ESG Due Diligence in a Share Purchase Transaction from an Investor's Perspective

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Abstract

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Abstract:

Sustainable or responsible investing has increased its popularity among investors throughout the last decade. Thus, nowadays, a growing amount of investors systematically include environmental, social and governance (ESG) factors as a part of their investment processes. In the context of a share purchase transaction, ESG integration during the investment phase is best achieved through a comprehensive ESG due diligence review performed by the purchaser to support its investment decision.

This thesis aims to find answers to the following research questions: (i) what are the benefits and drivers for investors to perform an ESG due diligence review; (ii) how is ESG due diligence process conducted; and (iii) what are the effects of ESG due diligence findings to a share purchase agreement and the proposed transaction.

Despite the accompanying financial and time costs, as a conclusion of this thesis, it was identified that performing an ESG due diligence review is beneficial for the investor in several ways. The main benefits of ESG due diligence review are risk mitigation and future ESG related opportunities, impacts on valuation, and higher return opportunities in the long-term perspective. Based on the ESG due diligence findings, an investor can make an informed decision whether to move forward with the share purchase transaction or not. These findings can also be reflected in the share purchase agreement through liability provisions and other terms to help the purchaser mitigate risks. The research suggests that in most cases the ESG integration benefits outweigh the cost issues and other ESG barriers.

As indicated by this thesis, ESG due diligence is often performed with the help of external advisors as a desk review. As there is no clear standardisation concerning relevant ESG issues, the scope of ESG due diligence review depends on what is considered material in each particular case. The materiality of ESG issues depends on various circumstances, *inter alia*, the sector and location of the investment target, investor’s previous knowledge about the target and investor’s other preferences. The conclusions section of this thesis also includes suggestions on how ESG assessments could be developed in the future.

Table of Contents

1. INTRODUCTION 1
1.1. BACKGROUND AND KEY DEFINITIONS 1
1.2. RESEARCH QUESTIONS, HYPOTHESIS AND LIMITATIONS 6
1.3. RESEARCH METHODOLOGY AND SOURCES 9
1.4. STRUCTURE OF THESIS 12
2. ABOUT DUE DILIGENCE 12
2.1. DUE DILIGENCE PROCESS IN GENERAL 12
2.2. ESG FACTOR INTEGRATION INTO DUE DILIGENCE PROCESS 13
2.3. PURCHASER'S DUE DILIGENCE OBLIGATIONS UNDER FINNISH LAWS AND SHARE PURCHASE AGREEMENT 16
3. ESG DUE DILIGENCE BENEFITS AND DRIVERS FOR INVESTORS 17
3.1. BENEFITS OF ESG DUE DILIGENCE FOR INVESTORS IN M&A TRANSACTIONS 18
3.1.1. GENERAL RISK MANAGEMENT 18
3.1.2. COMPLIANCE RISKS 19
3.1.3. RISKS RELATED TO CHANGES IN OPERATIONAL ENVIRONMENT 20
3.1.4. REPUTATION RISKS 20
3.2. HIGHER INVESTMENT RETURN EXPECTATIONS 21
3.2.1. HIGHER RETURNS FROM LONG-TERM PERSPECTIVE 21
3.2.2. EFFECTS OF TARGET'S FORMER ESG PERFORMANCE 23
3.3. IMPACTS ON TARGET VALUATION 24
3.4. COST SAVINGS 25
3.5. IMPROVED REPUTATION 27
3.6. OTHER DRIVERS TOWARDS ESG INTEGRATION 28
3.6.1. STAKEHOLDER PRESSURE 28
3.6.2. COMPETITIVE REASONS 31
3.6.3. CHANCE TO BE PART OF A REFORMATION 31
3.6.4. ETHICAL REASONS 31
3.6.5. BETTER CRISIS PERFORMANCE AND RECOVERY 32
3.7. ESG DUE DILIGENCE BARRIERS 33
3.7.1. THE SHAREHOLDER THEORY 33
3.7.2. LACK OF ACCESSIBLE INFORMATION AND STANDARDISATION 33
3.7.3. REGULATORY BARRIERS 35
3.7.4. FINANCIAL RISKS AND THE SHORT-TERMINISM PARADOX 35
3.7.5. GENERAL UNWILLINGNESS AND DOING THE BARE MINIMUM 36
4. HOW IS ESG DUE DILIGENCE CONDUCTED? 37
4.1. WHO CONDUCTS ESG DUE DILIGENCE? 37
4.2. WHY GO WITH OUTSIDE ADVISERS? 39

4.3. HOW IS INFORMATION GAINED? 42
4.3.1. MAIN ESG INFORMATION SOURCES 42
4.3.2. INTERNAL REPORTS AS AN INFORMATION SOURCE 43
4.4. ASSESSING ENVIRONMENTAL RISKS 44
4.5. ASSESSING SOCIAL RISKS 48
4.6. ASSESSING GOVERNANCE RISKS 50
4.7. MATERIALITY IN ESG DUE DILIGENCE 53
4.7.1. IMPORTANCE OF MATERIALITY IN INVESTMENT DECISIONS 53
4.7.2. WHAT IS CONSIDERED MATERIAL IN ESG DUE DILIGENCE? 56
4.8. ESG DUE DILIGENCE REVIEW ON A HYPOTHETICAL TARGET: PROJECT WOOD 58
4.9. ESG REPORTING 66
5. ESG DUE DILIGENCE FINDING IMPACTS ON TRANSACTIONS 66
5.1. EFFECTS ON LIABILITY TERMS OF A SHARE PURCHASE AGREEMENT 67
5.1.1. REPRESENTATIONS AND WARRANTIES 67
5.1.2. SPECIFIC INDEMNITIES 68
5.2. EFFECTS ON VALUATION OF THE TARGET 70
5.2.1. VALUATION PRACTICES TO INVESTOR'S FAVOUR 70
5.2.2. SELLER'S VANTAGE 71
5.3. OTHER FORMS OF PROTECTION UNDER SHARE PURCHASE AGREEMENT 71
5.4. ESG DUE DILIGENCE EFFECTS ON PROPOSED TRANSACTION 71
5.4.1. POOR ESG PERFORMANCE AND EXECUTION OF TRANSACTION 72
5.4.2. POSITIVE ESG PERFORMANCE AND EXECUTION OF TRANSACTION 73
6. CONCLUSIONS 73
6.1. IMPORTANCE OF ESG DUE DILIGENCE IN M&A TRANSACTIONS 74
6.2. MATERIALITY IN ESG DUE DILIGENCE PROCESS 75
6.3. HOW SHOULD ESG ASSESSMENTS BE DEVELOPED IN THE FUTURE? 77

LIST OF ABBREVIATIONS

AOA: Articles of Association

DD: Due diligence process

CSR: Corporate social responsibility

CP: Conditions precedent to closing

EHS: Environmental, health and safety

EIA: Environmental impact assessment

E&S: Environmental and social

ESG: Environmental, social and governance

ESG DD: Environmental, social and governance due diligence process

ESMS: Environmental and social management system

GRI: Global Reporting Initiative

IFC: International Finance Corporation

KKR: Kohlber Kravis Roberts

M&A: Mergers and acquisitions

MHRDD: Mandatory human rights and environmental due diligence

PE: Private equity

PRI: Principals for Responsible Investment

PWC: PricewaterhouseCoopers

R&W: Representations and warranties of a share purchase agreement

SASB: Sustainability Accounting Standards Board

SPA: Share and purchase agreement

UN: United Nations

VDR: Virtual data room

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1. Introduction

1.1. Background and key definitions

Larry Fink – the CEO and founder of BlackRock, one of the most important global investment management corporations, has stated that sustainability shall be the core goal when making investment decisions and ESG factors are issues that cannot be overlooked.[1] *Sustainable investing* or *(socially) responsible investing* is a strategy that integrates non-financial concerns, in more detail *environmental, social, and governance* (ESG) issues in investment decisions. An investment decision is an integral part of investors' investment process, which is in other respects driven by a financial perspective.[2] Sustainable investing has been a growing movement in financial markets over the last decade, which can be seen both from investors' desire to consider ESG issues in their investment decision analysis and investors' active ownership practices during their ownership.[3] In the narrower context of transactions, the term *ESG* is often used to solely describe sustainable and responsible investments. According to Admincontrol, a company that provides platforms for information sharing concerning due diligence and board decision-making, the term ESG may include, e.g., money laundering, corruption, compositions of board of directors, rights of employees and relevant emissions to a activities of a company. [4]

Principles for Responsible Investment (PRI) is a network supported by the United Nations promoting responsible investments. As of the year 2020, PRI was the leading sustainability initiative with more than 3000 signatories.[5] PRI's objective is to encourage and help institutional investors, such as banks, assets managers and pension funds, to integrate six voluntary principles that all concern responsible investing. According to the 1st principle of PRI, signatories will incorporate ESG issues into their investment analysis and their decision-making processes. Although signing the principles does not mean that the investor is actually responsible, PRI's support in implementing its principles indicates at least some

[1] (Herz et al. 2016, pp. 96-101; Sandberg et al. 2009, pp. 519-521).
[2] (PRI, What is responsible investment?, pp.1-6).
[3] (Clark et al. 2015, pp. 10-11).
[4] (Admincontrol).
[5] The list of PRI signatories includes investors from across the world. Examples of Finnish signatories are Bank of Finland and Hartwall Capital Oy Ab. Bank of Finland Ab has signed the principles on 18 December 2019 and Hartwall Capital Oy Ab on 10 June 2020.

level of commitment to responsible investing.[6] In 2015, 50% of all total institutional assets were managed by the signatories of PRI.[7]

Investors have been talking about sustainability for several decades, but it was not until the past years that sustainability became visible in their actions. Especially during the last couple of years, sustainable investing has significantly increased popularity among long-term investors.[8] For example, currently, many conventional asset managers and private equity (PE) funds are the ones who generally consider ESG factors in their investment decision analysis and investment processes.[9] In more detail, equity financing is an investment form in which an investor invests capital into a company's shares (stock), and in return, the investor expects to receive ownership interest.[10] A PE fund aims to increase its target's value and profit from the company's later sale for a higher price than its initial investment (the exit). Often the exit of a PE fund will take place within three to five years through a transfer of the shares to a company that is already in business in the same sector or through a floatation.[11] For their investments, PE funds typically receive their funds from institutional investors, such as pension funds. The management of a PE fund is often outsourced to a separate management fund.[12] Private equity funds are considered suitable for providing sustainable finance given their expert knowledge and their long and active nature of involvement with their target companies. [13]

According to surveys, most investment fund managers believe that a fund's ESG strategy can positively impact the fund's long-term investment performance. In practice, when an investor has developed an ESG strategy, the investor applies the same strategy to integrate ESG matters into its investment process. However, the scope of ESG aspects that are applied to investment decisions varies significantly between different investors.[14] However, for PE firms, it is expected that information regarding investment targets is obtained and assessed in the course of a due diligence review.[15] One driver towards more comprehensive ESG integration in investment decisions is increased general knowledge and understanding of

[6] (PRI, About the PRI; Majoch et al. 2017, pp.723-724).
[7] (Friede et al. 2015, p. 210).
[8] (Eccles and Klimenko 2019).
[9] (Van Duuren et al. 2016, pp. 1-2).
[10] (Global Environmental Facility).
[11] (Froud and Williams 2007, pp. 405- 416).
[12] Ibid, pp. 405- 406.
[13] (IFC 2018, p. 33).
[14] (Cappucci 2018, p. 1).
[15] (Zaccone and Pedrini 2020, pp. 1-3).

responsibility. People are becoming more conscious of the fact that the actions of companies impact our environment and society.[16]

Although each investor's approach to sustainable investing differs from others, there are some common grounds between different sustainable investing methods. Sustainable investing is derived from a set of environmental and social standards, of which one example is the performance standards prepared by the International Finance Corporation (IFC). The IFC standards act as a source for IFC's clients when fulfilling their responsibilities to manage environmental and social (E&S) risks.[17] The IFC standards have recently been supplemented by the framework of Anticipated Impact Measurement and Monitoring, an *ex-ante* quantitative methodology useful for assessments, monitoring, and reporting on the impact of financial and non-financial risks. The second example of an organisation providing standards is the Sustainable Accounting Board (SASB),[18] which has prepared sustainable accounting standards that investors can use when appraising their targets' sustainability.[19]

Responsible investing has been described as a comprehensive approach to investing that aims to include all material information that is relevant to investment performance. Responsible investing can be pursued by a different range of investors, such as investors whose driver is the promotion of sustainability, but also investors whose sole goal is to gain higher financial return and not promote sustainability. Given that ESG factors are relevant in assessing investment risks and providing further opportunities to receive higher returns, for the sake of the investor's beneficiaries, ESG factors cannot be entirely ignored in investment decisions.[20]

According to research, incorporating ESG issues into PE investment processes can positively affect the performance of firms' investment portfolios.[21] This indicates that despite the investors' actual motives, ESG aspects should be considered in PE firms' investment processes. It should also be stressed that for PE firms, ESG integration includes more than

[16] (Zaccone and Pedrini 2020, p. 1).
[17] The IFC Environmental and Social Standard has also been signed by one Finnish signatory: Finnfund has adopted the standards on 12 April 2020.
[18] SASB is an independent nonprofit organization that sets standards to help companies disclosure financially material sustainability information to their investors. The members of SASB organisation from Finland are, among others, banks operating in Finland, such as Nordea Asset Management, OP Asset Management and Danske Bank.
[19] (IFC 2018, pp. 11-14).
[20] Ibid p. 33.
[21] (Barclays 2016, pp. 5-6).

just the beginning of the investment phase. Namely, sustainable investing also consists of investor's active ownership practices.[22] Also, an investment horizon in all sustainable investments is considered essential. This is due to the fact that long-term ownership means increased long-term profits for ESG investors through increases in the target's value from a long-term perspective.[23]

Corporate sustainability derives from a boarder concept of sustainability developed for many decades due to influences from politics, the public and the academic world.[24] The definitions of the term corporate sustainability have varied over the years. While some researchers define corporate sustainability as a social responsibility of an organisation, other scholars prefer the term *corporate social responsibility* (CSR), which is described as an adaption of environmental, social, and economic concerns into the activities, strategies, decision making as well as culture of a company.[25] From a historical perspective, CSR has mostly covered environmental and economic aspects, while social matters have received less attention. However, in recent years, social factors have become more remarkable.[26] For example, in relation to corporate sustainability, environmental issues related to the company's commitments to protecting the natural environment and the planetary resources play an important role. This is especially important when considering the planetary boundaries and global warming.[27] The adoption of social factors means a company's engagement to social issues such as modern slavery issues.[28] Commitment to governance factors means ensuring the fulfilment of the company's stakeholders' rights and responsibilities.[29]

To highlight the society's increasing expectations towards companies in the context of CSR, the companies are referred to as "corporate citizens." The increasing CSR requirements and formation into voluntary CSR standards result from companies' ongoing growth.

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[22] (PRI, no date, *What is responsible investment?,* p. 1).
[23] (Flammer and Bansal 2017, pp. 1828-1829).
[24] (Linnenluecke and Griffiths 2010, pp. 357-366).
[25] Ibid, pp. 357-366.
[26] (Panapanaan et al. 2003, pp.133-134).
[27] (Goodland 1995, p. 1-6; Ding et al. 2020 pp. 3-14).
[28] (Litting and Griessler, 2005, pp. 5-8).
[29] (Zaccone and Pedrini 2020, p. 2).

Considering that nowadays, many companies are in the hands of large corporations rather than family-owned businesses, companies' stakeholders' trust has decreased.[30]

CSR also suggests that in addition to complying with mandatory regulations, such as environmental laws and employment legislation, companies should attribute to social responsibility beyond the legal compliance level. To achieve the mentioned goal, it is required that an organisational change is made. Also, CSR fundamentally assumes that companies should not only comply with registration state laws but also with the laws of jurisdictions in which they genuinely operate. As a result of globalisation, CSR attempts to create global ESG standards, especially for cases where state enforcement is weak or companies are avoiding their responsibilities by moving their operations across jurisdictions. Thereby, CSR creates social norms of business concerning people and the environment. Hence, CSR standards raise the compliance level above the requirements of national laws. The CSR principles have been modified over the years and implemented into different global standards, impacting other corporate practices.[31] To comply with CSR requirements on a practical level, companies compose different codes of conduct, some of which are general by nature and others address specific social concerns. [32]

For the avoidance of doubt, the terms ESG, responsible investing, sustainable investing, corporate sustainability and corporate social responsibility are used interchangeably in this thesis if not explicitly stated otherwise.

Conventionally *due diligence* (DD) has been defined as a process during which discoveries relevant to key business transactions and operational activities are made. Information collected during the course of a due diligence process is used in the decision-making, *inter alia*, in mergers and acquisitions (M&A), where the DD process helps determine target value, purchase price and accompanying risks. [33] *ESG due diligence (*ESG DD) is a due diligence process that focuses on collecting and assessing ESG related information. ESG DD

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[30] (Mattila 2006, pp. 159-164).
[30] (PWC and PRI 2012, pp. 1-3).
[31] (Sjåfjell and Taylor 2015, pp. 13-18).
See further about global standards: (OECD Guidelines; UN Guiding Principles)
[32] (Mattila 2006, pp. 159-160; Linnenluecke and Griffiths 2010, pp. 357-358).
[33] (Spedding 2008, pp. 3-4.)

helps investors consider ESG related information revealed during the process and assess its capacity to address the discovered risks and opportunities.[34]

ESG due diligence relating to transactions, which is the subject matter of this thesis, should be distinguished from mandatory human rights and environmental due diligence, i.e., *sustainable due diligence* (MHRDD). The latter is a legislative proposal in the EU for a regulatory transition of the EU company law and corporate governance.[35] In addition to the EU level, MHRDD is also a separate development in some EU countries. At the EU level, the MHRDD aims to create a regime that would include due diligence as a part of conducting business, in more detail, a duty of a company's management for mitigation of human rights and environmental risks to avoid the risks of unsustainability as well as impacts thereto. According to the proposal, the MHRDD would include identifying and assessing unsustainability risks improvement, companies' plans to improve their sustainability level, and annual reporting on the same matters concerning both the company in question and its supply chains.[36] Furthermore, the MHRDD legislation would include enforcement mechanisms and sanctions to hold non-compliant companies responsible. [37]

Even though sustainable due diligence is a different concept from ESG due diligence, the ESG DD could identify and assess the risk related to non-compliance with MHRDD assessment criteria with M&A transactions. Another distinction that should be made is between the above-described CSR, which is based on voluntary standards and which is a developing social norm, and mandatory sustainable due diligence, which is planned to be achieved through mandatory legislation that includes sanctions.

1.2. Research questions, hypothesis and limitations

This research contributes to the scarce literature examining ESG in the context of a share purchase transaction (hereinafter in this thesis generally referred to as M&A and more specifically, a transaction or a deal). The thesis has three main objectives. Firstly, given the fact that conducting an ESG due diligence review means additional time and financial costs, this thesis aims to examine the main reasons for the investor, i.e., in the context of the M&A

[34] (PWC and PRI 2012, p. 1).
[35] See further: (2020/2129 (INL); White & Case (2021).
[36] (Sjåfjell and Mähönen 2021).
[37] See further about the liability under the concept of MHRDD and the protection against liability, i.e., *the safe harbour"*:(Smit and Bright (2020).

transaction for the purchaser, to carry out the ESG due diligence review in a share purchase transaction. Secondly, the thesis aims to investigate how ESG due diligence is conducted, including, *inter alia*, how, to what extent and by whom the information is gained, assessed, and reported. In the context of a transaction, it is also relevant to study how ESG due diligence findings can affect the substance, timeframe and occurrence of the share purchase transaction.

To investigate the material ESG factor assessments in more detail and to make this research more concrete, this thesis includes a section about a ESG DD review on a hypothetical target. To set the ESG materiality filter, the following hypothetical situation is formed: two parties are in the middle of a negotiation phase in a share acquisition transaction. The parties are a Western European investor which is a manager of a private equity fund (hereinafter also referred to as investor or purchaser) and the seller who is a private individual from Finland. The purchaser desires to make an equity investment into a Finnish limited liability company (hereinafter also referred to as the target) which is a medium-sized company and whose field of activity is modular wooden house production and installation. The target company operates mainly in Finland but also sells some of its production to foreign countries, and the company has some cooperation partners outside Finland. Upon conducting the share purchase agreement, the purchaser becomes the sole shareholder of the target, and the seller receives cash funds to its bank account. The target company's shares are not publicly listed, and it does not intend to list its shares any time soon.

The reason for choosing a target company which operates in the field of wooden building manufacturing and construction for the hypothetical assessment is that the market share of wooden building construction is predicted to increase in Finland, even though the use of wooden frames in new construction has been decreasing during the 2000's.[38] Nonetheless, the market share of wooden buildings is forecasted to be double by 2022 compared to 2019, meaning a 30 % increase in the sector. An essential push for the predicted growth is the Finnish Government's Wood Building Programme (2016-2022).[39] Secondly, the reason for choosing a private equity investor as a hypothetical purchaser for this research is the fact that it is a growing global trend that private equity investments are a party to an M&A transaction. According to Mergermarket's 2019 M&A Report, 27,5 % of M&A transactions

[38] (Forecom 2020, pp. 2-32).
[39] (The Wood Building Programme 2019). About the national targets for wood in public construction, see further: (National targets for wood in public construction 2016-2022).

in 2019 included a private equity firm as a transaction party. [40] The origin of the investor has been chosen because sustainable investing is particularly salient in the European region.[41]

To guarantee confidentiality, it is a common practice that each M&A transaction party will a project code name. The purpose of this is to reduce confidentiality risks in case some of the confidential material should accidentally or wrongfully end up to any third party.[42] Thus, the hypothetical transaction will hereinafter be referred to as "Project Wood."

In connection with ongoing negotiations, the investor in Project Wood wishes to conduct an ESG due diligence process to: (1) determine the ESG level of the target company; (2) calculate the risk level of the investment and to mitigate any material risks; (3) gain information about possible ESG opportunities; (4) make an informed decision about the share purchase transaction; and (5) adjust the terms and conditions of the share purchase agreement. For the ESG DD review, the relevant risks related to the target of Project Wood will be determined.

Furthermore, on a more general level, this research examines the benefits of the ESG DD to the investor in every relevant stage of investment, including investment stage, ownership stage, and exit stages. However, the primary focus of this thesis is on the investment stage. All three of the mentioned investment stages are viewed from a future perspective. However, regarding assessments of the exit stage it is important to stress that the thesis assumes that the purchaser's exit does not happen earlier than five years from the completion of the transaction.

For the purpose of this research, the ESG due diligence is researched from a legal perspective, however the review is conducted with a focus on the ESG issues. Thus, other legal aspects that are not relevant from the ESG perspective will not be included. Furthermore, commercial, financial, and tax-related due diligence aspects are also excluded from the review. This thesis is also subject to the following limitations: transaction types other than a share purchase transaction, such as business purchase transactions are excluded. As the research focuses exclusively on private equity investments, the ESG issues relating to public companies have been excluded.

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[40] (Mergermarket 2020).
[41] (Paetzold and Busch 2014, p. 1).
[42] (Howson 2017, p. 42).

Moreover, this research does not address any benefits to the seller or the target company arising from the ESG DD process and ESG integration in general, and thus only the benefits for the investor are viewed. Nor does this study regard any other interested parties' attention, such as banks or joint venture partners, than the equity investors interests in the ESG matters of the target company. Also, this thesis does not discuss any bonds that are sometimes related to M&A transactions.

Regarding the Project Wood, the thesis does not include any other assumptions about the target other those set out above in section 1.2. Therefore, any other presumptions about the material ESG issues related to the target are excluded, and the review regarding the hypothetical target company will be solely limited to the identification of material ESG issues which could be viewed during the ESG DD process.

1.3. Research methodology and sources

Since, by its nature, this thesis positions in the middle of the legal and business world, the thesis exploits more than one research methodology. Firstly, legal dogmatic method or by its other name, legal doctrine, is applied to this research, which by the definition of Jan M. Smits is "*research that aims to give a systematic exposition of the principles, rules and concepts governing a particular legal field or institution and analyses the relationship between these principles, rules and concepts with a view to solving unclarities and gaps in the existing law.*" [43] Legal dogmatic research includes analysing and systemising the law in force and interpreting the content of the legal norms of law.[44] The systemisation task of the legal doctrine is to link practical and theoretical features of the doctrine together.[45] This research aims to use legal doctrine in a brief review of applicable Finnish legislation and court rulings where feasible considering the research questions and limitations of this thesis.

It is further suggested that applicable regulation should make sure that companies can create value in ways that are socially, environmentally, and economically sustainable, i.e., in a way that contributes to corporate sustainability. However, historical attempts to do so through company laws have been unsuccessful. For example, the company law currently in force in Finland has its main focus on shareholder primacy. Thus, the company law lacks a

[43] (Smits 2017, p. 5).
[44] (Hirvonen 2011, pp. 21-24).
[45] (Häyhä 1997, p. 37).

company's social norm that would link the purpose of a company to sustainable value creation, which would also make consideration of planetary boundaries principal for Finnish companies.[46] Despite that the Finnish company law is openly formed, there is room for different interpretations, the shareholder primacy as a social norm has become a dominant approach, while sustainability has been left without attention. However, despite the fact that company and other laws lack comprehensive corporate sustainability regulations, legal rules are not the only regulatory sources of power. In relation to corporate sustainability, regulation and thus, compliance can also be derived from non-legal sources.[47]

According to Lawrence Lessig, there are four types of constraints or modalities that regulate behaviour: (1) law through enforcement of state; (2) social norms through enforcement of community; (3) markets through price; and finally, by (4) architecture which means the features of the surrounding physical world that affect our behaviour. These features can be man-made or exist naturally. However, this does not mean that these constraints would regulate the same way or at the same degree or that the latter three types would be somehow alternatives to state law. According to this theory, regulation is much more comprehensive than the law only. In addition to the law's direct regulation, the law also has an indirect influence on other constraints, namely norms, markets, and architecture. Therefore, and according to the words of Lessig*: "the question instead is always to what extent is a particular constraint a function of the law, and more importantly, to what extent can the law effectively change that constraint."* [48] Correspondingly, to provide an example of a situation where the implementation of laws leads to changes in the market participants' actions in ESG investing, expectations of company's stakeholders could be another driver for the companies and investors towards sustainability. [49]

The mentioned polycentric approach, or by its other name, *regulatory ecology*, states that regulatory power is diffused. In the author's opinion, the same approach to regulation theory is also suitable for considering corporate sustainability issues in the context of this thesis. The polycentric approach to regulation does not mean that the powers of national states are somehow reduced; instead, the theory suggests that the state is not the only authority when taking into account the existence of a more extensive system in which other regulators, *e.g.,*

[46] (Sjåfjell and Mähönen 2014, pp. 58-59).
[47] (Sjåfjell and Taylor 2015, pp. 1-13).
[48] (Lessig 1998, pp. 661-672).
[49] (Indahl and Jacobsen 2019, pp. 34-36).

investors, other businesses and consumers cannot be disregarded. In addition to the regulatory powers of states, these other regulators also have regulatory influence. [50] ESG investing is mainly dependant on state regulations as well as on the regulation concerning markets and operations of an actor. For example, the investor's willingness to invest sustainably may depend on the consumers' preference to environmentally friendly products or the costs following from the ESG performance. [51]

Thus, the thesis primary proceeds from the concept that the regulatory system includes a complex set of power relationships that are a consequence of transnational economic and globalisation. To utterly understand how effective the applicable regulation is, it is crucial that one does not only view a single constrain of regulation. In addition to legal duties set by company law, relevant sources of regulation also include social norms, market incentives, and technology upgrades that have made an enormous difference in the activities of the companies and their shareholders. [52]

Taking into account that the ESG DD, the subject matter of this thesis, is used by business professionals when making informed decisions about risks and opportunities associated with M&A transactions, this research also makes use of arguments known in economics. Furthermore, as this thesis is also intended for anyone interested in responsible investments concerning M&A, as well as the fact that a part of ESG due diligence relies on the practises from recent years and that these practices have not yet been wholly rooted to law or academic literature, this research also attributes a pragmatic approach to the subject matter. Thus, this thesis makes use of information published in the field of M&A and by other professionals that provide ESG due diligence services or integrate ESG factors in their investment processes. Moreover, despite that this thesis does not qualify as a quantitative empirical research paper, the results of different quantitative empirical research from various countries will be used throughout this thesis to provide answers to the research questions.

It is important to emphasise that the research questions presented above, and the assessments and conclusions made in the later chapters of this thesis are partially based on a narrow review to answer the research questions about the ESG due diligence process from the context of this particular research paper. Therefore, the information presented herein is not

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[50] (Sjåfjell and Taylor 2015, pp. 1-15).
[51] (Gamlath 2020, pp. 1-11).
[52] (Sjåfjell and Taylor 2015, pp. 1-15).

directly applicable to other individual ESG due to diligence reviews as results and assessments depend on various factors, such as investor's interests, background and risk appetite, the scope of the process and characteristics of the target company. Also, many of the conclusions and assessments made in the following chapters are not to be deemed exclusive. On the contrary, as the findings of this research are reflective by their nature, the final decision regarding the severity of the facts, assessments and suggestions stated herein will be left to the reader. However, this thesis gives an indicative illustration of the ESG due diligence process in general. Furthermore, the review of the subject is intended to help the reader to acquire better general level understanding of why and how to perform ESG due diligence review in a share purchase transaction.

1.4. Structure of thesis

The thesis consists of the following structure: chapter 2 introduces the due diligence process and its importance to the investor on a general level and in the context of an M&A transaction. Chapter 3 will discuss the main benefits and drivers for an investor to perform ESG due diligence review in the course of the transaction. Chapter 3 will also briefly describe the barriers that could explain why investors do not consider ESG integration, or more specifically ESG DD, in their investment decisions. Chapter 4 will examine how and by whom ESG due diligence data is collected and assessed, and what are the material issues in ESG due diligence. The ESG DD materiality will be reviewed both on an overall level and under a more specific level regarding the Project Wood. Chapter 4 will also examine how ESG DD findings are reported. Chapter 5 focuses on the impacts of the information obtained during ESG DD on the share purchase agreement and on the contemplated transaction. Chapter 6 presents conclusions, summarises and reflects the analysis made in chapters 2-5 and provides answers to the main research questions. In addition, chapter 6 provides information on how ESG DD could be developed in the future.

2. About Due Diligence

2.1. Due diligence process in general

The due diligence (DD) process used in M&A transactions can be described as a process of enquiries and subsequent review conducted by the potential purchaser to verify that the target is what the purchaser thinks it is. To succeed in its review, the purchaser's DD shall include a systematic assessment of information and review the target's historical matters, as well as

evaluate the target's future perspectives. However, at the same time, due diligence exists to identify and mitigate risks, i.e., to make sure that the investor does not pay overprice for the target and that the risks accredited to the investor are properly mitigated through SPA provisions. According to research data, due diligence is a crucial phase in the investment process, considering that half of all acquisitions do not reach their intended purpose. The same research indicates that the due diligence process is, in practice, necessary for the investor to make an informed decision on whether to move forward with the transaction. [53]

In M&A transaction, the justification for the need of existing of due diligence follows from the nature of the transaction. M&A transactions include transfer of assets from the seller to the purchaser which also means new obligations which will be left to the transferee post-acquisition. However, given that there might be risks included which affect the value of the assets (i.e., the shares) or obligations to be transferred during the course of such transaction, the risks included need to be allocated between the transaction parties. Thus, proper due diligence is a key to secure the position of the purchaser in a share purchase transaction. [54]

In general, due diligence is one of the four phases of an acquisition process: (1) at first; the acquisition process starts with finding an investment target, after which the parties will usually sign a letter of intent (LOI) which is a non-binding agreement that sets out the main provisions on how parties intend to enter into negotiations and thereafter plan to move forward with the transaction; (2) in the second phase, the negotiations will be followed by due diligence review; (3) thereafter, assuming that the due diligence process goes well, the acquisition process continues with negotiations between the seller and the purchaser. If these negotiations are successful, the parties will sign a sale purchase agreement (SPA). When the conditions precedent (CPs) for closing included in the SPA are fulfilled, next the parties will close the SPA (hereinafter referred to as closing); (4) the fourth and final stage of the acquisition process is a post-completion phase which is the time when the investment profit should be earned.[55]

2.2. ESG factor integration into due diligence process

In general, the definition of ESG investing is rather broad. Thus, approaches to ESG investments do not necessarily need to be tailored products – it is possible to exploit existing

[53] (Howson 2017, pp. 1-13).
[54] (Spedding, 2008, pp. 4-6).
[55] (Howson 2017, pp. 1-4).

approaches by including additional ESG data, analysis, and tools in different investment stages. [56] The ESG aspects can be included in an investment process in more than one way. For example, negative screening excludes targets from specific sectors or for ethical reasons, such as, industries that deal with alcohol and tobacco. [57]

ESG integration used in private equity investments can be described as systematic integration of ESG risk management and performance development strategies across all investment stages.[58] Even though ESG factors can be included in the investment process in number of ways, Cappucci sees that" *the gold standard for sustainable investing is the full integration of ESF [environmental, social and financial] factors into the investment process.*" Sadly, according to surveys conducted in the US, most of the investors fall far from this standard and do not use the complete ESG integration approach.[59] This thesis relies on the same approach, i.e., the inclusion of ESG factors to the investment process means full integration of ESG factors unless explicitly provided otherwise.

To achieve ESG integration into one's M&A purchase transaction, the investor can perform an ESG DD review to support its investment decision making. The purpose of ESG DD is to: (1) understand the risks profile and exposure of the target, i.e., to understand associated ESG risks; (2) find any red flags relating to the issues revealed during the DD process; (3) to identify and analyse any risk mitigation measures and to find out whether the investor should fix these issues and if so; (4) how and when should these risks be mitigated.[60] Incorporation of ESG matters into DD process varies by integration level, meaning that there is no pre-made ESG DD package that would suit all cases. This is understandable when considering that ESG investors can choose between different ways to integrate ESG factors into their investment processes.[61] It can be stated that ESG DD is a way of ESG integration into the second phase of an M&A transaction.

Although the DD process has included some health and safety as well as environmental issues for the last 20 years or so, the review of ESG factors in DD processes did not increase rapidly until the last few years. This change is due to higher demands and expectations from

[56] (IFC 2018, p. 33).
[57] (Cappucci 2018, pp. 1-3).
[58] (IFC 2018, p. 11).
[59] (Cappucci 2018, pp. 1-7).
[60] (Admincontrol)
[61] (BlackRock 2016, pp. 1-2; Corporate Board Member Institute)

the customers, general concerns about climate and increasing natural resources prices.[62] Nowadays, ESG risk-based approach has been incorporated as a part of many investors' DD processes.[63]

Despite that the (ESG) DD aims to look what the target company could accomplish in the future (until entering the exit phase), the analytic view is rather focused on the past events.[64] ESG due diligence can be used to assess how the target creates its value and whether this value creation is sustainable.[65] Moreover, by conducting due diligence, the investor can foresee how to implement remedies post-closing to reduce risks discovered during the due diligence review.[66]

Integration of ESG factors does not mean that all the ESG matters will be weighted equally in ESG DD process. Among the three ESG factors, the environmental risks are still viewed as the primary issue. However, social and governance factors are also becoming more critical, especially in emerging markets. Nonetheless, the importance of ESG DD and scope are highly dependent on the transaction size, the sector and location of the transaction parties, and the target's products or services.[67] Differences in the relevance of the E, S and G can partially be explained with the fact that some sectors have included ESG DD in their investment process for a long time. For example, the energy sector is one of the fields where environmental issues have been in focus both in companies' everyday operations and also in M&A transactions.[68] Also, according to research, when deciding whether to perform ESG due diligence, investors will consider the business model of the target and the industry's ESG maturity.[69] Thus, more experienced investors know better how to set the ESG review scope to correspond with their needs and their previous experience.

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[62] (PWC and PRI 2012, pp. 5-14).
[63] Ibid, p. 11.
[64] (Spedding 2008 pp. 4-6).
[65] (Deloitte 2012, p. 1).
[66] (Howson 2003, pp. 1-6).
[67] Ibid, pp. 5-11.
[68] Ibid, p. 10.
[69] (Zaccone and Pedrini 2020, pp. 9-11)

2.3. Purchaser's due diligence obligations under Finnish laws and share purchase agreement

An investor's ESG DD exists so that the investor can make an informed decision about the proposed transaction. The ESG DD shall be distinguished from the mandatory sustainable due diligence, which, as described above in section 1.1, is a legislative proposal in the EU for a regulatory transition of the EU company law and corporate governance. Nonetheless, this difference does not mean that under applicable laws of Finland, the purchaser would not be obligated to investigate the target before purchasing the seller's sale shares.

As per Finnish laws, there are obligations for the purchaser to investigate the sale's object prior to purchase. Such legal obligations mainly lay on public companies, but private companies are not entirely left untouched.[70] According to the *caveat emptor principle* (the Buyer beware), and as a rule, the purchaser shall be responsible for neglectful fulfilment of its due diligence. This emphasizes the meaning of a due diligence process by setting the purchaser a general obligation to investigate the target during a sales negotiation process. However, it is also not in the seller's interest to hide any relevant information about the target because by disclosing information, the seller can pass the liability to the purchaser.

As a result of the seller's information disclosure, the purchaser's possibilities to use legal remedies will be restricted, and the purchaser cannot, for example, claim a reduction of the purchase price. Thus, it is in the seller's interest to disclose the purchaser right and accurate information.[71] Section 18 § of the Finnish Sale of Goods Act 355/1987 applicable to the sale of goods which also applies to the sale of Finnish liability company's shares, stipulates that the seller is obligated to provide the purchaser all the information relating to the properties or use of the goods when marketing or otherwise before the conclusion of the contract and that such information can be presumed to have affected the contract. The foregoing means that the applicable Finnish legislation principally assumes that the seller shall give the purchaser relevant information about the target company. Also, the purchaser has a right to rely on such information.[72]

However, according to subsection 20 § (1) of the Finnish Sale of Goods Act, the purchaser may not rely on a defect that he cannot have been unaware of at the time of the contract's

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[70] (Howson 2003, pp. 6-8).
[71] (Immonen 2018, p. 49).
[72] (PWC 2019).

conclusion. It is further provided in subsection (2) that if the purchaser had examined, before the conclusion of the contract, the goods or, without an acceptable reason, failed to comply with the seller's proposal to inspect the goods, the purchaser cannot rely on a defect that he ought to have discovered in the examination unless the seller's conduct was incompatible with honour and good faith. Thus, under the applicable laws of Finland, the seller shall provide information about the target company, but at the same time, the purchaser shall investigate the goods. Therefore, if the seller allows the purchaser to review the target, and if the purchaser rejects this opportunity, the purchaser cannot rely on any defects of the sale shares.

Yet, it shall be noted that some provisions of the Sales of Goods Act or the whole Act can be excluded by the SPA, which is customary practice in many sale share transactions.[73] It is also possible to include a section in wording suitable for the SPA parties whereby the purchaser is obligated to investigate the target. If the purchaser shall investigate the target either under the law or the SPA, the fulfilment of the obligation is assessed by comparing the purchaser's actions to the actions of a usual careful person, who is familiar with the circumstances of the relevant field. If the purchaser's actions are corresponding, the obligation is deemed to be fulfilled.[74] As it follows, it is in the purchaser's interest to carefully review the target company by conducting a due diligence review so that the purchaser is able to fulfil its obligations arising from the mentioned Sales of Goods Act or SPA.

3. ESG Due Diligence Benefits and Drivers for Investors

As stated above in chapter 2, the main reason investors perform due diligence reviews is to verify that all the information provided by the seller is true, to find out the actual target value and to *ex-ante* discover and also mitigate potential risks following from the transaction.[75] Thus, it is clear that DD helps the investor to ensure that too risky deals never go through and to calculate accurate target prices. But at the same time, DD findings can also be seen as excellent negotiation leverage for pricing and other terms of a proposed transaction.[76]

The following chapters will explain in more detail different ways of how investors could benefit from ESG integration to their investment decisions, i.e., from performing an ESG

[73] (PWC 2019).
[74] (Blomquist et al. 1997, p. 16).
[75] (Grebey 2018, pp. 133-134; Arouri et al. 2019, pp.1-5).
[76] (Howson 2003, pp. 1-5).

due diligence review prior to entering into M&A transactions. In addition to the ESG DD benefits, the chapter will also describe other drivers for the investors for ESG integration into their investment decisions.

3.1. Benefits of ESG due diligence for investors in M&A transactions

3.1.1. General risk management

Risk management opportunities are the main reasons for the investors to conduct ESG due diligence. One of the most important benefits is that due diligence helps investors to monitor and integrate ESG issues to mitigate their risks.[77] Monitoring risks in M&A transactions is particularly important given the nature of the investment type – more specifically, the concentration and excessive costs related to M&A transactions.[78] Many ESG related surveys show that the key risks investors wish to consider in their ESG DD processes, are matters related to the target's product impact and liabilities, management of supply chains, the target's business operation ethics and governance issues of the target. Furthermore, it is also expected that the ESG risks are assessed both at the target and subcontractor level. This is necessary to mitigate reputation risks of the investor as well of the target, which helps avoid negative effects to investor's return opportunities in the future. The earlier such risks are indemnified, the better these can be mitigated so that potential risk scenarios will not materialise.[79]

Methods to mitigate unsustainability risks involve performing expert valuations, conducting careful DD and making sure that the purchaser's and the target's ESG compatibility is not too far from each other.[80] The latter is a question of corporate culture, which according to former research conducted by KPMG, is essential in terms of success in M&A transactions.[81]

Research shows that including ESG factors may positively contribute to financial success of M&A transactions. Usually, an M&A transaction process itself contains risks for the investors, such as a risk of wrongful calculations regarding price valuation or losses caused by terminated or withdrawn transactions, leaving the investors with unnecessary costs. At the same time, the investor loses the benefits it hoped to gain from the transaction. Even if

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[77] (Zaccone and Pedrini 2020, pp. 1-5).
[78] (Gomes and Marsat 2018, pp. 72-76).
[79] (Spedding 2008, pp. 92-97).
[80] (Sustainalytics 2017 pp. 1-5).
[81] (KPMG, 1999, pp. 1-21). See further: (KPMG, 2011).

the transaction is completed, an investor is still at risk, for example, that its credit rating is downgraded if the review of the target has been insufficient. M&A transaction research findings have indicated that performing ESG DD may reduce these risks.[82]

In case an M&A transaction takes place cross-borders, the information asymmetry between the seller and the purchaser is even more significant, which could also harmfully affect the post-acquisition performance of the target. This, in turn, may negatively affect the investor's premium. Therefore, investors aim to mitigate risks in cross-border transactions through more extensive ESG due diligence review. Despite the challenges, cross-border activities bring the investor new knowledge and capability. A research carried out by M.Gomes and S. Marsat shows that cross-border acquisitions can be more profitable for the investor than domestic deals. Considering that the investor has less information available in international investments, some ESG issues are also highlighted. These include, among others, human resource matters and relationships with the target's stakeholders. If relevant deficiencies appear during DD regarding the mentioned matters, investors may experience more difficulties to manage risks from the distance post-transaction. Therefore, it is better to make sure that relevant issues are discovered early and fixed as soon as possible.[83]

3.1.2. Compliance risks

ESG trends can also be seen as important from a legislation point of view. Namely, ESG adherence can be a matter of compliance with applicable legislation, which is a principal risk management factor.[84] As already described above in section 2.3, if the purchaser decides not to perform a DD review of the sale’s object and the SPA does not exclude provisions following the buyer beware principle, the purchaser risks losing legal remedies.

The target’s compliance with applicable laws and regulations is something that the investor should ensure. This is because non-compliance with regulations and laws contains risks of sanctions such as penalties that the investor could become responsible for in the future. Thus, the investor should become aware of any non-compliance or, in the worst case, criminal activities prior to the transaction to mitigate such risks and make sure that actions against

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[83] (Gomes and Marsat 2018, pp. 72-78).
[84] Ibid, pp. 95-105.

applicable laws and regulations will not continue post-transaction. [85] Thus, the purchaser should review the target's compliance with laws that set ESG related obligations.

3.1.3. Risks related to changes in operational environment

The investors recognise that unsatisfactory performance in ESG may lead to changing the target's operating environment, for example, due to regulative changes, which leads to disruptions of natural patterns and may make the target's operations difficult in the future.[86] Risk management also includes mitigation of the risk relating to external costs that may affect a company's operations either directly or indirectly through its suppliers. These risks occur when natural assets, e.g., groundwater or climate assets, necessary for the target's operations become dependent or are disrupted.[87] In addition to direct legal and additional cost risks, operational risks are also linked to reputational risks. Reputational risks may lead to increased regulator supervisor, reimbursements, negatively affect the terms of supplier agreements or credit ratings of an investor, or affect the target's employees' efficiency, and lead to overall negative turnover of the target. Therefore, disruptions of natural patterns are also seen a threat to business continuity. Reputational risks are described in more detail in the following subsection.[88]

3.1.4. Reputation risks

Non-compliance with ESG issues may involve reputation risks, which may lead to a company's loss of goodwill. As a result of decreased reputation, the target may lose material contracts which in turn may reduce turnover and profit of the target, which will then cause loss for the investor.[89]

> A good example of loss of goodwill is the case of British Petroleum due to an oil spill in the Gulf of Mexico. According to research, due to this environmental catastrophe, the company did not only suffer from direct financial consequences (costs for cleaning and compensations) but also from reputational damages, which lead to loss of its share price by 50% between 20 April 2010 and 29 June 2010 after

[85] Admincontrol; Flammer and Bansal 2017, pp. 1827-1844).
[85] (PWC and PRI 2012, p. 12).
[86] Ibid, pp. 5-6.
[87] (Clark. et al,. 2015, pp. 10-11).
[88] (Herz et al. 2016, pp. 96-99; PWC and PRI 2012, p. 10).
[89] (Admincontrol; Zaccone and Pedrini 2020, p. 1).

the spill came to public's attention. Remarkably, the company was criticised for its bad environmental performance already two years prior to the catastrophe.

Considering possible damages following from loss of reputation, in its ESG performance assessments, investors should also consider non-financial metrics that could impact the value of the target. This is important because the reputation risks can be detrimental to investor's dividends during the ownership stage and the selling price of the company at the time of exit. Furthermore, ESG reputation could also affect the reputation of the investor itself.

3.2. Higher investment return expectations

3.2.1. Higher returns from long-term perspective

According to research regarding integration of ESG issues in M&A transactions based on the survey result of trade buyers,[90] target's contribution to ESG leads to higher investment returns for the investors in a long-term perspective. Another research suggests that ESG integration leads to better operational performance in the long-term.[91] Committing to the long-term view will let the investors to see how their targets are able to create and maintain good relationships with their stakeholders, which will generate goodwill and a better reputation of the target and thereby create more value. In relation to M&A transactions, value creation means that a target's performance will grow. Good performance of the target affects the return of an investor in a positive way as good performance will naturally increase the investor's future prospects to receive higher dividend payments and higher purchase price in case of exit in the later future. Thus, the importance of target's performance is one reason why the operational risks described in the previous section should be assessed with proper care. Any opposite actions could threaten the continuity of a target's business. It shall also be considered that long-term value creation may temporarily raise additional costs and affect the target's operationality. Still, ESG integration will be more beneficial for investor in the future.[92]

According to research, many investors are hoping to align its target's ESG performance to its own standards, which are seen as a way to increase the target's value in the future. [93] ESG

[90] Trade buyers are strategic buyers that already own a similar business and purchase or acquire additional businesses.
[91] (Arouri et al. 2019, pp. 1-28).
[92] Ibid. p. 10.
[93] (PWC and PRI 2012, p. 10; Clark et al. 2015, pp. 10-11).

integration into investment decisions and later investment stages can create higher value due to the combination of the target's and the investor's resources, increased capacity, market share growth, and better possibilities to develop new innovations. This is especially important when considering that PE funding is often the only way to finance companies in their growth stage. Thus, if no other financing forms are available at the time, PE funding can be seen as a bridge to other forms of sustainable capital, which will help sustainable companies to develop, create innovations and find sustainable business models for their business operations.[94] The mentioned ESG integration benefits could also give the target and the investor future competitive advantages.[95] Furthermore, good ESG performance through its targets generally increases the value of the PE firm itself. [96]

Particularly the target's E&S performance has been seen as an indicator of how a company's financial performance and value creation will become in the long run. According to most research in the field, there is a positive correlation between good E&S performance and the operational performance of a company.[97] This allows an investor to review the target's E&S performance and find out about its future return prospects. For example, the investors may gain higher profit through environmentally friendly product sales, which has been a developing worldwide market for many years. According to surveys, investors experience that even if environmentally friendly "niche" markets are more petite than developed markets, the investment is often more beneficial as it contains higher profit margins. [98]

Likewise, the state of governance matters implies the target's level of leadership and general management.[99] To mitigate governance risks, it is crucial that a company adopts sustainability to secure its future operations and reduces governance risks. This can be achieved by implementing proper internal sustainability policies. Good governance has also positive impacts on the volatility of a target's cashflows which helps to receive future finance.[100] An US research has also shown that the "G" factor of the three ESG factors has the most positive correlation with corporate financial performance. [101]

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[94] (Sustainalytics 2017 pp. 1-5; IFC 2018, pp. 11-14).
[95] (Indahl and Jacobsen 2019, pp. 34-36; Zaccone and Pedrini 2020, pp. 7-8; Arouri et al. 2019, pp.1-11).
[96] (Arouri et al. 2019, pp.1-28).
[97] (Clark et al. 2015, pp. 29-33).
[98] (Spedding 2008, pp. 92-95).
[99] (BlackRock 2016, pp. 1-3).
[100] (Paetzold and Busch 2014, pp. 1-6).
[101] (Friede et al. 2015, pp. 210-227).

However, social matters do not come far behind, which means that considering all three ESG factors simultaneously in an investment process can positively affect a company's corporate financial performance.[102] Although some studies show that ESG has a neutral correlation or is harmful to financial performance, this is mainly due to different variables used in the studies.[103] After all, more studies have found a positive correlation between corporate financial performance and ESG than studies that have found a neutral or a negative correlation.[104]

3.2.2. Effects of target's former ESG performance

One could expect that investing in companies with extraordinary ESG performance is the most beneficial from an investor's return perspective, but the studies have indicated the opposite. It is most helpful for investors to invest in companies with average ESG performance at the time of the investment as such companies will increase their value during the investment period the best. This is because companies with already good ESG performance will not have more room to improve their risk-adjusted financial performance during the investment stage compared to average performing companies. The problem with "too good" ESG scores is that exceptional performance of a company is already included in the purchase price, which does not leave as much room for returns in the exit stage.[105] This also applies to equity investments, as investors desire to increase the multiples in their exit stage when the target is later sold. From the exit perspective, the target must be kept suitable for potential future purchasers even though the exit phase does not usually happen until 5-10 years have passed from the investment.[106] In an M&A transaction, an investor should consider that extraordinary ESG performance may be already included in the purchase price of the target and therefore, the investor's return expectations could therefore be affected.

In conclusion, to assess whether the target's sustainability level gives opportunities for higher investment returns, an investor could integrate ESG criteria into its investment decision by performing an ESG DD review. ESG DD could help the investor understand whether the target's sustainability can be aligned with the investor's ESG standards which could lead to

[102] Ibid.
[103] See further about a study with regard to Italian listed companies which resulted that ESG does not have any systematic and significant positive impacts on CRS: (Landi and Sciarelli 2019).
[104] (Velte 2017, pp. 169- 172).
[105] (Cappucci 2018 pp. 1-7).
[106] Ibid, pp. 34-36.

higher returns in the future. ESG DD is also helpful for future planning. For example, to prepare for post-closing opportunities and risks, the investor could perform a GAP analysis that the investor can use to assess the target's ESG performance *pro forma* and assess how the performance level could affect the investor in the future. To mitigate risks and make use of opportunities revealed during the DD, the investor could also develop an action plan for post-closing.[107]

3.3. Impacts on target valuation

Impacts of ESG on the target's value are not easy to determine as the impacts depend on the sector and location of a particular target. The calculation is also hard given that many industries lack sufficient standards.[108] According to surveys, in many cases, ESG performance is not automatically reflected in the target price, which makes value creation a good reason for an investor to look into ESG issues. Namely, investors seek to identify and assess ESG related risks to find out how ESG DD findings affect the target's valuation prior to closing. The effects can either be positive or negative.[109] In case the ESG due diligence reveals that ESG issues are in poor condition, this could affect the purchase price payable for the target company's shares. Theoretically, there are many ways that ESG performance can affect the valuation of the target, both directly and non-directly:

(1) good ESG performance can increase the cost savings to the investor's benefit and increase the target's revenue. For example, sustainable production lines can increase the sales of target's products;
(2) better risk management.
(3) better reputation, employee engagement and customer loyalty.[110]

An investor can attempt to balance the target's poor ESG performance during negotiations with the seller by lowering its offer for the sale shares based on the results of the ESG due diligence review. Besides, as poor ESG performance gives the purchaser a better negation position and the purchaser may also demand more favourable formulations and terms of the share purchase agreement, for example, through representations and warranties (R&W) and specific indemnity clauses.[111] The foregoing shows that ESG performance could affect both

[107] (Corporate Board Member Institute).
[108] Ibid.
[109] (Eccles and Klimenko 2019).
[110] (PWC and PRI 2012, pp. 2-7).
[111] Ibid, pp. 2 and 5-7.

parties' negotiation positions and thereby impact both the price and the terms of the share purchase agreement (SPA). ESG DD impacts on the SPA will be further described in chapter 5.

Controversially, the majority of investors believe that ESG performance can be seen from the former annual accounts of the target and that any future positive impacts are included in the asking price of the seller. Thus, in practice, ESG performance level does not directly decrease or increase the share premium amount at the time of the transaction. However, it is suggested that good ESG performance may help the seller to retain its asking price. Yet, this does not mean that usage of the ESG factors when deciding on target valuation would not increase in the (near) future.[112]

As referred above, the empirical analysis shows that ESG performance increases target value in the long run. Additionally, an acquisition can be viewed as a strategy to improve ESG performance with regard to the target and the investor. It can be stated that M&A processes positively enhance corporate value. Thus, for investors who are less ESG-aware, acquiring a target with better ESG performance will increase investor's ESG and corporate performance. The latter follows from the investor's returns from the target, due to increased corporate efficiency and access to corporate resources. Taking into account better return opportunities, the valuation effects are a reason for the investors to pay attention to ESG issues in their investments.[113]

Furthermore, considering possible damages following from loss of reputation, referred to in subsection 3.1.4, investors should also include non-financial metrics to determine the impact of goodwill value when assessing its performance.

3.4. Cost savings

Investors are keen to determine whether their acquisition leads to additional costs during the ownership stage. For example, given the monetary risk of sanctions followed by non-compliance with laws, the investors wish to determine whether the target is at least at the minimum level compliance with applicable laws. The foregoing does not mean to suggest that investors would not be willing to accept some deficiencies in their target's ESG performance. Still, significant shortages that could potentially harm investors' reputation or

[112] Ibid, pp. 6-7.
[113] (Tampakoudis and Anagnostopoulou 2020, pp. 1865–1875).

pose high costs to the investor are considered findings which may prevent the investor from going forward with the transaction.[114]

ESG non-compliance costs are calculated based on the deal value. The exact sums are difficult to evaluate due to the fact investors may consider material ESG issues through overall costs (capital expenditure and operational expenditure). Therefore, potential ESG costs are not considered separately. Some investors view overall costs from a zero to two-year time future perspective from the deal, and some others have decided to obtain the approach based on lifetime assets.[115] Thus, cost calculation varies between different investors.

As ESG due diligence is also beneficial for assessing future operational opportunities of the target, the information collected during ESG DD helps investors view the target's affairs from a future perspective.[116] The possibility of aligning the target with the investors' standards with relatively low cost is also considered an essential factor in investment decisions. For example, obtaining data about Key Performance Indicators (KPI) is relevant for determining cutbacks that could be made for the target to operate more cost-effectively in the future.[117] However, reasons behind cost-savings evaluation may also be caused by other factors, for example, such as what investor's investors expect.[118]

Covering ESG issues may also help diminish the costs in the future by providing opportunities to prevent future ESG risk.[119] Furthermore, the research has found that ESG information disclosure can be associated with lower capital restrictions and lower capital costs in both debt financing and equity capital.[120] ESG performance further indicates other costs saving related to other advantages that may be more indirect and more difficult to predict. For example, later improvements to the target's value chain may reduce costs of materials.[121]

[114] (PWC and PRI 2012, p. 13).
[115] Ibid.
[116] (Grebey 2018, pp. 134-141).
[117] (PWC and PRI 2012, pp. 5-14).
[118] (Zaccone and Pedrini, 2020, pp. 4-9).
[119] (Renneboog et al. 2008, pp. 302-305).
[120] (Clark et al. 2015, pp. 22-23; Herz et al. 2016, pp. 96-98).
[121] (Indahl and Jacobsen 2019, pp. 34-36; Clark et al. 2015, pp. 29-33).

3.5. Improved reputation

In addition to financial and operational reasons as referred above, improved reputation is another contingent factor that affects a target's future performance. Non-financial performance indicators, such as customer loyalty and changes in the market expectations, can create financial value for the target in the long-term perspective. Some literature even suggests that a company requires a social license to operate, and thus, once such reputation has been achieved, it is not something that should be taken for granted.[122] Given the reputation risks referred to in subsection 3.1.4 above and the positive effects of a good reputation, advantages following from good target reputation is something to be regarded in investors' investment decision analysis.[123]

In line with a research concerning integration of ESG issues in M&A transactions which was based on the survey result of trade buyers, the investors experience that excellent ESG performance of the target can also improve investors' reputation.[124] In the context of PE firms, a good reputation is also linked to growing opportunities in investor's other transactions. For example, in action sales, the sellers may prefer a purchaser that has a proactive approach to ESG issues.[125] Regarding target companies, a good reputation relates to financial gains and gives a company a competitive lead.[126] Reputational matters also affect the investor's possibilities to gain more profit from its target company in the future.[127] According to surveys, most (81%) CEOs of companies believe that sustainable reputation significantly affects customers' decisions.[128]

Based on the foregoing, opportunities to improve the target's reputation is something that the investor should consider in its investment decisions. Assessing reputation opportunities based on ESG DD information could impact the operations and financial performance of the target, and at the end the investor's reputation.

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[122] (Deloitte 2012, pp. 1- 2).
[123] (Mattila 2006, pp. 159-164).
[124] (PWC and PRI 2012, p. 10).
[125] (Indahl and Jacobsen 2019, pp. 34-37).
[126] (Clark et al. 2015, pp. 10-18).
[127] (Grebey 2018, pp. 138-140).
[128] Ibid, pp. 10-11.

3.6. Other drivers towards ESG integration

3.6.1. Stakeholder pressure

By a definition of Edward R. Freeman, a *stakeholder* is any group or an individual who can affect or is affected by an organisation's actions.[129] An organisation can be seen as a set of independent stakeholder relationships. The stakeholders of a company jointly commit to company's success and engage both financial and non-financial capital to the company.[130] It is further suggested that stakeholders of a company are at least some level involved in its process-making.[131]According to the *stakeholder theory*, in addition to its shareholders, a company should also consider the interest of its stakeholders.[132]

Some literature indicates that both companies and investors experience external pressure following from the expectations that they need to make their business decisions beyond just bearing in mind the maximisation of their profits.[133] That is to say that investors and companies feel that they have a social responsibility towards their stakeholders and society in general. As it follows, there are also social considerations of the stakeholders that drive companies to take care of not only their own well-being but also the care of the common good. However, this does not mean that the investors would have to cheapen their well-being. *Per contra*, they have an opportunity to joy the benefits of risk-adjusted performance, which has been aptly described as "*doing well by doing good*."[134]

The investors and all companies in general, try to perform in a manner which protects the interests of their stakeholders and secures the inner relations between their different stakeholders. At the same time, there is an opportunity to help take care of the environment and fulfil social responsibility obligations. The shift towards this behaviour has not solely emerged from the companies' willingness, as this has also been encouraged and even demanded by policymakers and the public.[135] Moreover, according to surveys, investors have indicated that, in their experience, ESG factors need to be included due to the pressure of other investors.[136] This suggests that investors are generally beginning to understand that

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[129] (Deloitte 2012, pp. 1- 4). See further about the stakeholder theory: (Freeman 1984).
[130] (Bettinazzi and Zollo 2017, pp. 2465- 2466).
[131] Ibid, pp. 2465- 2467.
[132] (Majoch et al. 2017, pp.723-725).
[133] (Mattila 2006, pp. 159-161).
[134] ((Renneboog et al. 2008, pp. 302-322; Syed 2017, p. 1).
[135] Ibid.
[136] (Amel-Zadeh and Serafeim 2017, pp. 87-88).

they also need a social license to operate when it comes to their stakeholders and an opportunity to build an ESG track record.[137]

Considering that in addition to social and environmental aspects, the definition of CSR explicitly includes economic aspects, compliance with CSR requirements does not mean that a company would not be allowed to aim to receive gain from its investments. ESG should rather be understood from the stakeholder's perspective, which means that for the stakeholders, it is not socially acceptable for a company to pursue high returns at the cost of the welfare of others. Expectations of stakeholders have simply led to a situation where considering ESG issues in the long run of returns is, in fact, worthy for any company from the business perspective.[138] This is particularly true in M&A transaction where situations may change from what the stakeholders, such as contractual parties and employees, were use to before the transaction. In events that create uncertainty, sustainable companies are better positioned than companies whose ESG performance is lower as they get more support from their stakeholders.[139] Therefore, investors shall make sure that investment decisions do not pose any reputation risks in their stakeholders' eyes, for example, customers, and do tarnish the image of the investor or the target. This benefits the investor during the investment phase and at the time of its exit.

Many PE firms have indicated that ESG matters are in the spotlight of media and public stakeholders, which is why ESG issues are becoming increasingly important. It can be stated that the inclusion of ESG matters into investment decisions is already becoming a routine, at least in some industries. This is no surprise, given that, nowadays, one-quarter of assets under management has been incorporated the idea that ESG can have positive effects on a company's financial performance.[140]

PE firms also see that the pressure is also by the regulators, which is one reason why PE firms feel that they need to focus on ESG issues in their investments. According to PRI, responsible investment regulation has increased significantly – since the 2008 financial crisis, after which regulatory attempts towards sustainability were increased.[141] It is not

[137] (Bailey et al. 2016).
[138] (Mattila 2006, pp. 159-161).
[138] (PWC and PRI 2012, pp. 5-10).
[139] (Arouri et al. 2019, pp. 1-2).
[140] (IFLR Correspondent 2019, pp. 57-60).
[141] (PRI, no date, What is responsible investment?, p. 2).

uncommon that investors perform ESG due diligence to comply with international voluntary standards, applicable laws, and national regulation of certain countries.[142]

The pressure to integrate ESG factors has made its way to the inner company relations since the shareholders of a company expect the management to incorporate ESG aspects into their business decisions. Given the legislative changes and attempts in the EU, especially the mandatory sustainability due diligence, a company's management could also be held accountable for poor ESG performance.[143] Already in some countries, such as the United States, failing to incorporate ESG factors into investment decisions may be seen as a failure of the management's fiduciary duty.[144] Additionally, the ESG integration into business decisions has indirect effects on the willingness of the future talent to work for the target company and on the commitment of current employees. These mentioned employment issues are something that the investor should consider keeping in mind during its ownership of the target.[145]

Suppose the investors fail to accept that CSR is becoming the new reality, soon enough, issues relating to business leading and employment could arise. For example, board members appointed to the target's board by the investor could not be willing to take their chances of failing to follow ESG requirements as management may be held liable. Also, finding talented employees could be more challenging for the target.[146]

Unfortunately, the current reality is that investors remain conservative and are usually interested in fulfilling the ESG requirements only to its minimum levels. Taking into account that investors' motives are often to please its shareholders, it remains unclear whether the PE investors are genuinely aware of the opportunities following from ESG integration.[147] After all, business activities are strongly tied to their surroundings, and the investors should rather see themselves as interdependent than independent when it comes to sustainability expectations.

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[142] (Zaccone and Pedrini 2020, pp. 4-8).
[143] See further about the initiative regarding mandatory sustainability due diligence (MDRDD) in the EU in section 1.1, p. 6 of this thesis.
[144] (Eccles and Klimenko 2019).
[145] (Indahl and Jacobsen 2019, pp. 34-41; Zaccone and Pedrini 2020, pp. 7-8).
[146] (Indahl and Jacobsen 2019, pp. 34-41; Zaccone and Pedrini 2020, pp. 7-8).
[147] (Zaccone and Pedrini 2020, pp. 10-11).

3.6.2. Competitive reasons

When PE firms see that their competitors are integrating ESG issues in their due diligence process, they may feel the need to do the same. According to surveys, PE firms have indicated that they desire to know the ESG gap between them and their competition. Furthermore, some investors estimate that the popularity of ESG will rise in the near future, and therefore they aim to be the forerunners of ESG investing.[148] Also, as included in the previous sections, ESG performance is linked to the better operationality of the target, which affects the investor's returns and has reputation advantages. Hence, following ESG integration in one's investment and ownership practices may bring investors competitive advantages.

3.6.3. Chance to be part of a reformation

Sustainable private equity investments are one way to aim towards sustainable innovations and growth – for example, by including developing and adopting sustainable business models, which help solve environmental issues, create employment opportunities, and support economic growth. According to PRI, assets owners are the ones that set the direction of the markets, i.e., they make the best market practices. This means that the evaluation of ESG risks and opportunities in relation to value creation is yet to be created by the investors.[149] Thus, ESG investing allows the investors to reform the economy and become more resilient. Besides, the investors have a chance to be part of a sustainable breakthrough.

3.6.4. Ethical reasons

The need to make a difference or an opportunity to invest according to an investor's own values is similarly something that drives investors to perform ESG due diligence. In other words, investors seek to do good while doing well. Sustainability in investments offers opportunities to generate better returns and take into account the needs of future generations. Investing in companies with good ESG performance helps investors influence companies owned by them to produce goods and services responsibly. Thus, some investors integrate ESG factors because they see it as their ethical responsibility.[150]

[148] (Amel-Zadeh and Serafeim 2017, pp. 87-91).
[149] (IFC 2018, pp. 6-11 and 34).
[150] (Eccles and Klimenko 2019; Ding et al. 2020, pp. 3-14).

3.6.5. Better crisis performance and recovery

ESG integration can also improve an investment firm's recovery in a crisis. During the first months of the worldwide pandemic, it could be seen that the firms whose investments had better ESG ratings also had higher returns, decreased volatility, and had better profit margins. It has been suggested that this results from ESG involvement, which impacts supply chain resiliency and gives investor's stakeholders higher confidence.[151]

The resiliency of a firm also plays a role during economically critical times. Namely, research has evidenced that if a firm holds shares only in companies that are segmented according to ES principles, this contributes to a company's resiliency and therefore reduces overall risks during critical times.[152] Research has shown that high customer loyalty has been helpful during the COVID-19 crisis, and that the companies have not been affected by lower customer demand. Likewise, customer loyalty positively affects a company's stocks as well as its resiliency. Thus, the stakeholders are willing to accept more risks, which means that investor's investors are not as eager to exit when crises emerge.[153] Therefore, there is one more reason why investors should consider investing in companies with favourable ESG performance and to raise their target's ESG performance even higher during their ownership phase.

ESG investing has been trending in the last years, *inter alia*, because millennial investors have more interest in ESG investing. The pandemic has increased the forecasts of ESG investing even more. This is due to the stakeholder's increasing pressure as the private persons and society are aiming to live more sustainably. Besides, covering from financial losses will necessitate focusing on sustainable recovery possibilities rather than short-term solutions.[154] For the mentioned reasons, as of today and also after the crisis past, investors are likely to have increased interest in companies with favourable ESG performance. Therefore, PE investors should start thinking about ESG integration already today to receive the profits during their ownership and in later exit phase.

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[151] (Mattila 2006, pp. 159-163).
[151] (PWC and PRI 2012, pp. 5-10).
[152] (Albuquerque, et al. 2020, pp. 953-617).
[153] Ibid, pp.593-617.
[154] (Gamlath 2020, pp. 1- 8; Albuquerque, et al, 2020, pp. 593-617).

3.7. ESG due diligence barriers

Despite the statistics suggesting that sustainable investing has attention among private European investors, surveys also show that this interest does not often show in investors' actions. This is caused by different barriers which complicate investors' engagement to sustainable investment.[155] The below barriers are not listed in the order of priority as it is not entirely clear which of the mentioned barriers is the leading one.[156] It is however clear that one or several of the mentioned issues combined constitute obstacles that are in the way of ESG investing from the investors' standpoint.

3.7.1. The shareholder theory

According to shareholder (neoclassical) theory, which is contrary to the stakeholder theory, the sole responsibility of a management is to maximise company's profit. From the viewpoint of the shareholder theory, CSR that is beyond the compliance with applicable laws is seen as a waste of resources and benefitting non-financial stakeholders at the expense of company's shareholders.[157]

However, research point this dispute to the favour of the stakeholder theory. The benefits of a more considerable support gained from stakeholders and more substantial commitment to contractual obligations, customer loyalty, and higher reputation when hiring new employees, come also to the benefit of a company's shareholders.[158]

3.7.2. Lack of accessible information and standardisation

From the investors' point of view, the ESG integration problem is that relevant data is difficult to find. Further, the data lacks detail, and there are no comprehensive ways to measure and qualify ESG related information cross-companies. Even if there ESG data was available, investors are concerned about its reliability.[159] One reason, why other investors find that the ESG data is available, and others do not, is that the information assessed during the DD process is highly sector dependant. For example, ESG issue impacts may depend on the following factors: the requirements for resources in the specific sector, the applicable

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[155] (Paetzold and Busch 2014, pp. 1-2; Arouri et al. 2019, pp. 1-9).
[156] Ibid, pp. 1-9.
[157] (Arouri et al. 2019, pp. 1-9).
[158] Ibid.
[159] (Amel-Zadeh and Serafeim 2017, pp. 87-92; Zaccone and Pedrini 2020, pp. 1-5).

regulation level, and the industry's social norms.[160] The target's geographical location will also affect what investors consider to be material in their reviews. Even strategies of a particular company may affect the availability of data.[161]

There are only some comprehensive methods to assess ESG information. This is because most of the information available is not meant for the use of investors given that the information is originally intended for other stakeholders of a company. One of the best known barriers of the ESG investments is that ESG information is difficult to compare because information is in different forms.[162] Nonetheless, there are some attempts to fulfil the need for standardisation which will increase comparability of information. For example, Global Reporting Initiative (GRI) standards or standards of Sustainable Accounting Standards Board are becoming more popular reporting methods concerning environmental, economic, and social impacts.[163]

Notwithstanding with the foregoing, surveys show that in the opinion of some investors, the lack of ESG definitions is not considered to be a problem.[164] According to Sandberg et al., standardisation of sustainable investing terminology might not be practically desirable or even possible, given that the different terminology has been born in practice and the heterogeneity of various terms. The following examples about different terms can be provided: ethical investing, CSR or responsible investing. All of the mentioned terms concern the same subject matter but are used in different regions due to cultural and historical dissimilarities, translation versions or possibly because of different values, norms and ideologies towards relevant stakeholders (such as clients) in the field of sustainable investments. Sandberg argues that standardisation is not possible alone if there is no top to bottom movements from an international trade organisation or legislative attempts that would contribute to sustainability. Further, even if standardisation of ESG terms is possible, it may not be desirable because the definition is not as important as the actual ESG performance itself. Therefore, it is not necessarily reasonable to focus on definitions as the ESG performance should be the most essential. Nonetheless, there is no argument against

[160] (PWC and PRI 2012, p. 14).
[161] (Amel-Zadeh and Serafeim 2017, p. 101)
[162] (Howson 2017, pp. 42-44; Amel-Zadeh and Serafeim 2017, pp. 87-88).
[163] (Zaccone and Pedrini 2020, pp. 8-11). See further about popularity of GRI: (Brown et al. 2009; Eccles and Klimenko, 2019).
[164] (Sandberg, et al, 2009, pp. 519-530).

applying standard definitions to introduce ESG to more investors and thereby promote sustainable investing.[165]

3.7.3. Regulatory barriers

With regard to different regulatory barriers, sustainable investments are not generally in a better position compared to other investments. Thus, PE investors may experience that sustainable investing is difficult because of barriers arising from applicable laws and regulations. Such problems can relate to legal, regulatory, and taxation framework, which pose complex administrative and approval processes for the investors, making it difficult to provide (sustainable) capital for companies. Such barriers may take various forms, such as lack of relevant regulation, or controversy, a form of over regulations which can lead to time and money consuming processes.[166] Due to regulatory barriers, sustainable investors may suspend their investment plans regarding certain regions.

3.7.4. Financial risks and the short-terminism paradox

Surveys further indicate that one issue for investors regarding sustainable investing is that investors believe ESG investing to be too volatile. The shorter the investment horizon, the more an investor will be influenced by the volatility.[167] These financial risks have been recognised as one major barrier of ESG investing as some investors seem to think that ESG investing is disadvantageous to their financial performance.[168] As indicated in the previous subsections above, this belief is usually not true.

However, it is true that ESG DD poses additional costs, which are often borne at the beginning of an investment. Also, the problem is that at the beginning of an investment, benefits associated with ESG integration into investments cannot yet to be seen. This is due to the paradox between short-terminism performance incentives of PE firms and the long-terminism benefits of ESG investing.[169] Luckily, there is a fix available to this issue – the conflict between financial risks and ESG investing can be solved if investors shift from

[165] (Sandberg, et al. 2009, pp. 519-528).
[166] (IFC 2018, pp. 37-44; Shelagh W, et al. 2018, pp.6-14).
[167] (Paetzold and Busch 2014, pp. 1-3).
[168] Ibid pp. 1-9.
[169] (Cappucci 2018, pp. 1-7).

short-terminism towards longer investment horizons, in other words, stay around long enough to see the benefits of ESG integration.

Thus, considering the various benefits associated with ESG involvement in investments, versus the mentioned financial risks that can be managed through longer investment horizons, it can be argued that the ESG investing benefits outweigh the mentioned financial risks.

3.7.5. General unwillingness and doing the bare minimum

While some survey results indicate that most of managers consider ESG incorporation important for the purchase behaviour of its customers, other surveys have found that only 33 % of CEOs believe that their business is making satisfactory efforts to address the challenges of following sustainability goals. The mentioned contrast is again caused by the short-terminism of the markets.[170] Thus, there is a general challenge to bring ESG willingness into real actions. Investors need to understand that ESG is not a box-ticking exercise and that doing more than just the bare minimum will be required to see the real opportunities following from ESG integration. This shows once again that more work needs to be done in order to promote the shift from short-terminism towards the long-terministic approach.

For the time being, there is no specific legal framework which would help the use of sustainability criteria in risk assessments in Finland. However, such legislation is under preparation in the EU.[171] So hopefully, this "top to bottom" pressure from legislators will change the situation soon enough.

As can be seen from the above subsections, ESG integration barriers primarily result from a lack of general knowledge about ESG benefits and from the issue with short-terminism. Changing these makes possible to overcome the mentioned obstacles. However, this will require a shift towards a more sustainable business culture on many levels.

[170] (Clark et al. 2015 pp. 10-11).
[171] (Admincontrol).

4. How Is ESG Due Diligence Conducted?

4.1. Who conducts ESG due diligence?

According to a survey which included interviews with leading experts around the world, it appeared that several PE funds have their own internal committee which is accountable for ESG related issues. The same survey also suggested that some consideration of ESG factors take place even before official due diligence phase has begun; namely, PE funds oftentimes exclude industries that are not in line with their internal ESG standards. Such industries are typically tobacco, gambling, and alcohol related.[172] This excluding method, or *negative screening,* typically occurs due to unsuitable products of the target as well as ethical considerations of the investor.[173] Surveys show that investors generally regard negative screening as the least beneficial ESG method.[174] Therefore, for full integration of ESG matters, a more comprehensive ESG due diligence review is required.

Due diligence (DD) process is usually lead by the purchaser's party according to party's pre-planned schedule. In DD the purchaser makes information requests to the seller required for purchaser's assessments. It is common that the purchaser wishes to inspect relevant areas or buildings of the target company. Furthermore, the purchaser usually meets the seller during the negation phase of the transaction to gain more information about the target and to get to know the current owner(s) of the shares. Sometimes the purchaser also wishes to meet some important clients or suppliers of the target. [175] However, traditionally, most of DD assessments are performed with the help from legal advisors who focus on potential liabilities and perform their review as desk work. In addition to legal experts, due diligence often uses the help of tax and financial advisors.[176]

According to a survey conducted by PricewaterhouseCoopers (PWC), a vast majority of investors use both in-house and external experts in lieu of their ESG due diligence review. A survey conducted by *Zaccone* and *Pedrini* indicates that private equity (PE) firms have reported the following: "*when we perform an ESG due diligence we employ external advisors specialized in compliance assessments*." Moreover, an interviewee stated that "*most*

[172] (Zaccone and Pedrini 2020, pp. 4-7).
[173] (Amel-Zadeh and Serafeim 2017 p. 87; PRI, no date, *What is Responsible investment*?, p. 2).
[174] (Amel-Zadeh and Serafeim 2017 pp. 90-96.)
[175] (Grebey 2018, pp. 134-135).
[176] (Spedding 2008 pp. 3-5).

PE firms do not have standardized ESG procedures, neither at due diligence level or at portfolio level".[177] Controversially, another research revealed that PE firms in particular do not usually employ external industry experts in their ESG due diligence (ESG DD) process.[178] These research results suggest that compliance with applicable laws and regulations may be a key risk for PE investors that they wish to mitigate by conducting a due diligence review focused on ESG matters. This indicates that ESG DD can in many cases be a part of legal DD review assuming that these legal advisors have sufficient ESG expertise.

However, the general need for external advisor depends on the specifics of a deal. Advisors are usually experts of M&A, CSR, Healt and safety, environment and technical matters. Use of external help is also highly dependent on an investor's own ESG policies and procedures that are used in their ESG DD process.[179] Hence, a lot depends on the investor's background. For example, active trade purchasers tend to have experience and expertise which mean that they require less external help. The need for external experts increases noticeably in case the in-house expertise is low in certain sector or jurisdiction or in case the transaction type is not well-known to the investor.[180]

Legal advisors have numerous tasks in due diligence process, which include, *inter alia*, preparation of questions, register searches and document review, drafting of different transaction documents, selection and instruction of other legal specialists as well as project and data management.[181]

Occasionally, external ESG DD is superficial and is conducted by "box ticking." This means that the purchaser will not be able to make an informed decision regarding ESG issues based on the ESG DD results. A remedy to this issue may come in form of investors establishing a shared industry practice which could help them to understand the ESG matters better. This could help to form a higher ESG DD review standard.[182] Nonetheless, the mentioned box ticking issue does not mean that investors should not engage external help, rather this gives investors courage to take a more active role in the ESG DD process in order to understand the relevant ESG metrics and issues and gain all the benefits that ESG DD has to offer.

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[177] (Zaccone and Pedrini, 2020 pp. 4-6).
[178] (PWC and PRI 2012, pp. 10-12).
[179] Ibid, p. 23
[180] Ibid, pp. 10-12.
[181] (Spedding, 2008 pp. 8-15).
[182] (Bailey et al. 2016).

To successfully review DD documents and to understand what is important for the purchaser, the advisors need to be properly briefed by the purchaser regarding the background information, such as contemplated transaction itself, most relevant issues and materiality limits, specific industry risks, the timetable of the transaction as well as expectations of the investor. Adequate briefing is the key to a focused DD review, and it also helps to prevent redundant costs.[183]

Cross-border transactions require more general management and efforts to understand where the other party is coming from. To ensure smooth transaction and to avoid any legal consequences, using local (external) advisers is especially essential in cross-border transactions.[184] In such case engaging external help may be crucial to the investor to make an informed investment decision.

4.2. Why go with outside advisers?

Despite that the services of due diligence advisors are expensive, their outside help brings lots of expertise and support to project management. While in some cases it is sufficient if the investor relies on its internal team to conduct DD, but for the following reasons it can be argued that using external help is often more beneficial for the investor: (i) advisers have lots of former experience which brings efficiency and saves time; (ii) advisors' former experience makes them good at spotting and solving any shortcomings regarding the transaction; (iii) due to their experience DD findings are properly assessed; (iv) advisors work in bigger teams which is often beneficial from the time perspective; (v) the seller may be more open to disclose information to a third party than to the investor itself; (vi) external advisors entail assurance that the investigation has been conducted by professionals; (vii) outside experts are more objective than internal employees and have the courage to inform the investor about any found deficiencies and problems; (viii) if an investor's decision requires acceptance from the board of directors, it is better if their decision is based on a review conducted by a neutral party, and; (ix) it is supposed that confidentiality obligations are better assured if DD is performed by external professionals than the employees of the investor.[185]

[183] Ibid, pp 30-33.
[184] (Howson 2017, pp. 19-20).
[185] Ibid, pp 30-31.

Despite the mentioned benefits, some investors are still concerned that legal advisers lack sector knowledge which is definitely important in ESG assessment and should be one criteria when choosing an advisor. Nonetheless, there are sectors that are close to each other and therefore knowledge of that very field is not essential assuming that there is knowledge about reasonably similar sectors. Besides, industry knowledge is not always up to date and former experience of an investor firm does not automatically mean experience of every employee of such firm. Moreover, if sector knowledge is deemed essential, advisors may engage a specialist from the relevant field.[186] Despite the importance of sector knowledge, a legal adviser has essential knowledge about the protection under the share purchase agreement and this cannot be disregarded or completely replaced by sector knowledge.

Using professional advisers also provides the investor some extra insurance which follows from the liability of the advisers. An adviser may be held liable in case the adviser fails to consider that its other contracting party (in this case the investor) has less information than the adviser, and the adviser fails to give its client information about the risks relevant to the contractual relationship. It is further assumed that an advisor corrects possible misunderstandings of the investor. However, the liability in such cases requires that the investor has suffered a loss that is caused by the adviser's consideration failures. Taking into account that the purchaser cannot usually rely on circumstances of which it should have become aware of in the process of purchaser's DD, the DD process plays a significant role for the investor and if relevant information is not given by the adviser, the investor could suffer loss from the transaction.[187] The Supreme Court of Finland has in two cases assessed the liability of an adviser failing to inform its client based on their contractual relationship. KKO 2001:128 regarded an accounting firm and KKO 2007:72 was about liability of a bank. However, these cases are analogous to assess the liability of a (legal) ESG adviser.

> In the first case KKO 2001:128, an accountant firm was held liable for not informing their client about tax liabilities arising from a company share transaction. Despite the fact that the accountant firm did not provide any advice about taxation, the Supreme Court of Finland stated that the accounting firm had a liability based on contractual relationship with its client to inform the client about tax liabilities.[188]

[186] (Howson 2017, pp. 30-35).
[187] (Hemmo 2005, pp. 87-88 and 210-211).
[188] (KKO 2011:128).

In the second case KKO 2007:72, the case concerned a contractual relationship between a bank who was also a pledgee of the target company's shares and its client, who was the seller of the target. The Supreme Court of Finland held the bank liable for failing to take into account the benefits of its contracting party. The court stated that as a professional adviser, the bank should have understood that the client had incomplete knowledge about the pledge and therefore the bank should have drawn the client's attention to such fact, especially when taking account that the bank, as a contracting party, had a duty of loyalty towards its client. Hence, the court found bank liable for breaching its information and duty of loyalty.[189]

These cases referred above indicate that Finnish advisers may be held liable in case an adviser fails to comply with its duty of loyalty towards the client. However, taking into account the limitations of this thesis, other requirements of liability to rise will not be reviewed herein. Further, taking into account the risk of liability, it is certainly not uncommon for professional advisers to limit their liability with regard to the DD process. Such liability caps are usually tied to certain monetary limitations or to a percentage of a deal value. Liability limitations are usually agreed in engagement letters between the adviser and its client.[190] Yet, even if the adviser's liability is limited, the investor is in a better position to claim losses compared to a situation where the investor has conducted the ESD DD review without outside help. However, the benefit from this type of "insurance" depends on a particular case and shall be assessed against the amount of ESG DD costs.

Despite the mentioned advantages of using external advisers, it shall be stressed that every transaction is unique and therefore the investor should consider if the particular case requires other kind of advisers, such as technical and sector experts in addition to the legal advisers.[191] For example, in ESG DD using legal advisers for desk review of the ESG issues may be a suitable but any analysis that require other type of technical know-how should be outsourced. Using different advisers should not be frightened as there is no need to worry that advisers would completely take over the process and make the transaction decisions on behalf of the investor. Advisers are there to give advice on which grounds the investor is able to make its final decisions regarding the transaction.[192]

[189] (KKO 2007:72).
[190] (Howson 2017, pp. 40-41).
[191] Ibid, pp 22-44.
[192] Ibid, pp 30-33.

4.3. How is information gained?

4.3.1. Main ESG information sources

Typically, due diligence begins when the purchaser's advisors send a questionnaire to the seller. Thereafter, the seller gives the answers to the questions. Any following queries could be made from time to time if deemed necessary.[193]

In addition to the questionnaire, DD regularly includes document disclosure and searches from public registers. The disclosure usually comprises disclosure of all the relevant data regarding the transaction, which helps the purchaser assess whether the target meets its investment requirements. The requirement to disclose all the material facts about the target is, in many jurisdictions, provided by laws, and this is especially true regarding the common law system. In case the disclosure is not properly made or in case there are misdescriptions or misrepresentations included, the purchaser has an option for remedies, including *inter alia*, backing from the transaction before completion, price deduction, or claiming damages under the share purchase agreement provisions post-closing. Purchaser's remedies will be further discussed in chapter 5.[194]

In practice, during the DD review, an investor (or its advisors) usually requests numerous documents, which in general consists of legal documents, customer agreements, agreements with employers of the target, and documents regarding the target's operations. These documents will be included as scanned versions of hard copies in the virtual data room (VDR). In addition, the purchaser typically requires an asset list to be disclosed in the VDR.[195]

> *Inter alia*, the asset list discloses the following: (i) tangible assets, e.g., fixed assets, which for example, contains information about the real property of a target; (ii) intangible, e.g., non-psychical assets, such as goodwill and intellectual property; and (iii) current assets which include balance sheet information, such as accounts receivables, debts, and monetary balances.[196] The asset list is relevant from the ESG point of view, given that tangible assets disclose information about the property

[193] (Spedding 2008, pp. 8-18).
[194] (Spedding 2008, pp. 4-24).
[195] (Grebey 2018, pp. 134-137).
[196] Ibid.

which will be reviewed from an environmental perspective, and intangible assets may be relevant from a governance perspective.

In addition to the mentioned information sources, broader ESG indicators can be used as assistance in a DD review. As an example, some PE firms use the UN's Sustainable Development Goals as framework assistance in their DD process for risk assessment. The DD review focuses on ESG and compliance risks which need to be reviewed broadly. For example, data protection issues may be considered important regardless of the target's field of activity or the target's other ESG performance. [197]

According to the research conducted by Zaccone & Pedrini, the following information should be reviewed during the ESG DD process: (i) checklists concerning business risk management to understand the options for value-creation and/or other business orientated checklists to understand if the company complies with different ESG standards and laws; (ii) data and reports relating to properties of the company; (iii) advice from external advisors (ESG, law, tax and sometimes business advisors); (iv) Ad-hoc expert advice as well as public business ratings. However, using external industry experts is not as popular as could be excepted among the PE firms.[198]

In summary, a proper DD review should include the following elements: (i) identification and verification of target's assets and liabilities; (ii) finding out risks and risk qualification; (iii) safeguards to discovered risks which will have an impact in negotiations of the deal; (iv) assessment of synergy benefits; (v) identification of issues that could have an impact in negotiations; and (iv) recognizing necessary post-closing steps.[199]

4.3.2. Internal reports as an information source

ESG issues are mainly checked in the course of the DD phase, and for that, a common method is to check the target's ESG compliance against international ESG voluntary standards.[200] For this, one source to compare the target's ESG matters against international ESG standards is the data reported by the target itself.

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[197] (Indahl and Jacobsen 2019, pp. 36-40).
[198] (Zaccone and Pedrini, 2020, pp. 8-11)
[199] (Howson 2017, pp. 1-6).
[200] (Zaccone and Pedrini, 2020 pp. 5-19).

Together with the investors' interest in ESG factors, ESG data reporting has spread widely over the past 25 years.[201] Also, some companies include their ESG information in their annual reports. Despite the growing popularity, ESG reports prepared by the company itself have been seen as problematic due to the reason that companies tend to mainly disclose data that is favourable to them and leave out the negative data. This may be considered misleading to the persons who base their decisions on such results, like purchasers. In case the target has self-reported data available, the reliability of such reports shall therefore be critically analysed. The form and practice of disclosing data vary by field of activity and location. Even if the management warrants that the reported data is reliable, oftentimes the accuracy has not been ensured by any higher-level governing body.[202] However, if the information is gained from audited reports, it is more reliable than non-audited reports that the company itself has prepared.[203] To overcome the mentioned issues and increase the reliability of self-reported data, the formation of generally applicable ESG standards is necessary.

4.4. Assessing environmental risks

As a piece of background information, signing the international treaty on climate change, i.e., the Paris Agreement within United Nations Framework Convention on Climate Change in 2016, and especially its Article 2.1c,[204] has brought in the spotlight the importance of green finance. Green Finance means making finance consistent with agreed goals in the Paris Agreement to prevent climate change. According to *Whitley, Thwaites, Wright and Ott,* to achieve this goal, it will be required that a shift and mobilisation of finance towards low-emission and climate-resilient by policies and regulation will have to occur. Furthermore, increased sustainable finance awareness as well as shifting general behaviour of market participants play an important role in achieving the goals of green finance.[205] While the agreement concerns public actors, this does not mean that these goals would not invite private actors to aim towards similar goals. Controversially, this shifts the new "normal" operation environment towards higher sustainability, which, when considering investors' perspective, means better consideration of sustainable finance and environmental matters in particular.

[201] (Amel-Zadeh and Serafeim 2017, pp. 87-88).
[202] (BlackRock 2016, pp. 1-3; Deloitte 2012, pp. 1-12).
[203] (Deloitte 2012, pp. 1-7).
[204] See further: Paris Agreement, 2015.
[205] (Shelagh et al. 2018, pp.6-21).

Besides better finance opportunities, environmental risks are important to investors, given that investors need to take their future exit into account already during the investment phase. This is a particularly challenging task for the time being as no one knows which climate change scenario will materialise. Thus, environmental issues are fundamental for future risk mitigation and value creation, and therefore, these risks shall not be ignored even at the beginning of an investment stage.[206]

Especially in the US, some investors will not be giving their legal teams DD briefing before the seller has ordered a first draft report from environmental experts. This indicates that investors often prioritise environmental issues and possible liabilities thereunder before giving the due diligence phase a green light. By the example of the US, environmental due diligence from a legal perspective is therefore becoming a more integral part of due diligence worldwide.[207]

Environmental risks consist of many issues that are well known and often deemed as risks that are visible to the naked eye, for example, soil contamination, but these risks also include operational (future) issues. To avoid any surprises, the environmental part of ESG DD needs to assess whether the target complies with applicable laws and regulations as well as the extent of possible liabilities and nature of costs if environmental risks should arise in the future. It is also important to stress that in a share purchase transaction, environmental risks will by rule be inherited, which means that the target will be liable for any future environmental issues which will affect the purchaser. Also, compliance with environmental legislation may pose high costs if the target has had significant non-compliance in the past.[208]

Compliance assessments with environmental regulations require collecting information regarding environmental permits as well as the emancipations of the target to air, water, and ground waste disposal.[209] Also, professional licences and certificates of the target which are currently effective, pending or expired and which relate to the mentioned issues should be viewed.[210]

Collecting data about environmental issues begins with sending the seller inquiries concerning environmental matters. For environment review, due diligence is often carried

[206] (Indahl and Jacobsen 2019, pp. 34-37; Howson 2017, pp. 30-38).
[207] (Howson 2017, pp. 30-38).
[208] Ibid, pp. 165-174.
[209] Ibid, pp 165-173.
[210](Grebey 2018, pp. 97-98).

out by consultants, such as environmental lawyers, but also by other types of specialists. Since the regulation varies in different jurisdictions and environmental due diligence involves public registry searches that may not be accessible on the internet, local advisors are, in many cases essential. Again, the scope of environmental review depends on particular circumstances. Sometimes the review focuses on main environmental issues, such as current and future risks of land contamination, compliance with laws and environmental management level (such as adherence to environmental management system) and with environmental policies. In other cases, the environmental due diligence may comprise of reviewing everything that might have an impact on environmental risks.[211]

As an example, regarding the land contamination review, DD can be divided into two phases: in phase one, the focus is on public data and the existing knowledge about possible risks and any other information collected from the target company to assess risks and concerns. This analysis is usually made as a desk review, and information is collected from different sources, which help the advisers to assess the psychical nature of area related to the target's operations, economic review of the land use and records of any authorities which would reveal possible environmental issues. The scope of desk review depends on the amount of available information.[212]

Usually, the data room (VDR) contains information about the following: (i) environmental reports; (ii) environmental policies; (iii) lists on hazardous waste on manufacturing areas; (iv) information of possible accidents and spillages; (v) enforcement notices that are caused by environmental damages or non-compliance with regulations; and (vi) information of any breaches of consents. Furthermore, in order to assess whether the discovered risks are covered by insurance, insurance policies should also be reviewed. If this first phase reveals any concerns regarding the mentioned environmental subjects, phase two will concentrate on further analysis and monitoring of these concerns. The second phase usually mainly focuses on soil and groundwater contamination, which could include soil and water sample analysis. However, the second phase is not necessary in every case.[213]

It is not uncommon that the target uses an environmental (and social) management system (ESMS), such as ISO 14001, which is an important source for environmental review.[214] Even

[211] (Howson 2017, pp. 165-174; Zaccone and Pedrini, 2020 p. 4; IFC Performance Standards 2012).
[212] (Howson 2017, pp. 165-177; Corporate Board Member Institute).
[213] (Howson 2017, pp. 165-177).
[214] See further about the ISO 14001 management system: (ISO 14001).

though this does not guarantee that the environmental management is 100 % effective, the ESMS provides some level of assurance that the target considers the risks following from its operations to the environment and that there are controls set to manage such risks. It is also important to note during DD that even if the seller's group has taken care of environmental management, the situation could change post-closing as the target is sold out from the group. Environmental management assessment includes viewing; (i) target's environmental policies, standards, and practices; (ii) environmental monitoring programmes in use; (iii) any outstanding civil or regulatory claims or actions; and (iv) which methods the target uses to address environmental liabilities.[215]

It is also possible that the target's ESMS has been certified by a third party. This does not directly imply that the company's ESMS would be on a better level than in case the ESMS has not be certified (especially considering that the scope of certification may be limited). Nonetheless, certification may at least provide investors with some assurance about management systems' accountability and help improve the target's environmental policy in the future. The benefits of certification may, however, be marginal when considering that the certification process is costly. Certification should not be deemed as an alternative to comprehensive DD review, and ESMS should in these cases be reviewed and compared with observations and conclusions of the ESG DD.[216]

However, in reality, a survey conducted by PWC and PRI shows that the investors seem to consider certificates and other assurances given by third parties as a green light to go through with the transaction. This is due to the reason that third party certificates assure the purchaser that the target has fulfilled at least minimum level requirement in relation to ESG factors and that it is not too far from the investor's own standards. However, given the limited scope of certifications, certificates should not be considered as substitutes to the ESG DD process.[217]

If necessary, in addition to the desk-review, environmental issues may also be reviewed during a site visit to the target's property. During the on-site visit, the employees can be interviewed about environmental issues, and environmental auditors are able to gather more

[215] (Howson 2017, pp. 165-173).
[216] (CDC Group, *ESG Toolkit* – ESG Topics – Company ESG management systems).
[217] (PWC and PRI 2012, p. 12).

information regarding the history and present situation of the environmental matters of the target.[218] The latter can be deemed to be outside the legal (ESG) due diligence's scope.

4.5. Assessing social risks

Briefly, the social responsibility of a company comprises adoptions of decisions and actions that would increase the welfare of the organisation as well as general welfare at a societal level. Social responsibility is considered the responsibility of an organisation's management.[219] As stated in the above chapters, the CSR related responsibilities of the management are likely to increase in the future given the regulatory initiatives regarding the sustainability due diligence in the EU. In the investment context, social risks are often assessed by PE funds themselves, and it is not uncommon that social risks are entirely left without an assessment.[220]

Assessment of social risks includes, among others, the following topics: (i) health & safety information; (ii) information about monitoring and occurrences of incidents and accidents; (iii) information about enforcement actions against the target; (iv) existence of claims with regard to socially related claims which are related to employees or key shareholders; (v) question relating to human resources; (vi) certifications and standards; and (vii) supply chain risk management. Reviewing social risks also includes paying attention to codes of conduct regulations of a company which may include the following topics: (i) ethics; (ii) laws; (iii) human rights; (iv) conflicts of interest of a company; (v) workplace habits; (vi) gifts policies; (vii) data security; (viii) diversity; (ix) responsible purchasing policy and (x) anti-bribery policies. However, the sole existence of such codes does not suffice as a commitment to implement the policies included in the mentioned codes. [221]

Regarding social risks, assessment of labour-related risks and compliance with applicable laws is standard practice for investors. Regarding labour issues, an assessment from a sector-based view is usually a key starting point. Therefore, it is important to ask questions from the seller that are most common to the relevant sector during DD. Questionnaires help purchasers to identify and further assess risks related to labour issues. These assessments may include, *inter alia,* reviews of employees of the target as well as the contractors. Sub-

[218] (Howson 2017, pp. 165-172).
[219] (Mattila 2006, pp. 159-160).
[220] (Zaccone and Pedrini, 2020, pp. 4 and 168).
[221] (Mattila 2006, pp. 159-164; ESG DD Questionnaire, pp.1-5).

contractors may be included in the review depending on the material risk set-up and considering the sector in question.[222]

In addition to risks specific to relevant sector, commitment of the management of a company as well as available sources for E&S management is also essential in terms of E&S management capacity. The main aspects when assessing management commitment and E&S performance capacity are as follows: [223]

- the existence of E&S policies and their scope relating to E&S risks and validity of the policies, i.e., whether these policies are subject to review and update over time;
- general reasons and business drivers behind the target's E&S awareness, approach and scope;
- E&S standards of the company, such as laws and international standards;
- whether the policies include information about how the company assesses its E&S impacts and whether these assessments are comprehensive (including supply chains, contractual parties and other third parties);
- assessing who is nominated as the person in charge of the E&S policies within the company. In case no responsible person exists, whether these issues are included in the business strategy of the company and considered by the management of the company;
- is the staff of the company aware of the E&S matters in the company;
- has the company prepared any reports evidencing that the company has comprehensively assessed E&S relating to its business and whether these reports have been subject to audits;
- whether the target has integrated E&S into its business practices in order to improve its value creation through costs savings, higher revenues, reduced risks, enchaining employees' productivity and improved access to its capital and investments. Integration could be done,e.g., through better governance practices;
- whether there is any training of staff relating to E&S issues;
- whether the target monitor and review its E&S risks in any other ways.

The assessment of the current situation is not sufficient as such, and therefore it should also be reviewed whether the company is willing to adjust its E&S practices under changing

[222] (CDC Group, *ESG Toolkit* – ESG Topics – Managing the risk of modern slavery).
[223](CDC Group*, ESG toolkit* – Investment Cycle – Assessing commitment, capacity and track record).

circumstances. It is also important to find out what information the target discloses and what are the aims of such information disclosure. [224]

Furthermore, ESG DD also concerns many issues related to human rights. The scope of including human rights in DD remains at the investor's discretion by far as there is no mandatory regulation that would affect the amount and availability of data and relevance of human rights issues. By default, human rights issues are to some extent included in the ESG review, and a more comprehensive human rights review can be included if it is necessary for reasons relating to the operations of the target and supplementary higher risks or in case such issues are particularly important to the investor. There might be an argument for heightened human rights risks, for example, in cases where there are human right conflicts or because of current operations of the target the target is known to have issues regarding human rights.[225]

The supply chain of a company is not always reviewed but it is important in the context of social issues. If the supply chain of products or services is long and the company imports products from abroad, there is not a 100% assurance that the company's suppliers comply with, e.g., CSR, on the same level as the company itself. Yet, according to the opinion of many investors, the suppliers of a company are also expected to reach the same ESG benchmarks as the company itself. The social issues, among other ESG issues, may occur in a different country or continental, especially in emerging markets. Unfortunately, local institutions are often too weak to change the situation. Due to this, ESG investing lags behind in developed countries, and managing the risk from the top, meaning the investor level, becomes even more important.[226]

4.6. Assessing governance risks

According to some literature, corporate governance issues are often in a preferred role in the context of sustainable investing.[227] This is no surprise when looking into the study which reviewed ESG performance impacts on financial performance in Germany. The same study revealed that governance performance has the most correlation with the financial

[224] CDC Group, *ESG toolkit* – Investment Cycle – Assessing commitment, capacity and track record).
[225] (CDC Group, *ESG toolkit* – ESG Topics – Human rights).
[226] (Herz et al. 2016, pp. 96-98).
[227] (Sandberg, et al. 2009, pp. 519-523).

performance of a company.[228] In general, investment decisions and decision documents tend to include more governance issues than social and environmental issues. This may be because many investors consider governance a material issue that can affect the value of a company and investor's future returns.[229]

Johann Porritt, the chairman of the Sustainable Development Commission, has explained the concept of governance as follows: *"the way in which organisations manage or govern themselves, and the way in which they account for their performance to their respective "stakeholders" – those constituencies or interests to whom they are accountable in one way or another."* The importance of governance issues has grown, especially through the private sector becoming more powerful in its role as an owner of a company. The overall trend suggests that stakeholders expect companies to carry out their operations in a responsible and transparent manner. Thus, companies increasingly aspire to meet these growing expectations.[230] Moreover, research has shown that companies that tend to pay more intention to governance matters have higher gains. This can be explained by the fact that, in the acquisition phase, investors consider good governance as a possibility to get higher returns to their investments and therefore invest in companies with good governance.[231]

Over the last years, expectations of corporate governance best practices have increased the number of governance rules as well as adherence to voluntary codes. It is further expected that a company discloses supplementary information regarding ESG matters. Thus, the regular reporting mechanism is becoming more widespread, which also benefits companies' stakeholders.

In the later investment stage, the investors themselves play a significant role in the governance of their target company, considering that active owners promote sustainable practices, which in turn enhances the governance of the company and increases its resiliency.[232] Therefore, it can be suggested that investors desire to make sure that the target's corporate governance is in good order at the time the investment is made to avoid adverse governance incidents post-acquisition.

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[228] (Velte 2017, pp. 169- 176).
[229] (Sandberg, et al. 2009, pp. 519-523).
[230] (Spedding 2008, pp. 106-107).
[231] (Wang & Xie 2009, pp. 830; Spedding 2008, pp. 96-98).
[232] (Gamlath 2020, pp. 1-4).

One way for the investor to ensure better governance of the target in the future is to alter the management compensation mechanisms post-closing and link the management compensation to the long-term initiative of a company. This increases the interest of the management to create long-term value instead of following the problematic short-term approach.[233]

The main reason behind the importance of governance issues is that in M&A changes of ownership also mean that the control of the target will change. After the transaction has been completed, it is important for the purchaser that his shareholder rights are assured in the most feasible way. This is especially important in cases where the investor is from another country than the target. However, empirical research indicates that if the investor's governance is in good order and a change of control will take place, this will affect how the target is managed in the ownership phase, which will lead to higher future returns for the investor.[234] Therefore, it can be argued that poor governance is not always a detrimental issue for the deal if the investor is willing to develop the target's governance during its ownership phase. Still, the investors would like to make an informed decision about the completion of the transaction which means that corporate governance issues cannot be overseen in the DD phase.

Today, the situation of PE funds regarding governance issue assessment is similar to social risk assessment meaning that PE funds either do their own review or do not make any assessments about governance risks.[235]

According to the CDC Group[236], considerations regarding the topic of business integrity and corporate governance are as follows:

- structure of the target;
- assessment of reputational risks in terms of business integrity;
- existence of anti-corruption and whistle-blower policies;
- existence of economic sanctions;
- any documentation on how the management governing bodies of the target have carried on their tasks and how this has been indicated in the relevant documents of these bodies;

[233] (Flammer and Bansal 2017, pp. 1827-1830).
[234] (Wang & Xie 2009, pp. 830-855).
[235] (Zaccone and Pedrini 2020, p. 4).
[236] The CDC Group is the UK's development finance institution.

- whether the target is committed to corporate governance or not: this includes reviewing the articles of association (AoA) of the target to find out the level of protection of its shareholders. The review further provides authority relations between the management and general meetings of shareholders as well as the information disclosure level and transparency in the activities of the target. In addition, it should be assessed whether the before-mentioned provisions of AoA comply with applicable laws. This further includes assessment of corporate governance and ethics codes of the target if these exist;
- how is the board of directors structured, and what falls under its competence? How does the board align with other governing bodies, committees, and shareholders of the target? In addition, the election process of are members of the board of directors and how the decision-making process of the board is established, e.g., whether the board meetings are held and how often such meetings are arranged;
- whether the company's share capital is divided into different classes and the share capital impacts voting and profit distribution rights. Also, the mechanisms in place ensuring the rights of minority shareholders and issues related to change of control situations will be assessed;
- who is the beneficial owner of the target;
- how is the annual shareholder meeting arranged: how are the voting and other procedures arranged;
- has there been any shareholder disputes;
- existence of shareholder agreements;
- financial statements and how are these prepared, audited and what is their scope.[237]

4.7. Materiality in ESG due diligence

4.7.1. Importance of materiality in investment decisions

The materiality filter is the key to drive value from an investment process and to find relevant risks during the DD process. Therefore, the determination of materiality should be considered crucial. Determination of which matters should be reviewed during the ESG DD process is, in each case, one of the most significant decisions prior to beginning with the

[237] (CDC Group, *ESG Toolkit* – Business integrity – Corporate Governace – Corporate governance questionnaire).

review.[238] When determining materiality, help can be found from the principle of materiality, which has formerly been used in financial accounting practice. Deloitte has in its research defined materiality in the context of ESG information disclosures as information that "*is useful to the economic decisions of an interested user*." However, as a difference to its initial use, materiality in ESG also considers the company's stakeholders. The same approach is used by GRI, where ESG materiality is based on the risks and opportunities which are the most relevant to the company's key stakeholders. Key stakeholders are affected, for example, in cases the ESG matters impact the target's business operations or business goal achievements.[239]

There are classifications invented to help identify the material ESG issues in every industry. One of the mentioned classifications is the materiality map developed by the Sustainability Accounting Standards Board (SASB). SASB's Materiality Map identifies which issues would be likely to be deemed as financially material ESG issues. By definition, these *"are the issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors."* [240] The SABS has listed 77 standards from different industries, which help identify the subset of environmental, social, and governance issues that are most relevant to financial performance in the relevant sectors.[241] Although these matters are created for publicly listed companies, at least some analogy can be applied to assessments concerning private companies. Therefore, this thesis uses the help of the SABS' Materiality Map in determination of material ESG issues.

According to a report published by Deloitte, matters that have a probable effect on the value creation or destruction of a company or a possible positive or negative impact on the company are considered material. Thus, if an ESG issue could probably change a company's value creation, it should be regarded as material. Issues that could affect the valuation of the company are, among others: (i) the company's loss of its license to operate; (ii) changes in cash flow; and (iii) reputation losses through the losing goodwill of the company. While the level of materiality should consider monetary amounts regarding value losses, it simultaneously considers ESG issues that several company's stakeholders would be

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[238] (Herz et al. 2016, pp. 96-101).
[239] (Deloitte 2012, pp. 1- 4; Corporate Board Member Institute).
About GRI see further: https://www.globalreporting.org.
[240] (SASB Materiality Map).
[241] (SASB Standards).

interested in. Also, issues that imply operational risks of a company can affect a company's resilience and make the company vulnerable to certain ESG risks in the future should be included in the DD review. Last but not least, the ESG issues that affect the behaviour of the target's customers should be considered material from the company's future value creation perspective.[242] In the determination of materiality, it is crucial to consider both qualitative and quantitative factors.[243]

For example, with regard to ESG due diligence review, Kohlber Kravis Roberts (KKR), which is a global investment company, has in its operations set materiality to ESG issues that have been defined as material by KKR in its sole discretion, and also to issues that can potentially have a significant effect on the economic and social value creation of the relevant organisation and to its stakeholders. However, in any case, the scope also depends on the provisions of any partnership and confidentiality agreements between KKR and its client fund. Moreover, when setting materiality, KKR considers operational locations to determine which regulations and standards are applicable. [244]

Despite some similarities of ESG approaches among different investors, the materiality of ESG issues is highly dependable on the field of operations of the target.[245] As ESG due diligence depends on each transaction's characteristics, some of the investors have decided not to use any pre-drafted checklists, which means that their approach is based on the particular case.[246]

Given that DD resources are limited, materiality is a crucial consideration in ESG DD because addressing all ESG issues is not possible nor cost-effective. Thus, each target shall be viewed from a perspective focusing on material ESG issues. Also, according to research, limiting the ESG review to material issues only is in general more cost-effective than not considering ESG risks at all. On the other hand, a materiality-based review is more cost-effective than additionally reviewing non-material ESG issues. Thus, in their investment decisions, investors that focus on material ESG issues and ignore the immaterial issues,

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[242] (Deloitte 2012, pp. 1- 11).
[243] (IFC 2018, pp. 34-41).
[244] (KKR 2016, p. 1-4).
[245] (Clark et al. 2015, pp. 1-20).
[246] (Zaccone and Pedrini 2020, p. 1).

generally outperform investors that do not derive material ESG matters from immaterial ESG matters.[247]

4.7.2. What is considered material in ESG due diligence?

The following subsection lays out material issues to be considered during the ESG DD review from various sources. As can be seen from below, various research emphasise ESG materiality differently.

For example, Clark, Feiner and Viehs 2015 have researched several sources and put together the following table with regard to material ESG factors on a general level: [248]

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Biodiversity land use	Community relations	Accountability
Carbon emissions	Controversial business	Anti-takeover measures
Climate change risks	Customer relations/product	Board structure/size
Energy use	Diversity issues	Bribery and corruption
Raw material sourcing	Employee relations	CEO duality
Regulatory or legal risks	Health and safety	Executive compensation schemes
Supply chain management	Human capital management	Ownership structure
Waste and recycling	Human rights	Shareholder rights
Water management	Responsible marketing, research and development	Transparency
Weather events	Union relationships	Voting procedures

[247] (Eccles & Klimenko 2019; IFC 2018, pp. 34-41).
[248] (Clark et al. 2015, pp. 10-12).

According to another source, PRI, the fundamental issues to be considered in the ESG due diligence process are; (i) energy and water use; (ii) greenhouse gas emissions; (iii) supply chain management; (iv) waste management; (v) materials used in production; (vi) use of renewable materials; (vii) materials and minimising deforestation. According to PRI, the "second-best matters" to be reviewed are social issues because investors are interested in the well-being of the target's employees and the relations between the target and local communities.[249]

Dan Hanson, a Portfolio Manager at BlackRock, has stated that material ESG issues to be routinely considered when making investment decisions are related to corporate culture, the behaviour of the company's management, the engagement level of the company's customers and employees, and not to mention the governance issues in general.[250] Notably, this listing is mainly focused on matters that can be classified as governance issues but the list also includes some social issues. The list does not include any environmental matters.

When comparing the lists of Clark, Feiner and Viehs to PRI's view of material ESG issues, it can be seen that the environmental matters considered material are somewhat similar in both listings. As regards social issues, all three sources highlight matters relating to the engagement of stakeholders. In PRI's listing, governance issues are entirely left out while other sources consider governance issues necessary. As can be seen from this brief comparison, there is no “by default standard” about which matters should be deemed relevant in ESG DD review. While governance issues are usually most similar in different ESG DD reviews, E&S matters differ rapidly given that these are based on more circumstantial aspects.[251]

Most research shows that environmental risks are most material to the target’s business, and thus, the environmental issues are usually in investor's focus. Notwithstanding the foregoing, also the relevance of environmental matters depends highly on the target, for example, in case the target is a manufacturer, environmental review is definitely essential. Controversy, if the target is an IT company, environmental matters have less relevance in the ESG DD.[252]

[249] (PWC and PRI 2012, pp. 10-19).
[250] (Deloitte 2012, pp. 1- 7).
[251] (Herz et al. 2016, pp. 96-101).
[252] (PWC and PRI 2012, pp. 10-19).

Given that there is no general consensus of the scope of ESG DD review, the adequate scope for ESG DD comes down to what are the possible risks considering the target and investor's risk appetite, but also, what kind of tools and funds are available for risk mitigation.[253] When deciding on materiality, it should be kept in mind that the ESG DD materiality should, in any case, be related to valuation impacts through future value growth and also to accompanying liabilities of the target that could increase future risks.[254] Further, the scope of due diligence can be dependent on protection provided under the SPA. [255]

Despite that achieving superior knowledge about every risk is not possible due to costs, time limitations and patience of the seller, reasonable ESG DD can usually be performed in a way that allows the purchaser to know about the most crucial ESG matters.[256] This means that the purchaser needs to choose the most relevant ESG issues for its DD review.

4.8. ESG due diligence review on a Hypothetical Target: Project Wood

To bring a specific understanding of materiality in ESG DD, this section includes an overview of material issues to be reviewed during ESG DD in a hypothetical case where the target company operates in modular building manufacturing and instalment. CDC Group has prepared an ESG toolkit that serves as a practical guide for investors in their ESG considerations using sector profiles helping to determine materiality in different sectors. Regarding the hypothetical target, relevant sector profiles prepared by CDC Group are the following: (i) project design and construction, which is applicable to design and construction facilities of any kind; (ii) forestry and plantation; and (iii) manufacturing.[257] The foregoing sector profiles are based on the IFC's Environmental and Social Performance Standards and World Bank Group Environmental, Health, and Safety Guidelines (the EHS Guidelines).[258]

According to SASB Sustainable Standards, the target belongs to the building products industry, given its design and manufacturing of house modules. Further, if the target does not use external subcontractors and assembles the buildings themselves, the company also belongs to the engineering & construction industry. The following list comprises relevant ESG issues according to the SASB's Engineering & Construction Services Sustainable

[253] (Howson 2017, pp. 165-170).
[254] (Deloitte 2012, pp. 1- 5).
[255] (Howson 2017, pp. 15-28).
[256] (Howson 2017, pp. 15-28).
[257] (CDC Group, ESG Toolkit). Available at: http://toolkit.cdcgroup.com. [Last accessed 20 March 2021].
[258] See further: (IFC Performance Standards; EHS Guidelines).

Accounting Standard, the Construction Material Standard and also according to the SASB Materiality Map that are relevant considering the operations of the hypothetical target: [259]

Issue	Description of issue
Environmental impacts relating to project development	• incidents relating to non-compliance with environmental permits, standards and applicable regulations. • management of environmental risks associated with design, siting and construction of projects to mitigate risks related to biodiversity impacts, emissions into the air, water discharges, natural resource consumption, waste generation, and the use of hazardous chemicals.
Structural integrity & safety	• Amount of defects and costs thereto • Monetary losses relating to legal proceedings concerning defects and safety incidents • Compliance with relevant codes and standards
Workforce health & safety	• Information concerning work-related incidents and fatality rates of employees and direct contract workers • Existence of employee health and safety training
Lifecycle impacts of buildings & infrastructure	• Projects certified and to be certified to comply with a third-party sustainability standard • Assessment of environmental impacts of the buildings and human health outcomes • Description of processes for the incorporation of operational-phase energy and water efficiency considerations into project planning and design • Description of applied risks management in relation to the operational-phase energy and water efficiency considerations • Description of efforts to manage product lifecycle impacts and ways to meet demand for sustainable products

[259] (SASB Materiality Map; SASB Sustainable Accounting Standards – SASB Construction Materials Sustainability Standard – SASB Engineering & Construction Sustainability Standard).

Issue	Description of issue
	• Amount of end-of-life material recovered and % material recycled
Climate impacts	• Amount of renewable energy projects • Amount of non-energy projects regarding climate change mitigation
Business ethics	• Monetary losses resulted from legal proceedings in relation to bribery, corruption and anti-competitive practices • Information about employee training in relation to bribery, corruption and anti-competitive practices • Description of policies and practices for the prevention of bribery and corruption, and anti-competitive behaviour in bidding processes • Number of active projects of the target and backlog in countries that have the 20 lowest rankings in Transparency International's Corruption Perception Index
Waste management	• If the company provides cleaning, grading and excavation services that may create harmful waste, disclosure of the amount of waste generated and % of hazardous and recycled waste
Greenhouse gas emissions	• Information concerning gross global Scope 1 emissions and the % covered as stipulated by the applicable emission-limiting regulations • Plan to manage Scope 1 emissions and reduction targets, and plan to analyse performance from both short- and long-term perspectives.
Air quality	• Information concerning emissions to air with regard to different pollutants.

Issue	Description of issue
Energy management	• The total amount of energy consumed, electricity usage % and source (/type) of the electricity consumed
Water management	• The total amount of freshwater withdrawal, recycle % as well as in regions with High or Extremely High Baseline Water Stress
Biodiversity impacts	• Description of environmental management policies and practices • Terrestrial acreage disturbed, % of the impacted area restored
Product innovation	• % of products that fall within the scope of credits in sustainable building design and construction certifications • Aggerate market share for products that reduce energy, water, and/or material impacts during usage and/or production
Pricing integrity & transparency	• Total amounts of monetary losses resulting from legal proceedings relating to cartel activities, price-fixing, and anti-trust activities
Wood supply chain management	• Information about the total weight of food fibre purchased • % of wood fibre purchased from certified forestland belonging to a third party • % of wood fibre purchased by standard • % certified to other wood fibre standards • % by standard [260]

As stated in previous subsections, information about material issues can be obtained from the target upon request of an investor or its advisers. However, especially when the investor originates from a different cultural environment than the target, there might be a need to assess additional ESG matters.[261]

[260] (SASB Materiality Map; SASB Sustainable Accounting Standards – SASB Construction Materials Sustainability Standard – SASB Engineering & Construction Sustainability Standard).
[261] (CDC Group, *ESG Toolkit* – ESG Topics– Company ESG management systems).

In addition to issues indicated in the table above, when considering that as part of the target's operations, the target projects and constructs new timber buildings, the size of projects is also relevant. In case a project is larger and may pose adverse environmental impacts, there may be a need to conduct detailed Environmental Impact Assessment (EIA). EIA should be performed before the target starts construction work. The findings of EIA might affect the planned designs or sites. The recommendations laid down in EIA shall be implemented in a relevant scope by persons responsible for EIA in the company or a pre-closing group.[262] If the target has large projects, the investor may be interested in target's EIA related matters and review the EIA(s) during its ESG DD.

Given that the target may use subcontractors in its business, contracts are of significant importance in the construction sector. Also, it is relevant to verify that the target's contractors understand the level of required ESG performance.[263] Therefore, the investor would probably review who the target uses as main contractors and whether these contractors comply with the investor's ESG standards.

On the other hand, when considering that the target manufactures wooden products, its activities also fall within the scope of forest activities. In addition to the target, it is also relevant to review the contractors belonging to the target's supply chain. Taking into account that the target is in the business where its materials are sourced from forests, it is also essential to assess the following issues comprehensively: (i) management's commitment and sufficient capacity focused on keeping E&S requirements up to date and use the opportunities following from E&S activities; (ii) labour and working conditions; (iii) health, safety and security issues relating to the target’s manufacturing operations; and (iv) land access and acquisition.[264]

Likewise, business ethics may be a highlighted issue as the target operates in Finland. From a general Finnish way of thinking, a company shall act responsibly and ethically in its business operations. The reasons behind this phenomenon originate from the Finnish welfare society, which has led to a situation where most companies have acted according to CSR principles for 40 to 50 years.[265] Therefore, it can be claimed that Finnish business ethics are

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[262] (CDC Group, *ESG Toolkit* – Sector profile – Project design and construction). See further about Environmental impact assessment in Finland: The Ministry of the Environment of Finland, EIA)
[263] Ibid.
[264] (CDC Group, *ESG Toolkit* – Sector profile – Forestry and plantations).
[265] (Panapanaan et al. 2003, pp. 133-138).

on higher level than in average. To maintain competitive advantages in the Finnish market, the investor is likely to make sure that the target's operations are in accordance with Finnish ethics and moral standards.

When viewing employee-related matters, some matters could be relevant considering the possible use of foreign workforce. According to a road mapping study in 12 Finnish companies, another matter that is on an elevated level in Finland is employee welfare. Finnish companies acknowledge their need to manage and organise their procedures and data concerning employee welfare. While Finnish companies recognise that Finland's employee matters are generally in good order, the companies also recognise issues related forced labour that become particularly important when a Finnish company runs operations outside Finland. Also, considering that Finnish companies shall comply with applicable laws and regulations and the regulation is rather extensive, the compliance with laws and regulations of the target is something that the investor should examine.[266]

The construction sector is prone to modern slavery, especially considering the use of foreign sub-contracted workforce. Modern slavery has been described as an umbrella term which includes forced labour, money laundering, human trafficking and debt bondage. The assessment of modern slavery belongs in the field of social issues. It is typical for modern slavery that workers are not free to start working or stop working. Investigating modern slavery issues is essential during the ESG DD to better understand the risks included in the target's activities, within the target's supply chains and intermediate contracts.[267]

The issue with modern slavery is that forced labour is well hidden behind complex supply chains. The use of forced labour follows from the efforts to keep labour costs low in the markets, which helps companies to gain competitive advantages, and which in turn helps to keep capital costs low. According to information provided by CDC, during the COVID-19 pandemic, contemporary slavery issues have increased. At the same time, travel restrictions have made it harder to identify these risks on the spot. Thus, desk-review of these issues during ESG DD has become even more important. One way to fight the issue is to cut off its

[266] Ibid, pp.133-140.
[267] (CDC Group, *ESG Toolkit* – Sector profile – Project design and construction).

illegal financing. Therefore, ESG assessments should also include an assessment of the target's AML procedures.[268]

To help manage modern slavery issues, there are guidance and screening questionnaires, followed by document requests which can be used. Also, to tackle modern slavery financing, the investors could use FAST Initiative Toolkit to implement specific financial related principles to their investment decisions.[269]

From the investor's perspective, assessing modern slavery issues is about risk mitigation. Under the UN Guiding Principles of Human Rights, if modern slavery issues emerge, these risks need to be remedied by the investor if the investor has caused or contributed to adverse effects.[270] Even if the investor has not caused these risks, there is also the issue with reputation risks. However, the extent of remedy depends on the circumstances in question.[271]

Unfortunately, research indicates that Finnish companies experience difficulties when considering CSR issues in their supply chains, especially when the company also operates in a foreign county. It is possible that CSR information cannot be obtained from suppliers and such information is not available from any other sources. The fact that suppliers may have sub-contractors makes the information requests even harder, and therefore in practice, assessing the whole supply chain is rarely possible. Of course, the scope of CSR issues also depends on the country of origin of the relevant supply chain. On a positive note, in Finland, there are attempts to pay supplementary attention to supply chains.[272]

Particularly in case the target has larger projects, it would be desirable if the target has developed and uses an environmental and social management system ESMS, giving the company a structured approach to E&S matters. Briefly, ESMS includes elements of policies, risks and impact identification systems, management programmes, readiness for emergencies and responses, stakeholder engagement, risk monitoring and review. By viewing the ESMS, the investor can assess whether the compliance level of the target, its contractual parties, and supply chains corresponds to the target's activities, giving the

[268] (CDC Group, *ESG Toolkit* – ESG Topics – Modern Slavery, Managing Risk Associated with Modern Slavery).
[269] Ibid. See further from the FAST Toolkit and (CDD Group, ESG Toolkit – Management Materials).
[270](UN, Guiding Business and Human Rights, Guiding Principle 22).
[271] (CDC Group, *ESG Toolkit* – ESG Topics – Modern Slavery; Managing Risk Associated with Modern Slavery).
[272] (Panapanaan et al. 2003, pp.133-145).

investor information regarding post-closing ESG opportunities. The existence of ESMS can also assure the investor that the target complies with applicable laws and regulations. However, the sole existence of ESMS is not sufficient, and the company should also continuously implement its ESMS in its business operations and improve its management system. Lack of ESMS documentation does not imply that the company would not manage its ESG issues, and it is possible that the company identifies and manages its risks despite ESMS. However, the existence of ESMS is a convenient tool when assessing ESG risks during the DD process.[273]

Further to the above, with regard to a company operating in the field of installing modular buildings, it is important to evaluate whether the target's operations involve constructions for the public sector. If so, special attention shall be paid to fire safety-related issues. Moreover, the consideration of stakeholders is also something that could be important to assess. In construction projects, stakeholder engagement is relevant, and in practice, relevant stakeholders should be informed and consulted about the key concerns and development plans on an ongoing basis. In case there is a probability that the target's business operations could significantly adversely affect local communities, it may be advisable that the target follows an informed consultation and participation process, which is comprehensive information exchange process relating to shareholder engagement.[274]

To conclude, the materiality in Project Wood mainly includes environmental and social issues while governance matters get less attention within the ESG DD scope. However, considering that the transaction of Project Wood includes transferring 100% of the target’s shares, the governance risks are not as important. As can be seen from above, when setting the materiality filter, the sector and its operations have significant relevance – in Project Wood environmental matters are especially important. Moreover, the fact that the target operates in Finland highlights some additional social matters to be reviewed. Of course, the determination of materiality is also highly dependent on the investor's intent, which cannot be taken into account in this hypothetical review.

[273] (CDC Group, *ESG Toolkit* – ESG Topics – Company ESG management systems).
[274] (CDC Group, *ESG Toolkit* – Sector profile – Project design and construction).

4.9. ESG reporting

After relevant DD has been performed, the purchaser's advisor(s) will usually prepare a due diligence report in which the relevant findings will be documented. The formality of the report varies, and it is even possible that there is no need for a formal report, but instead advisers could give short assessment regarding the main risks in a simple email. However, a DD report is often prepared because written report allows the investor to have an expansive view of the risks involved and recommendations concerning risk mitigation. A written report is also often helpful to any other concerned parties, usually, the advisers use a standard report. [275]

ESG DD reports are generally extraordinarily rich in detail. DD reports are about providing information and opinions regarding the discovered risks. Furthermore, the reports include recommendations to mitigate such ESG risks. To be more reader-friendly, DD reports usually include an executive summary which includes the main red flag issues. The language used in the report should also be understandable for non-advisors.[276]

An idea of DD report is to give the investor a general understanding of the following aspects: (i) business of the target; (ii) risks related to the target's business; (iii) what is recommended to improve the business of the target or to mitigate risks; and (iv) what are the costs and benefits of these suggested improvements. The ESG report should also include which findings have been considered material and record which data has been reviewed during the process. The aim of the report is to help the investor make an informed decision about its investment.[277]

5. ESG Due Diligence Finding Impacts on Transactions

In M&A transactions, ESG findings are usually reflected in the share purchase agreement (SPA), especially regarding the liabilities concerning environmental contamination of land and health and safety matters. Also, it is common to include ESG reports to the SPA as annexes.[278] Taking into account that ESG findings relate to business opportunities and risks,

[275] (Grebey 2018, pp. 137-141; PWC and PRI 2012, p. 15).
[276] (PWC and PRI 2012, p. 15).
[277] (CDC Group, *ESG Toolkit*).
[278] (PWC and PRI 2012, p. 15).

it is expected that DD findings have impacts on the SPA terms. These impacts will be further described in the sections below.

Also, ESG DD results affect the results of negotiations between transaction parties, the probability of the transaction taking place, and the transaction timeline. For example, ESG DD results may slow down the completion of the transaction through condition precedent to closing clauses to be included in the SPA, which will affect the timeframe of the transaction.[279]

5.1. Effects on liability terms of a share purchase agreement

5.1.1. Representations and Warranties

Representations and Warranties (R&W) can be defined as guarantees whereby the seller states that particular circumstances or affairs concerning the target exist. In other words, R&Ws are statements that confirm to the purchaser that some specific facts are true and correct at a particular time. The R&Ws can confirm the situation at the time of signing of the SPA, but the statements may also refer to the time of closing of the transaction. However, if the state of the matter does not correspond to what has been stated in the R&Ws, the seller discloses to the purchaser certain exemptions to the warranties in a written form. These disclosed exemptions are usually stated in a separate disclosure letter. The mentioned exemptions are necessary to the seller to avoid any liability due to breach of R&Ws. In turn, this means that multiple exceptions to R&W coverage are not desirable to the purchaser because the seller cannot be held liable for the disclosed information. Thus, if there are many R&W exemptions, it becomes an argument for the purchaser to ask for a purchase price reduction. However, if there are no exceptions, the R&Ws can offer the purchaser extra protection given that possible warranty breaches by the seller will be compensated under the SPA.[280]

At first, the purchaser usually includes as many details about the ESG findings to the R&Ws as possible. Thereby, the first drafts of the SPAs often contain lots of R&Ws and specific indemnities, which are later used as a lever against the seller who can agree to trade some

[279] Ibid, pp. 5-11.
[280] (Howson 2017, pp. 21-28).

warranties against a lower purchase price given that the seller does not prefer to have any ongoing liabilities post-closing.[281]

The warranties section of the SPA usually includes environmental R&Ws. For example, the seller could give the following representations and warranties: (i) the target complies with environmental legislation; (ii) the target has all necessary permits to carry out its operations; (iii) the target is not a party to any environmental processes; (iv) the target has not caused any toxic or hazardous discharges to the soil, ground, and water and; (v) the target has no obligations to remedy toil at any site.

However, the SPA warranties will not provide the purchaser with full protection, because they are usually in force for a limited amount of time. Some issues, such as environmental damages, may be hidden for an extended period of time. As per SPAS, R&Ws are usually in force for three years, which may have elapsed by the time the environmental damages emerge. Thus, it is crucial that the most essential environmental warranties are deemed "fundamental warranties", which remain effective for a more extended period compared to the "basic" warranties, usually from five to seven years. In any case, the purchaser should pay extra attention to general liability provisions and R&W coverage, as sometimes SPA provisions do not actually cover environmental liabilities, or the coverage may depend on other circumstances. The seller may also have qualified the warranties to material effects only, or the warranties do not include anything the seller has not been aware of.

Furthermore, it is possible that warranties do not apply if there is appropriate insurance coverage available. Thus, if the SPA R&Ws are insufficient, there is a risk that the purchaser suffers a loss, for example, in the form of environmental clean-up costs for damages that occurred prior to the transaction. Despite its loss, the purchaser cannot claim damages from the seller under the SPA.[282]

5.1.2. Specific indemnities

A specific indemnity is a guarantee whereby the seller undertakes some explicitly set liability. The difference between an indemnity and warranty is that the purchaser's right to remedy does not depend on whether the seller has disclosed underlying information to the

[281] Ibid, p. 16.
[282] Ibid, pp 165-177.

purchaser or not. Secondly, whether the value of the target has been affected is not a relevant matter when claiming indemnification, which makes the indemnity much more beneficial for the purchaser than a warranty. Specific indemnities are usually provided when an occurrence of potential future liability or its extent is not known at the time of signing of the SPA. Thus, the seller undertakes to meet full liability in case the indemnified event occurs. Yet should the seller's financial status be uncertain, a specific indemnity may not provide full coverage. The scope of the liability covered by the indemnity and procedure for claiming loss depends on the SPA provisions. For example, some types of loss may be excluded, or time and monetary limitations will apply.[283] Also, as the name specific indemnity indicates, every ESG finding cannot be covered by indemnification as it is not in sellers' interest to have pending liabilities post-closing.

Commonly, the seller gives specific indemnities in relation to environmental matters. For example, the seller could indemnify that it shall bear the costs of a possible future environmental claim identified by the purchaser during the DD. This indemnity will be in force for a limited amount of time and may include various further limitations. It is also vital to agree under which circumstances the indemnity will be triggered.[284] It is equally important to establish benchmarks to understand the contamination on the closing date and which amount of contamination triggers the right to claim losses post-closing.[285]

Further, if the purchaser chooses not to perform DD at all, the purchaser should also realise that the seller is not likely to provide any indemnifications. The seller is also expected to limit its warranty protection to standard warranties only. Besides, any information which qualifies the warranties, for example, a warranty is given to the seller's knowledge, is based on information that is not available for the investor in all material respects.[286] This means that when not performing an ESG DD, the purchaser takes a known risk that the target's ESG matters may not be in order, and that this may generate a liability to the purchaser post-closing. Also, without the DD, the purchaser has fewer arguments to balance between favourable SPA provisions and lower purchase price.

[283] (Howson 2017, pp. 21-28).
[284] For example, an indemnification may require notice from the authorities or that a claim is filed by a third party.
[285] (Howson 2017, pp. 165-176).
[286] Ibid, pp 1-8.

R&W, as well as specific indemnities, ensure the purchaser from past events within the target company, even in situations where some issues have not been reviewed during the due diligence process. Still, and taking into account that such provisions are subject to different limitations, [287] it is unquestionably better if such problematic aspects are disclosed and reviewed already in the course of the ESG DD. Furthermore, there is always a risk that claims under the SPA may become disputable or even inadmissible.[288]

However, given that the purchaser has to rely on the quality and quantity of the disclosed data and the fact that this set-up bears a risk of non-disclosure or misrepresentation, R&Ws provide key support to the purchasers in M&A transactions. Yet, there are details that the purchaser will not be able to completely verify or even check during the DD. In such situations, additional support from R&Ws is needed that the purchaser could verify the wholeness and accuracy of the seller's data. Also, when issues found during the DD phase, they have an important effect on the R&W and specific indemnities of the SPA.[289] As a conclusion, it can be stated that the negotiations regarding the SPA provisions are about balancing between coverage of R&Ws, specific indemnities and the purchase price payable for the target. The limits of this balancing depend on the purchaser's risk appetite. Nevertheless, grounds for the negotiations can best be obtained during (ESG) DD.

5.2. Effects on valuation of the target

5.2.1. Valuation practices to investor's favour

ESG due diligence findings that indicate poor ESG performance affect the target value, which in turn may reduce the purchase price payable for the target in a share purchase transaction. In addition, if the ESG performance is poor compared to an investor's expectations, some investors may be up for a challenge to even the distance between the targets and the investor's standards which could increase the target's value at the time of investor's exit.[290]

On the other hand, in cases where ESG DD findings indicate good ESG performance, this is usually already reflected in the target's valuation. Consequently, good ESG performance is

[287] Such limitations may include gap limitations, de minimis thresholds and timely limitations.
[288] (Spedding 2008, pp. 10-25).
[289] Ibid.
[290] (PWC and PRI 2012, pp. 14-15).

considered a primary feature that has already been taken into account during the valuation process. While discounts are given in relation to weak ESG performance, good performance does not usually lead to any additional valuation premiums for the seller.[291]

Based on the above, it is clear that the investor gains in both cases. In case the ESG performance is poor – the purchaser is usually able to negotiate a discount on the purchase price and has an opportunity to increase the target's ESG performance post-acquisition and thereby increase the target's value for the time of its own exit. Conversely, if the ESG performance is proven good, this is included in the valuation calculation but has not in practice, led to any additional ESG performance bonuses. This may lead to a situation where the investor purchases a company worth more than the original valuations show.

5.2.2. Seller’s vantage

Notwithstanding the foregoing, there are situations where valuation issues are more relevant than usual. For example, if the seller is a PE firm, it is expected that the SPA does not contain extensive R&Ws, or these are entirely missing. If so, it also follows that the SPA lacks specific indemnities. In such situations, any shortcomings should be solved during the transaction process via price reductions as the seller is unlikely to agree to any liabilities that would emerge post-acquisition.[292] However, if this is not sufficient, the purchaser always has an option to not move further with the transaction.

5.3. Other forms of protection under share purchase agreement

Apart from price adjustment and the inclusion of warranty and indemnity protection, there are other ways under the SPA for the purchaser to seek protection concerning risks discovered during the DD process. The purchaser may negotiate that part of the purchase price will be retained on an escrow account, the purchase price is adjusted based on earnings, or a third party may be willing to provide a guarantee for the seller's obligations. Different SPA protections are not substituting to each other, and their usage depends on specific transaction circumstances.[293]

5.4. ESG due diligence effects on proposed transaction

[291] Ibid, p. 15.
[292] Ibid, p. 15.
[293] (Howson 2017, pp. 1-29).

In an M&A transaction, it is in the purchaser's interest that the seller will not be able to make "a clean exit" from the share transaction in case any significant negative ESG factors arise during the DD process. According to research, unsatisfactory results from ESG due diligence process affect the probability of the transaction taking place or at least affects the investor's motivation to go ahead with the purchase. *Vice versa*, satisfactory results from DD process increase the purchaser's willingness to complete the transaction.[294]

Also, according to research, investors who hold a more advanced sustainability level have a higher performance in M&A transactions because the transaction is faster to complete, and the deal is less likely to fail. A noticeable factor is that sustainable investors have a better reputation in the eyes of regulators, and therefore, a regulatory intervention that would impede the completion of the deal is less likely to occur, which reduces uncertainty of an M&A deal. Furthermore, a higher trust level by the investor's stakeholders may also impact the financing of the deal positively.[295]

Awareness of the importance of a target's stakeholder relations may bring the investor a better understanding of the customers and suppliers of the target. This will help the investor in both valuations and future planning, e.g. how to keep the target's key employees in the firm after the transaction has been completed and further planning of its post-acquisition actions. Despite any accompanying DD costs that mainly occur in the pre-acquisition phase, information asymmetry is considered to be a major issue in investments, which can be relieved by positive stakeholder orientation, thanks to the ESG integration.[296] For the mentioned reasons, as an end result, an investor is likely to benefit from ESG DD in a share purchase transaction.

5.4.1. Poor ESG performance and execution of transaction

Findings that refer to poor ESG performance may, in some cases, be detrimental to the transaction as they eliminate the purchaser's willingness to proceed with the transaction. Such deficiencies may be related to all three ESG categories. Some examples of issues relevant to the investor are soil contamination, lack or insufficient trade union relations, risks associated with possible natural disasters and the use of child labour. Regarding such findings, investors are prudent in cases where the potential risks cannot be sufficiently

[294] (PWC and PRI 2012, pp. 5-11).
[295] (Arouri et al. 2019, pp. 1-28).
[296] (Bettinazzi and Zollo 2017, pp. 2465-2482).

foreseen, the costs remain uncertain, or required remedies appear too expensive.[297] Also, as stated above in section 5.1, ESG DD findings may affect the conditions precedent clauses which can stipulate that the completion shall not occur if a particular risk has not been properly eliminated. However, in these cases, delays are for the investor's benefit.

5.4.2. Positive ESG performance and execution of transaction

Positive ESG performance is a factor that increases the investor's motivation to go through with the transaction. From an investor's point of view, good ESG performance predicts reputation, operational performance and brings a better return for the investor in the future. When ESG matters are appropriately managed, it is also likely that the transaction moves forward more swiftly and smoothly.[298]

Thus, concerning the transaction itself, it can be stated the hat ESG DD review works for the benefit of the purchaser. With the help of DD findings, the investor will have more power during negotiations with the seller. The investor will be able to mitigate financial and reputational risks through various SPA provisions. The investor can also rest assured that the target is not overpriced. Based on DD findings, the investor will have an opportunity to terminate the transaction process in case the risk cannot be sufficiently mitigated in the SPA before the completion occurs or the seller is not willing to adjust the purchase price.

6. Conclusions

In relation to private equity investments, responsible investing can be described as a systematic integration of investment strategies relating to ESG risk management and ESG performance development by the investor across all investment stages. A comprehensive way to integrate ESG into share purchase transactions is to perform an ESG DD review on the target to verify whether the target complies with the investor's expectations and risk appetite. For the ESG review, the investor can use internal help or external advisors, such as lawyers and environmental experts.

At the beginning of the investment process, ESG DD incurs financial and time costs due to external advisors' engagement and execution of a comprehensive ESG review on the target.

[297] (PWC and PRI 2012, p. 15).
[298] Ibid, p. 15.

The review may include public registry searches, management interviews and inquiries regarding the target. The outcome of the review will consist of assessed data, provide answers to the information collected during the process and report DD findings. Issues revealed during the ESG DD may also affect the schedule of negotiations and time frame of closing of the transaction. Despite the costs, performing ESG DD comes with many benefits, which in many cases outweigh the costs.

6.1. Importance of ESG due diligence in M&A transactions

This thesis suggests that the main benefit of ESG due diligence for the investor is risk management by securing the investor's interests in the share purchase transaction through contractual protection mechanisms included in the SPA. Such mechanisms are, e.g., representations and warranties, specific indemnities, and conditions precedent clauses based on the ESG risks revealed during the ESG DD process. Also, the ESG DD findings may impact the amount of the purchase price payable for the target or payment terms under the SPA.

ESG DD is essential during the negation phase of a transaction as material ESG findings can impact target valuation. Given that different ESG findings may affect the target's value, the purchaser should ensure that the purchase price payable for the target is reduced if the target's poor ESG performance could lead to monetary penalties post-closing of the transaction, of which the investor could be liable. Such penalties may arise due to non-compliance with applicable regulations and may lead to the increased operational cost of the target in the future, or negatively affect the terms of the target's supplier agreements during the investor's ownership stage. In addition to direct monetary risks, a share purchase transaction includes accompanying reputation risks that could affect the financial performance of the target through lower sales or reduced customer loyalty. Furthermore, effects on the share price at the time of investor's exit shall be evaluated as ultimately any potential loss will be to the investor's detriment. Any risk to the reputation of the target may also reduce the expected performance of the investor, which, consequently, could mean fewer investments to the investor or affect the credit ratings of the investor. Risk management is especially important in case the investor comes from another country and is not aware of the local regulations and operational standards.

The research indicates that integration of ESG DD process in M&A transaction is beneficial to the investor thanks to higher returns during the ownership stage as well as higher selling price at the time of the investor's exit. The main reasons behind higher returns are better operational performance as well as lower capital costs of the target. Based on the ESG DD results, the investor will be able to evaluate the target's potential for future growth. While ESG DD increases the investor's costs at the beginning of the investment stage, long-term benefits in the form of improved risk management and target's operations may outbalance the initial costs, provided that the investor does not perform an exit shortly after its investment.

In addition to the above benefits, the investor may have additional motives to integrate ESG matters into its investments. These motives can be internal or external. External motives include pressure to consider other factors than profit maximization only. Such pressure may originate from, e.g., investor's stakeholders, regulators and from the public at large. Further, based on the applicable legislation, the *caveat emptor* principle (the Buyer Beware) can limit the purchaser's legal remedies which lead to situations where the investor should investigate the sale object prior to the share purchase transaction. While such provisions can be excluded by SPA provisions, it is unlikely that the seller would agree to completely exclude the purchaser's obligation to DD. Also, ESG DD affects the course of the transaction and the investor's M&A transaction performance. To perform the ESG DD, the investor may have internal reasons, such as being able to participate in solving ESG issues and to follow good market practice. Furthermore, the investor could feel an ethical responsibility to invest sustainably.

6.2. Materiality in ESG due diligence process

The materiality filter is the key to drive value from the investment process and to find relevant risks in the course of the DD process. Given that ESG DD resources are limited, the scope of ESG DD shall be set to material issues. The approach can be the investor's standards perspective or set to issues that can affect all stakeholders of the target. Further, it shall be stressed that the materiality of ESG DD is always highly dependent on the sector and operation location of the target, as well as the previous knowledge of the investor regarding the same aspects. In case the investor is from a foreign country, the scope of the ESG DD review may be broader compared to a domestic transaction. Thereby, the investor can expect

to have access to all the relevant data regarding the target that could affect its investment decision in relation to the proposed transaction.

The reason ESG DD is not universal and does not fit every purpose is that different sectors and operation locations have a various emphasis on relevant ESG matters. Also, the protection clauses provided by the SPA, such as R&W and specific indemnities, may limit the scope of the ESG DD process, but the inclusion of these SPA provisions do not provide the purchaser complete protection. Therefore, ESG DD review focusing on material issues should be the first option. As materiality depends on circumstances in a particular transaction, there is no uniform understanding what should be considered relevant in each case.

As an example, and with regard to the hypothetical target in Project Wood, the ESG scope should be set to highlight environmental and social matters because the target uses materials sourced from forest and operates in the field of manufacturing and construction. Given that the target operates in Finland, where the employee welfare is at a high level, the investor shall make sure that the target complies with the usual standards and applicable laws. This shall not mean that governance issues should be completely excluded from the ESG DD review, but the main focus should be on environmental and social matters that are the most relevant in this particular case.

Also, it is important to stress that the ESG DD review should not solely be limited to the operations of the target – compliance evaluation of target's contractors and suppliers with investor's own standards and risk appetite are also deemed important.

It shall further be stressed that the ESG due diligence process is a risk management tool – it is about finding the balance between knowledge about specific risks and transaction expenses as well as the timeframe of the transaction. Therefore, the review cannot include all possible data and every risk cannot be foreseen and mitigated. The essential idea of ESG DD is that based on the DD findings, the investor is able to calculate whether the target is suitable for its investment, taking into account the investor's standards and to what extent the investor is willing to accept deficiencies. Under the ESG DD findings, the investor should be able to make an informed decision whether to move forward with the transaction or not.

6.3. How should ESG assessments be developed in the future?

Given the subject nature of ESG assessments, lack of standardization is an issue regarding ESG review. While there are some companies that disclose ESG data, there is no standardisation. With this, it may be expected that any disclosed data is neither comparable nor sufficiently useful for the investors in their own particular investment.[299] Furthermore, there is also an issue with regard to sustainable data – the lack of clear verification of what constitutes a suitable investment.[300] Lack of standardisation and clear definitions no doubt poses an obstacle for the use of sustainable information and makes the ESG DD process longer and more complex.

A long-term ESG risk and opportunity assessments can be formed through standardisation by setting the most relevant data metrics for each industry which will, in turn, eventually establish an industry standard. For this to materialize, various relevant industry stakeholders should take the lead by lobbying their understanding of good ESG practice to investors, other stakeholders, ESG data providers and other active ESG investing participants of relevant industries. Such proposals could include references to international best practices such as Sustainable Development Goals, PRI or IFC Performance Standards. In this way, different ESG data would become compatible and thereby help the reliability of future ESG reviews. Furthermore, investors themselves can participate in the development of sustainable investing standards, tools as well as reporting templates to overcome the lack of standardisation issue.[301]

Market actors cannot bear the load of standardisation alone. The shift towards sustainability through non-financial reporting requirements that would help produce relevant material for EG DD will also require support from regulators.[302] Thus, the EU taxonomy regulation that will cover all of the ESG subjects during 2021, the Non-Financial Reporting Directive and the Sustainable Finance Disclosure Regulation may become important answers to the lack of standardisation.[303] It remains to be seen whether this regulation will become an adequate remedy to the above-mentioned standardization problems. Moreover, the initiative to set requirements for mandatory sustainability due diligence can affect the developments of

[299] (IFC 2018, pp. 34-41).
[300] (IFLR Correspondent 2019, pp. 57-60).
[301] Ibid.
[302] (IFLR Correspondent 2019, pp. 57-60; Bailey et al. 2016).
[303] See further: (Regulation (EU) 2020/852; Directive 2014/95/EU).

different standards and social norms. Any attempts towards standardisation will be welcomed as it increases the general knowledge of the importance of the ESG, which, in turn, could help mainstreaming sustainability and will hopefully lead to adequate ESG integration in the near future.

In addition to standardisation, legislators and regulators should also attempt to gain a better understanding of the nature of PE investing. Their considerations should be given to current problems relating to legal, regulatory, and taxation framework, which pose complex administrative and approval barriers for the investors. However, changes relating to regulatory barriers can only take place if both public and private actors take steps towards a change. Therefore, it is required that different organizations will change their way of thinking about PE investments and swift towards a sustainable-orientated culture.[304]

The shift towards sustainability may prove equally profitable for legislators and regulators. Considering that regulation affects capital investment movements from one country to another, it is clear that justified and predictable regulation is becoming a national competitive advantage, while lack thereof will work counterproductively. Practical restriction reliefs may be achieved by bringing transparency to relevant processes in M&A transactions by creating clear and stable policies that support sustainable investments in the target sectors.[305]

An increase of general ESG DD knowledge regarding sustainable investments benefits and creates best practices in the relevant field, generating more temptations towards sustainable investments. It may be expected that experience will increase the knowledge of identifying risks as well as the knowledge of potential and capable transaction parties.[306] One of ESG investing issues is a culture trap that leaves sustainable investing as a secondary matter in investment decisions and focuses solely on financial matters. In the future, an integrated ESG process could change the game towards the benefit of those who understand the importance of ESG.[307]

Finally, some research suggests that sustainable companies had better recovery opportunities during the COVID-19 crisis. This can be explained through findings, which indicate that sustainable companies have better customer loyalty when compared to non-sustainable

[304] (Linnenluecke and Griffiths 2010, pp. 357-366).
[305] (IFC 2018, p. 37), (IFLR Correspondent 2019, pp. 57-60) and (Shelagh et al. 2018, pp.6-14).
[306] Ibid.
[307] (Bailey et al. 2016).

companies, gain higher returns, have decreased volatility, and earn better profit margins. For the mentioned reasons, the author predicts that sustainability is going to be a key advantage and improves perseverance during the current COVID-19 or any other similar crisis, and as such, will significantly increase the popularity of sustainability and ESG DD in the near future.