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ESG Considerations in M&A Transactions

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In the past few years, environmental, social, and governance ("ESG") issues have increasingly influenced dealmaking, and, specifically, M&A transactions. Generally, ESG can be used to measure a target's performance in ways that cannot be determined from financial statements, which include a target's sustainability measures, social impact (such as human rights and labor relations considerations), and organizational and management structure, among other factors.

I. Value Creation and Risk Mitigation

ESG considerations have become key drivers in M&A activities because a target's ESG performance can increase the long-term valuation of the acquisition and send positive signals to shareholders, or, in the case of a private equity fund, it can increase the value of the target before a sale. A target's ESG performance can also create reputational and financial risks for the acquirer. Because of this, it is crucial for companies to assess ESG factors and the target's alignment with them, including the target's due diligence performed on the acquirer, so that the target can protect their reputation and financial exposure and possibly increase support from shareholders based on positive ESG metrics.

Long-Term Performance and Growth

ESG metrics are an important tool in selecting a target that will maximize the acquirer's growth and revenue. It is important to consider whether certain targets are a good cultural fit for the investor's portfolio and if they are well-positioned to handle environmental and social changes in the future. A target's ESG performance can also provide insight into its long-term value and potential for higher financial returns.

Acquisition Risks and Safeguards

Before ESG became a focus in M&A activity, due diligence primarily focused on the target's financial and legal materials. By incorporating ESG in the due diligence process, ESG metrics can further aid in assessing the target company's risk exposure and potential liabilities. Reputational and financial risks include whether the target company is subject to sanctions, if there is a toxic workplace culture, or if there are any controversial customers or suppliers.

ESG issues from both a financial and reputational perspective can be quantified in several forms. Financial issues may leave investors exposed to sanctions or fines, but this risk can be mitigated through the due diligence process. Reputation issues may include negative press or social media commentary, which can lead to revenue loss and a drop in consumer confidence. Reputation-related post-merger liabilities can be mitigated if there is a greater understanding of the target's culture and workforce, and this can be developed through social media, reports from third-party providers, and desktop news searches. If an ESG issue has been identified during the due diligence process, the investor can request protection via the purchase agreement in the form of representations and warranties or Material Adverse Effect (MAE) clauses.

Acquisition safeguards for public companies should also include adherence to the proposed SEC Climate Disclosure Rules, along with awareness of any additional SEC requirements for ESG disclosure. The buyer and target should have respective reporting structures in place to address the proposed requirements for disclosures in registration statements and annual reports. For example, a company will need to disclose the greenhouse gas emissions they are directly responsible for, in addition to emissions from their supply chains and products. Companies without these reporting structures in place may create a barrier in the acquisition process or a reason for a price discount because the structures may prove cumbersome to set up. The due diligence process in M&A transactions should include a buyer and target's data management, audits, and standard reporting methods or templates in order to ensure both accuracy and efficiency in their climate-related disclosures.

II. Investor and Shareholder Expectations

Private equity firms are in a unique position to center ESG factors in their target selection. Having high-scoring ESG portfolios can improve the reputation of a private equity fund, and by selecting targets that have successful ESG metrics, there is opportunity for sustainable growth, which can increase the target's value for a potential sale.

Boards and management should be prepared to demonstrate the ESG measures in place, along with any growth prospects. After an acquisition is announced, companies should affirm their commitments to sustainability, social responsibility, and strong corporate governance as a combined business. Certain considerations may be at the forefront, such as board diversity. For example, NASDAQ requires disclosure in the form of board diversity statistics, and two diverse board members are also required; otherwise the company must disclose why this minimum was not met.

III. Post-Merger Governance and Integration

ESG considerations continue after the closing of the deal, and they further influence post-merger governance and integration in several ways. The internal policies of the acquirer may require changes to the target's governance structure, and any ESG issues identified during the due diligence process will need to be addressed. Integration efforts should include managing the sustainability goals of the combined company and workforce efforts should focus on employee well-being and retention.

ESG's role in deals will continue to increase as trends, regulations, and legislation change, but companies should be aware that it is becoming increasingly fundamental in M&A activity, particularly in due diligence and disclosure requirements.

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