racial justice movement, and the threat of political violence.

How boards and C-suite executives consider ESG in the context of a deal requires an astute understanding of evolving issues to ensure that a company's value is not impaired or the next transaction derailed.

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### ESG'S INFLUENCE ON CORPORATE VALUE

While some remain skeptical of ESG's importance, it is hard to ignore the compelling facts.

Investors are increasingly seeking companies that care about ESG matters. In just three years, assets under US management that are designed to advance sustainable investing have grown 42 percent, to $17.1 trillion. This makes up one-third of the total US assets under professional management, according to a 2020 report from the Forum for Sustainable and Responsible Investment.

The growth trend is even more pronounced when narrowing the focus to stock and bond mutual funds, which, according to Morningstar, "constituted nearly a fourth of overall net flows into stock and bond mutual funds in the US in 2020." Goldman Sachs reported in January "that ESG-oriented capital is now the fastest growing segment of the asset management industry and that global, non-ESG fund flows have been contracting." BlackRock, State Street Global Advisors, and Vanguard, the three largest global asset managers, have all issued statements emphasizing the importance of ESG in their investment decisions.

In addition, reports and studies increasingly are finding a connection between ESG matters and a company's financial success.

- A *Barron's* report on sustainability showed that returns on the 100 most sustainable companies handily beat the S&P 500 index in 2019.
- McKinsey & Co. reported in 2019 that a "strong ESG propo-

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sition correlates with higher equity returns… [and] a reduction in downside risk."

- Institutional Shareholder Services (ISS) finds parallel trends, posting on the Harvard Law School Forum on Corporate Governance website that "there appears to be a link between ESG—Environment, Social, and Governance—and financial performance." ISS has reported that a company's high or favorable ISS ESG Corporate Rating generally correlates to higher profitability and higher valuations.
- A study by Cornerstone Capital examined 231 M&A deals, measuring whether firms involved in the same transaction were ESG compatible. The research found that ESG-compatible deals outperformed ESG-incompatible deals by an average of 21 percent on a five-year cumulative return basis.
- In January, a Goldman Sachs Briefing emphasized this point, noting, "As companies evaluate a potential deal, they are more likely to consider the transaction's effect on their carbon footprint, supply chains, and social impact, and to incorporate assumptions about those factors into their valuations. Where a company is evaluating a target with a different ESG profile than its own, positive differences in ESG footprints and disclosure practices may be a source of synergies. In other situations, drastic differences in buyer and target ESG profiles can even scuttle deals."

Based on the above, it should be no surprise that ESG matters are influencing M&A transactions and their long-term outcomes. In the M&A context, boards should consider ESG matters both as a potential driver of value and as an element of risk.

Boards are likely already familiar with how environmental matters may drive M&A decisions. Potential environmental liabilities have long been a hot topic of indemnification provisions, and environmental matters are today responsible for multibillion-dollar deals. Fiat Chrysler's pending merger with Peugeot was initiated for a number of business reasons, but ESG was a leader among them. The tie-up will reportedly prevent billions of dollars' worth of carbon emissions-related fines from the European Union.

The past few years have seen enormous and rapid change in the social and governance areas—the "S" and "G" of ESG—with new points of focus where the direct correlation to value is harder to see, but no less important. The #MeToo movement, for example, has increasingly led companies to launch due diligence on social issues pre-transaction. Since 2018, "Weinstein" clauses have become commonplace in M&A representations and warranties. Such clauses generally include a statement that the company's managers, executives, and directors face no accusations of sexual harassment and can cover the period from two to ten years prior to signing. Buyers are not prepared to take on either the reputational risk or the potential disruption to their businesses resulting from such allegations.

As COVID-19 swept the globe, stakeholders increasingly expected companies to focus on human capital, including worker safety, health and wellness, and job and wage security. Some made swift adjustments, while others were left to defend themselves against lawsuits, for example, for failure to provide workers with sufficient protections during the pandemic.

Additionally, public companies need to reconsider their disclosures regarding human capital in the wake of the US Securities and Exchange Commission's (SEC) recent amendments to Regulation S-K. These require public companies to disclose material human capital measures and objectives that are used in managing their businesses.

Companies preparing for a transaction should anticipate that employee protection will be a focal point. As companies reacted to the pandemic with a broad range of work-from-home policies and cultures, these and related retention matters will be front and center during due diligence and post-merger integration.

The events of the past year also led to or heightened focus on diversity and demands for immediate attention to this issue. In October, the *Wall Street Journal* reported that 2020's protests over racial issues "are accelerating change in the way investors, workers, and the public view the role of companies in society."

Increasingly, stakeholders are focused on corporate policies regarding the hiring and promotion of Black employees, and are pushing for boardroom and management diversity not only based on gender, but also on race and sexual orientation.

Oracle, Facebook, and Qualcomm have faced lawsuits in California based on claims that they failed to implement their own di-

## ESG IMPACTS TRANSACTION VALUES

For decades, "maximize shareholder value" was the mantra of boards in the context of M&A. In 1986, the Delaware Supreme Court developed what has become known as the Revlon doctrine, holding in essence that when a company is sold directors become "auctioneers charged with getting the best price for the stockholders."

Historically, this maximization of shareholder value has been focused strictly on price—the Revlon case involved a cash sale during a hostile takeover—while other elements that often contribute to long-term shareholder value were largely ignored. But ESG's influence has grown exponentially in recent years and is increasingly shaping how deal makers approach and value transactions.

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versity policies. Meanwhile, that state's legislature once again returned to the issue of board diversity, expanding beyond gender to include race and sexual orientation in its mandates.

Elsewhere, ISS proposed revised voting guidelines for 2022 focused on companies in the Russell 3000 or S&P 1500 that have no identified ethnic or racially diverse board members. Nasdaq recently filed a rule request proposal that would require its listed companies to have at least two diverse board members or to explain why they do not. And several states have adopted legislation requiring or encouraging board diversity.

Companies preparing for a transaction will need to evaluate their diversity policies and practices and their long-term strategies on social issues as part of due diligence. Where companies—whether buyers or sellers—have made public commitments, those will need to be maintained by the new, integrated company or risk backlash.

As if 2020 didn't bring enough pressure to bear on ESG, 2021 began with the siege of the US Capitol on Jan. 6. Companies should add to the ESG mix the need to assess the potential impacts on their businesses of acts of political violence that may arise, while also reviewing their political contributions and activities. *(For more recommended action on this topic, see "10 Actions for Boards in Response to Political Violence" on the NACD BoardTalk blog.)*

## PREPARING FOR AN M&A TRANSACTION

To ensure a successful transaction, it helps to have a road map—and the board plays an integral part in building that framework. As it relates to ESG specifically, the board should consider three main queries: what are the company's strengths to preserve, what are the other company's strengths to leverage, and what are the potential weaknesses that might come to light or be exacerbated by the combination? Related questions can help the board understand what might be gained or lost.

1. What ESG programs does the company have in place? What internal systems and expertise in these areas are key to the company's success? Certain ESG matters are the cornerstones of the business, others secondary. Understand the full range of existing programs, and know which are essential to the company's function, brand, and key stakeholders, in order to ensure these programs are protected through any future transaction, whether it's the sale of the company or a purchase by the company. For example, if your company has developed a robust supply-chain program that promotes diversity and roots out child labor, management and advisors will want to pay close attention to this area so that a changes don't dilute those efforts. Similarly, issues that go to the heart of the culture of the company, like employee benefits and training and pay equity initiatives, can be key to attracting and retaining employees. Combining with another company with a different culture could cause setbacks and result in losing key personnel.

2. What ESG programs does the transaction counterparty offer that could help move your ESG program forward? Either as a seller or buyer, the merger partner may have in place systems or programs that would be beneficial to the combined company. For example, perhaps the other company has adopted a system to track environmental improvements such as those relating to carbon emissions, a goal your company has not yet accomplished. Alternatively, the merger partner may have already achieved a level of diversity that your company is still seeking. While not traditional areas of M&A focus, these potential synergies may help one potential merger partner stand out above others. Before identifying partners and to help narrow the field and guide the inquires, clarify what ESG areas are important to your company in a transaction partner.

3. Identify ESG weaknesses that could expose your company to value loss in the context of a transaction. The board and its advisors should understand the target company's material environmental, human rights, and employee issues that could be a drag on value or that might be enhanced through the right acquisition.

Every company stands at a different point on the ESG journey. Identify the material areas where your company needs improvement before engaging with a merger partner. Sellers may want to consider an ESG-focused risk assessment to help avoid any surprise impact on value. As a buyer, knowing the key areas for ESG improvement may guide which company is targeted in the transaction. A buyer must also understand their own weaknesses if equity is intended to be a part of the transaction consideration. Ultimately, developing clarity on these issues early will help avoid surprises later.

### BOARDS, ESG, AND M&A

The core duties of any board rest on oversight, governance, and strategy. When it comes to M&A, directors have a powerful role to play, focusing the company and its leadership on the necessary steps to ensure a smooth transaction while maximizing value for the shareholders. With the rise of ESG, boards need to incorporate ESG matters into their engagement with management through all stages of an M&A transaction. Boards should help set the M&A goalposts, ensure a skilled deal team is in place, and be ready to review proposed transactions, measuring them against company strategy while questioning all assumptions.

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## EVALUATING AND NEGOTIATING A TRANSACTION

Once a transaction partner is identified, the ESG analysis continues. Boards should consider the following:

**1.** Using the road map identified pre-transaction, dive deeper to evaluate what expertise, strengths, and weaknesses the new company presents in the ESG context.

**2.** During the negotiation phase, more information will be available to the potential transaction partners. Consider how these partners compare to the company and to industry peers. Identify the risks and opportunities. For example, is a potential partner facing regulatory exposure or shareholder concerns as they relate to current or potential future environmental rules or diversity guidance? This process should also examine if the M&A partner is ahead or behind its peers in these areas. Does the partner have policies, systems, processes, or internal controls in place to measure progress on ESG matters? Look behind ESG disclosures to spot-check the accuracy of public information. Identify and assess areas that will need to change to meet your ESG goals, policies, and protocols. Similarly, identify areas that can enhance your ESG programs.

**3.** How should this combination of ESG risks and synergies be priced? Difficult questions about valuation can be addressed using cost estimates and risk analysis. Could ESG exposure cause reputational harm and impair market price? What will it cost to align the ESG practices? What will it cost to ensure the combined company can provide stakeholders with the disclosure they expect?

**4.** What contractual protections are needed to minimize risk and preserve value? Any matter that arises during ESG due diligence can be translated into representations and warranties, indemnities, or price reductions. Beyond the Weinstein clause (essentially language that provides assurance that the target company is not subject to sexual harassment claims or other actions that would result in embarrassment, liability, or loss of value to the acquirer), many ESG matters are either relatively new or so unique to a particular company that drawing from precedent language may prove difficult. Sellers may resist making representations that are broader than simply stating current compliance with existing laws. But addressing material ESG matters often requires more than meeting minimum standards set by the law. For example, a company may not be required by law to take steps to ensure worker satisfaction, but human capital management practices will often include programs for employee wellness.

**5.** Similarly, errors in ESG reporting may not rise to the level of a misstatement of a material fact but could create issues with stakeholders. Where material risks are uncovered, companies may seek escrows or special indemnities. In a public-company transaction, where representations do not last past closing, they can still provide an important avenue to exit a deal if something arises in the months between signing and closing.

## POST-TRANSACTION

During the integration phase, ESG matters should have significant influence on the nuts and bolts of combining sourcing, suppliers, and systems. For example, supply partners may be chosen based in part on their labor practices, rather than strictly on price. Similarly, employee incentive plans may be selected based on impact on diversity, not just cost.

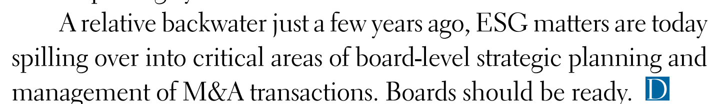
Companies and their boards should look for opportunities for ESG improvement and avoid costly mistakes that lose key employees or confuse investors. Some areas to consider:

**1.** How will ESG policies and structures be integrated? Does either company have a board-level ESG committee? The board should determine whether it should be kept or integrated, and new roles assigned. If none exists, the board may consider an ESG steering committee to help guide integration. A similar assessment is required for key employees and divisions related to ESG matters.

**2.** How are the key ESG policies and procedures maintained, incorporated, and communicated across the combined company? The board should ensure the company has an employee training plan to create a smooth transition, including briefings for key teams and new employees. Examine management structures across relevant teams. Information gaps are likely to arise during this fluid time—seek them out and overcommunicate, especially where ESG matters represent serious risk. Also consider how to monitor compliance with ESG standards within the company's operations that present the highest risk.

**3.** How will ESG materiality and subsequent reporting processes and metrics evolve? Inevitably, new issues and concerns will arise during integration. The board and management must maintain flexibility and be ready to identify and address such matters. After integration, take a step back and review all ESG matters to fully understand the challenges and opportunities ahead. Utilize this moment as well to review ESG data collection and processes and update them as necessary. Incorporate these changes into the next ESG reporting cycle.

A relative backwater just a few years ago, ESG matters are today spilling over into critical areas of board-level strategic planning and management of M&A transactions. Boards should be ready.



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