ESG as business critical

Keeping up with (investor) expectations and new regulations

Wolf Theiss

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Environmental, Social and Governance (ESG) criteria are no longer just a trend – their importance and impact on companies is growing exponentially on a global level. Reinforced by regulatory trends both in Austria and the EU as a whole, key investors have started to fully embrace ESG and sustainable investing. This of course moves ESG compliance up the boardroom agenda.

On a local and regional level, as the importance of ESG is growing rapidly, target companies are more often selected based on criteria/risks related to ESG compliance. On the international level, some mergers and acquisitions have already been abandoned due to (high) ESG risks involving one or more of the target businesses. As a result, investors are increasingly taking ESG factors into account during due diligence, not only reviewing whether the current legal requirements and market standards have been met, but also whether they correspond to general best practice expectations and having due regard to (potential) risks which could arise in the future.

Therefore, an appropriate ESG strategy and approach may also result in an essential competitive advantage, which is one of the reasons why ESG should be rising to the top of the priority list of every company.

Move towards binding law & consistent definitions

Taking Austria as an example, there is currently no legally binding definition or consistent and comparable information with respect to ESG criteria of Austrian companies. However, efforts are being made to increase the relevance, consistency and comparability of ESG-relevant data.

In addition, a trend towards binding law concerning ESG criteria can be observed on a national as well as international level.

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In its consultation guide on how to deal with sustainability risks, the Austrian Financial Market Authority (*Finanzmarktaufsichtsbehörde* – **FMA**) approached a definition of ESG by further specifying the following criteria:

Environmental

- Climate protection
- Adjustment to climate change
- Protection of biodiversity and healthy ecosystems
- Sustainable use and protection of resources
- Transition to a circular economy

Social

- Observance of recognised labour law standards
- Observance of employee safety and health protection
- Application of the same requirements to entities in the supply chain
- Appropriate remuneration, fair working conditions, diversity, training and development opportunities

Governance

- Tax honesty
- Measures for prevention of corruption
- Sustainability management by the management board
- Remuneration dependent on sustainable business activities
- Facilitation of whistle blowing
- Data protection

The management is responsible for identifying where addressing ESG issues is either required under applicable laws and regulations or appropriate under best practice considerations as part of their general obligation to ensure compliance of the company and to pursue the company's best interests.

In addition, the supervisory board is responsible for monitoring the conduct of the management and ensuring compliance with overall business strategies. The monitoring obligations also include compliance with ESG related laws and company guidelines as well as the management's approach to identifying and handling ESG risks. The supervisory board is further required to include long-term sustainability goals into the management's remuneration system and to take these goals into consideration when selecting board members.

The recently published proposal by the European Commission for a new directive on corporate sustainability due diligence takes this responsibility one step further and holds directors (meaning any member of the administrative, management or supervisory bodies) directly accountable for setting up and overseeing the corporate sustainability due diligence.

The directive proposal further defines the scope of the director's duty of care regarding sustainability matters when fulfilling his/her duty to act in the best interest.

The proposal also commits all member states to ensure their laws governing the breach of director's duties apply to this provision.

Clear trend: due diligence and risk prevention obligations are rising

ESG criteria impact various business areas and dealings. First and foremost, companies must comply with all applicable national and EU regulations. Currently, this is particularly important for the disclosure of ESG criteria in non-financial reporting and the consideration of ESG criteria in the remuneration of board members. Regarding reporting, the transparency requirements are becoming increasingly tighter and market expectations more sophisticated. Not only are companies required to publish a sustainability report on how they deal with ESG issues, but also institutional investors and asset managers must monitor the companies in which they have invested regarding certain ESG criteria and must publish a corresponding policy.

In addition, the proposal for a new EU directive on corporate sustainability mentioned above creates further obligations regarding human rights as well as environmental impacts. The directive proposal commits all member states to implement due diligence and risk prevention obligations laid out by the proposal in detail, both in the relevant companies and their "value chains". Further, civil liability for companies is also included in the proposal, based not only on breaches of the duty of care set forth in the directive proposal but also for a failure to take appropriate preventive measures.

> In the near future, we expect to see liability for ESG compliance and risk management tightened in all EU member states.

ESG criteria can also influence the valuation of companies and have a negative impact on their asset, financial and earnings position. Neglecting to manage sustainable activities and ESG criteria may not only result in sustainability risks, it may also entail reputational risks and potential litigation, especially arising from shareholder activism. Even doing business with a company with ESG risks can have a negative impact on a company or involved investors. Therefore, investors, asset managers and other stakeholders are increasingly conducting comprehensive due diligence with respect to ESG criteria before entering a transaction or a legal relationship with relevant third parties.

For the same reasons, ESG criteria impact M&A transactions and should be taken into consideration throughout the entire transaction process. Especially during legal due diligence, ESG-related risks associated with the target company should be assessed, and any identified instances of non-compliance should ideally be rectified before completion of the transaction. ESG compliance and/or the remediation of (high) risks based on non-compliance may also be a condition precedent to completion. To the extent that remediation is not possible, the relevant risks need to be appropriately reflected in the valuation of the target company or the transaction documents (e.g. as an indemnity).

Handling ESG with our support

In the fast-evolving, complex area of corporate sustainability which is governed by multiple national as well as European regulations and recommendations, we are able to assist you with the necessary knowledge and expertise in all relevant legal areas. We follow national and international developments closely and are prepared to assist you with all corporate and governance matters and M&A transactions, as well as matters in banking and finance, real estate and regulatory issues related to ESG criteria and corporate sustainability.

We have the expertise to support you in successfully implementing and managing an ESG strategy that is appropriate for your business/industry as well as navigating ESG-related risks that may occur in your company, its value chain and business activities.

Our expertise includes

- assistance with non-financial sustainability reporting requirements
- advising the management and supervisory board as to their respective ESG obligations
- determining ESG-related risks within the company as well as its value chain by conducting corporate sustainability due diligence
- support with sustainability risk prevention and risk management
- assistance in managing ESG-related risks in M&A transactions by considering specific environmental, social and governance aspects within the legal due diligence of the target company as well as by reflecting any existing ESG-related risks in the transaction documents
- advice and support on all legal aspects and different types of sustainable/ green financing and investments as well as green banking
- and sustainability in real estate

About WOLF THEISS

Wolf Theiss is one of the leading European law firms in Central, Eastern and South-Eastern Europe with a focus on international business law. With over 360 lawyers in 13 countries, over 80% of the firm's work involves cross-border representation of international clients. Combining expertise in law and business, Wolf Theiss develops innovative solutions that integrate legal, financial and business know-how.

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