ESG & DUE DILIGENCE: WHY DOES IS MATTER?

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Introduction

The term ESG was popularly first used in a 2004 report titled "Who Cares Wins", which was a joint initiative of financial institutions at the invitation of the United Nations. In less than 20 years, the ESG movement has grown from a corporate social responsibility initiative launched by the United Nations into a global phenomenon.[1] More specifically, the growing awareness of global sustainability issues, including corporate governance, social injustice, and climate change, is one of the primary forces behind the expansion of ESG as a public policy consideration. As investors and the general public have become increasingly conscious of the environmental and social impacts of business activities, there has been a corresponding rise in the demand for investment strategies that prioritize these factors alongside traditional financial metrics.

This shift in investor and public sentiment has led to a significant increase in the adoption of ESG principles by corporations, financial institutions, and policymakers around the world. The ESG framework has become a widely recognized approach for evaluating the sustainability and ethical impact of investment decisions, with a growing number of investors incorporating ESG considerations into their investment strategies.

The rapid growth of the ESG movement reflects the growing recognition that long-term business success and societal well-being are inextricably linked. By integrating environmental, social, and governance factors into decision-making processes, organizations can better manage risks, identify new opportunities, and contribute to the creation of a more sustainable and equitable global economy.

To this end, in an effort to reduce risk and promote sustainability, investors and businesses are increasingly realizing how important it is to include environmental, social, and governance (ESG) considerations when making decisions. As a result, advances in regulation have been a major factor in the growth of ESG investing and reporting. To make sure that investors and businesses take into account the environmental and social implications of their operations, policymakers over around the world are enacting mandatory ESG reporting and disclosure standards. For instance, the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainable Finance

[1] www.mayerbrown.com/en/insights/publications/2023/04/the-rise-and-stall-of-esg-a-brief-history-and-a-hopeful-look-ahead ; www.thecorporategovernanceinstitute.com/insights/lexicon/what-is-the-history-of-esg/ ; www.msci.com/esg-101-what-is-esg/evolution-of-esg-investing

Disclosure Regulation (SFDR) of the European Union are influencing ESG reporting requirements and promoting greater transparency.[2]

Environmental – Social - Governance (ESG)

The ESG acronym stands for Environmental, Social and Governance and refers to the set of organizational practices that consider in their context environmental, social, and governance factors, with a view to achieving long-term sustainability.[3] The proportionality of these three aspects in business management has the purpose of analyzing the operations in a holistic way, not limited merely to economic and financial aspects.[4] In this sense, economic, transparency and ethical precepts are articulated, seeking to ensure the competitiveness and the perdurability of a company.[5]

Propelled by climate change and social injustice, ESG disclosures are popularizing and are driving for building a more transparent and responsible investments and supply chains. As many unsustainable and unethical activities are concealed in the upstream supply chain[6] , it demands ESG reporting from suppliers. Against this background, buyers conduct due diligence (DD) to assess, manage, and report the ESG practices of the upstream suppliers.[7]

Due diligence is a comprehensive assessment that goes beyond a simple audit. It involves examining core business areas like financials (financial statements, cash flows), people (workforce dynamics and culture), legal aspects (compliance audits, risk evaluation), and operations (facilities, equipment).[8]

The term "due diligence" originated in the United States, where it was referred to as "reasonable investigation" in the Securities Act of 1933. This act required securities brokers to provide prospectuses with information about companies, allowing investors to perform due diligence before investing.[9]

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[2] www.wealthbriefing.com/html/article.php?id=197951
[3] www.researchgate.net/publication/325514523_Environmental_Social_and_Governance_ESG_and_Investment_Decision_in_Bangladesh
[4] www.researchgate.net/publication/342111668_Does_environmental_social_and_governance_performance_influence_economic_performance
[5] www.researchgate.net/publication/341636755_Corporate_Sustainability_Reporting_and_Financial_Performance
[6] The upstream supply chain refers to the activities and processes involved in sourcing and acquiring raw materials and other inputs before the manufacturing or production stage
[7] www.exiger.com/perspectives/esg-due-diligence-process/ ; www.linkedin.com/pulse/back-basics-what-supply-chain-due-diligence-lrqa-sustainability ; www.hinshawlaw.com/newsroom-updates-esg-business-insights-supply-chains.html
[8] www.merriam-webster.com/dictionary/due%20diligence ; https://dictionary.cambridge.org/us/dictionary/english/due-diligence ; www.lexisnexis.com/en-us/professional/risk-management/glossary/due-diligence.page
[9] www.perkbox.com/uk/resources/blog/everything-you-need-to-know-about-due-diligence ; https://thenonprofittimes.com/npt_articles/what-due-diligence-really-means-or-not/

Over time, the term "due diligence" evolved from referring to an investigative process to describing the process itself. It became associated not only with public securities offerings, but also with private mergers, acquisitions, and other business transactions [10]

Today, due diligence is a fundamental practice across many industries, used to evaluate risks and inform decisions in mergers, investments, partnerships, and other business dealings.[11] It is intrinsically linked to legal advances, namely Regulations regarding anti-corruption and, anti-money laundering (AML) that require looking into sensitive media, sanctions, regulatory breaches, and the overall risks of corruption activity. When it comes to ESG Due Diligence, corruption remains important factor with many similar risk checks, however with a targeted slant towards ESG issues like the Environment, health and safety, human rights and governance.

The purpose of this paper is to establish the intersection between ESG and Due Diligence (Chapter 1) by analyzing the ESG Regulatory Framework (1.1), the sources and data (1.2) as well as the challenges and limitations (1.3). Furthermore, it will examine relevant case law (Chapter 2) and will highlight the significance of ESG in the business industry (Chapter 3). Finally, it will provide some general conclusive remarks.

[10]https://en.wikipedia.org/wiki/Due_diligence
[11]www.theforage.com/blog/skills/due-diligence ; https://en.wikipedia.org/wiki/Due_diligence

The intersection between ESG and Due Diligence

The correlation between Environmental, Social, and Governance (ESG) factors and due diligence processes is of paramount importance in today's business landscape. ESG due diligence entails a comprehensive analysis of a company's ESG policies, practices, and risk exposures. This rigorous evaluation informs ethical and prudent investment decisions, mergers, and acquisitions.

However, the scope of ESG due diligence extends beyond the confines of a single entity. It is a crucial mechanism for ensuring that ethical and sustainable practices permeate throughout a company's supply chain ecosystem. This proactive approach involves assessing suppliers, manufacturers, and distributors to identify and mitigate potential environmental, social, and governance risks.

Furthermore, ESG due diligence assesses the compliance of targets with national and international regulations, and it highlights the environmental, social, and governance status of a company[12], with the main purpose of addressing potential controversial conduct or failure to adhere to responsible ESG programs. When carried out correctly, ESG due diligence provides vital information and insights about the worth and performance of a business's ESG commitments, which eventually affects its operational, financial, and reputational aspects.[13]

Regarding the environmental aspect, companies have to ensure that on the one hand, hazardous materials and pollutants are properly found, handled, permitted and mitigated, and on the other hand, natural resources such as waters, wetlands, endangered species etc. are properly identified, and mitigated.[14]

Regarding the social aspect, businesses are expected to comply with internationally and regionally recognized norms to ensure they drive a sustainable change that has a positive impact on workers, communities and society.[15]

Regarding the governance aspect, companies are required to manage their business in a responsible manner. Corporate governance involves interactions with various stakeholders like

[12] www2.deloitte.com/ce/en/pages/real-estate/articles/ESG-due-diligence-on-the-rise.html
[13] https://esg.conservice.com/esg-solutions/benefits-of-getting-your-esg-due-diligence-right/
[14] www.fema.gov/sites/default/files/2020-07/hazardous-materials-incidents.pdf
[15] https://link.springer.com/article/10.1007/s10551-023-05417-w ; www.keltonglobal.com/perspectives/social-norms-in-culture-and-business/ ; www.fsg.org/blog/power-companies-influence-social-norms/

competitors, suppliers, shareholders, and governments. It encompasses factors such as leadership, executive pay, audits, internal controls, and shareholder rights.[16]

ESG Regulatory Framework

As ESG has gained ground in recent years, different stakeholders around the globe have taken action and created relevant legislation. The European Union, for instance, has issued a number of regulations regarding ESG considerations. The most important piece of legislation is the Corporate Sustainability Reporting Directive (CSRD), which aims to enhance corporate transparency and sustainability reporting since January 05, 2023. More specifically, the Directive requires EU businesses to report on environmental, social, and governance (ESG) aspects of their operations and it introduces European Sustainability Reporting Standards (ESRS), in order to align with international standards. As a result, companies subject to the CSRD must report according to ESRS, ensuring harmonized reporting across the EU.

Another important piece of legislation is the Corporate Sustainability Due Diligence Directive (CSDDD). It is proposed by the European Commission to ensure that companies identify, prevent, mitigate, and account for negative human rights and environmental impacts in their operations and value chains. The directive aims to foster sustainable and responsible corporate behavior by obliging companies to conduct due diligence not only on their own operations, but also on the subsidiaries and entities in their value chains. However, despite its importance, the vote of the Directive had been postponed for a long time over criticism that it would be too burdensome, leaving questions about next steps and whether financial institutions will be included. Both Germany and Italy stated they would abstain from a vote, while other EU countries had also voiced concerns about the rule, leading to apprehensions that the vote would fall short of the 15 countries needed, representing at least 65% of the EU population required for legislation to pass. The CSDDD was finally adopted on Apr 24, 2024 by the European Parliament after several delays and alterations. EU Member States have two years to implement the Directive into their national laws. Compliance with the CSDDD is crucial as failure to adhere to it could result in fines of up to 5% of a company's global turnover.

[16] www.diligent.com/resources/blog/the-role-of-the-board-of-directors-in-corporate-governance ; https://corpgov.law.harvard.edu/2016/09/08/principles-of-corporate-governance/ ; https://boardable.com/resources/governance-committee-structure-roles-responsibilities/

Sources and data

ESG-related information can be found in a variety of sources, each offering unique insights and perspectives. Governmental lists and databases often maintain comprehensive data on emissions, environmental compliance, and labor practices. Media reports provide valuable real-time information on ESG-related developments, trends, and best practices. Specialized tools and methodologies can be used to measure and analyze the carbon footprint of organizations, products, or services, shedding light on environmental impact. Health and safety inspections can uncover important social and governance-related insights, such as workplace safety and worker well-being. Additionally, labor unions often have a deep understanding of labor-related issues, such as fair wages, working conditions, and employee rights, which are crucial ESG considerations. By leveraging this diverse range of sources, organizations can gain a more holistic and well-rounded understanding of the ESG landscape, enabling them to make informed decisions and drive meaningful progress.[17]

However, establishing standardized and universally accepted procedures for evaluating ESG factors on a global scale still remains an imposing challenge. Achieving consistency and comparability in ESG assessments necessitates a concerted effort to develop robust, transparent, and widely adopted international standards that can facilitate accurate cross-border analyses and informed decision-making processes. Overcoming this obstacle is crucial for fostering sustainable business practices, responsible investments, and effective risk management strategies in an increasingly interconnected global economy.

[17] https://corporatefinanceinstitute.com/resources/esg/esg-disclosure/ ; https://corpgov.law.harvard.edu/2020/06/22/the-rise-of-standardized-esg-disclosure-frameworks-in-the-united-states/

Challenges and limitations[18]

When the stakeholders try to comply with the ESG requirements set in place, they may face certain challenges and limitations. For instance, in terms of ESG reporting, stakeholders may face challenges when attempting to measure, quantify, and report on their sustainability performance. This challenge involves the need to establish a robust data collection process to demonstrate performance and build a reputation as an ESG-compliant company.

When it comes to data collection, data collection poses a significant roadblock in corporate sustainability reporting due to issues like data fragmentation, inefficient workflows, and the complexity of data across environmental, social, and governance dimensions. Usually, efficient data collection is hindered by manual processes, data silos, and the diverse nature of ESG data requirements within organizations. Collecting data from multiple sources, ensuring data quality, and consolidating it into a standardized format can be a daunting task, especially for large organizations with complex operations.

Furthermore, the evolving nature of ESG regulations adds another layer of complexity to reporting efforts as organizations need to stay abreast of changing standards and frameworks. Keeping up with the latest developments, understanding the nuances of different reporting frameworks, and aligning their reporting practices accordingly can be a significant challenge, especially for organizations with limited resources or expertise in this area.

In addition, the presence of multiple ESG frameworks contributes to low comparability between reports, making it challenging for investors who demand consistency in reporting. On top of that, it is reasonable that organizations struggle with understanding, managing, and quantifying ESG risks effectively, which are crucial for improving ESG plans and addressing material issues.[19]

Identifying and assessing ESG risks, such as climate change, human rights violations, or governance failures, can be complex and require specialized expertise. Quantifying the potential financial and reputational impacts of these risks is also a significant challenge, as they often involve long-term and systemic factors that are difficult to measure and predict.

[18] https://novisto.com/challenges-of-esg-reporting-and-strategies/ ; www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf
[19] www.wolterskluwer.com/en/expert-insights/the-5-biggest-hurdles-to-effective-esg-reporting ; https://novisto.com/challenges-of-esg-reporting-and-strategies/ ; https://sparkle.consulting/7-key-challenges-esg-reporting-challenge/ ; www.workiva.com/blog/high-stakes-and-critical-stakeholders-esg

Overcoming these challenges requires a concerted effort from organizations, regulators, and industry bodies to streamline data collection processes, promote standardization and harmonization of reporting frameworks, and enhance risk management capabilities. Collaboration, knowledge sharing, and continuous improvement are essential for organizations to navigate the complexities of ESG compliance and drive meaningful progress towards sustainability goals.

Once the legal framework surrounding ESG factors becomes more well-defined, along with clarification on the sources of data, challenges, and limitations involved, it will be prudent to examine real-world applications through relevant case law. The cases discussed below illustrate the critical importance of conducting thorough due diligence and comprehending a company's pre-existing obligations in order to accurately assess its future prospects.

Relevant case law

The legal landscape surrounding ESG issues is rapidly changing, with some high-profile court decisions setting significant precedents. These cases have addressed a wide range of ESG issues, including climate change and emissions reduction, corporate control of material ESG risks, and diversity and inclusion procedures. Companies must be informed about these legal developments, since they can have a substantial impact on how organizations approach ESG strategy, governance, and disclosure. Understanding significant ESG-related court rulings can help businesses reduce legal risks and align their activities with evolving corporate responsibility norms.

Milieudefensie v. Royal Dutch Shell plc[20]

On April 5, 2019, the environmental group Milieudefensie/Friends of the Earth Netherlands and co-plaintiffs presented Shell with a court summons alleging that the company's contributions to climate change violate its duty of care under Dutch law and human rights duties. The complaint was filed at the Hague District Court. Other non-governmental organizations (NGOs) (ActionAid NL, Both ENDS, Fossielvrij NL, Greenpeace NL, Young Friends of the Earth NL, Waddenvereniging) and more than 17’000 civilians were also plaintiffs. The plaintiffs sought a court order requiring Shell to cut their CO2 emissions by 45% by 2030 compared to its 2010 levels, and to zero by 2050 in accordance with the Paris Climate Agreement.

This lawsuit draws on the historic Urgenda decision, which determined that the Dutch government's weak response to climate change violated its duty of care to its residents. Plaintiffs in the lawsuit against Shell extend this argument to private firms, claiming that given the Paris Agreement's goals and scientific evidence of the dangers of climate change, Shell owes a duty of care to minimize its greenhouse gas emissions. Plaintiffs base their duty of care claim on Article 6:162 of the Dutch Civil Code, which is supported by Articles 2 and 8 of the European Convention on Human Rights (ECHR), which provide the right to life (Article 2) and the right to a private life, family life, home, and communication (Article 8). Plaintiffs' case illustrates how Shell's extensive knowledge of climate change, inaccurate representations about climate change, and insufficient effort to mitigate climate change all contribute to a conclusion of Shell's unlawful endangerment of Dutch citizens and conduct constituting dangerous negligence.

[20]https://climatecasechart.com/non-us-case/milieudefensie-et-al-v-royal-dutch-shell-plc/

On May 26, 2021, the Hague District Court ordered Shell to reduce its emissions by 45% by 2030, relative to 2019, across all activities including both its own emissions and end-use emissions. The Court wrote that it "orders [Royal Dutch Shell ("RDS")], both directly and via the companies and legal entities it commonly includes in its consolidated annual accounts and with which it jointly forms the Shell group, to limit or cause to be limited the aggregate annual volume of all CO2 emissions into the atmosphere (Scope 1, 2 and 3) due to the business operations and sold energy-carrying products of the Shell group to such an extent that this volume will have reduced by at least net 45% at end 2030, relative to 2019 levels." In other words, the Court ordered Shell to reduce emissions by a net of 45%, including emissions from its own activities and emissions from the usage of the oil it produces. The Court made its verdict temporarily enforceable, which means Shell will have to achieve its reduction requirements even while the case is appealed.

Shell contended that the EU Emissions Trading System (ETS) overruled any additional emissions reductions mandated by the court, and that the reduction duty would be meaningless. However, the court dismissed these claims. The ETS only covers a portion of the emissions in Europe that Shell is accountable for, and it excludes emissions from sources outside the EU, hence the Court rejected the ETS argument. However, Shell is required by the standard of care to cut all global emissions that will negatively impact Dutch citizens. Further, the Court rejected the claim that a reduction obligation would have no effect because such emissions would be substituted by other companies. The Court wrote that it remains to be seen whether other companies will substitute Shell production in the face of Paris Agreement obligations and noted the causal relationship between production limitation and emissions reduction. The Court wrote, "The court acknowledges that RDS cannot solve this global problem on its own. However, this does not absolve RDS of its individual partial responsibility to do its part regarding the emissions of the Shell group, which it can control and influence."

On July 20, 2022, Shell appealed the decision and the case is still pending.

Marchand v. Barnhill[21]

Marchand v. Barnhill was a historic Delaware Supreme Court ruling in 2019 that enabled a shareholder derivative litigation to be filed against Blue Bell Creameries' board of directors. The issue occurred following a listeria epidemic in Blue Bell's ice cream products, which resulted in three deaths, a huge product recall, and significant financial losses for the company. Shareholder Jack Marchand sued the board, claiming they violated their fiduciary duties by failing to install adequate oversight and monitoring mechanisms for food safety hazards.

The Delaware Supreme Court ruled that directors could be held accountable under the Caremark doctrine if they failed to make a good faith effort to develop a board-level food safety monitoring system. The court also determined that the complaint adequately asserted that the board had no committee managing food safety, did not regularly discuss food safety at board meetings, and lacked a mechanism for management to communicate food safety issues to the board. Finally, the court rejected the directors' argument that compliance with some food safety regulations was sufficient, stating the "mundane reality" of regulation does not foreclose the possibility of director liability for lack of oversight.

This case was significant in expanding the scope of director oversight duties under Caremark to include mission-critical risks like food safety, setting an important precedent for ESG-related litigation.

[21]https://law.justia.com/cases/delaware/supreme-court/2019/533-2018.html
https://www.juscorpus.com/marchand-v-barnhill/
https://casetext.com/case/marchand-v-barnhill-1/analysis?citingPage=1&sort=relevance
https://www.quimbee.com/cases/marchand-v-barnhill
https://law.justia.com/cases/delaware/supreme-court/2019/533-2018.html

The significance of ESG for the business industry

The significance of ESG for businesses is multifaceted. Businesses that prioritize ESG initiatives can gain a competitive advantage, attract more investors and lenders, improve their financial performance, build customer loyalty, and ensure regulatory and stakeholder compliance.

A Harvard Business Review[22] suggests that an ESG focus can help management reduce capital costs and improve the firm's valuation. This is because companies that demonstrate better ESG performance will have access to greater capital pools as more investors choose to participate in them. According to the study, this does not only happen in equity markets, but also in loan markets where some banks are also tying loan interest rates to ESG performance.

Second, positive action and transparency on ESG matters can help companies protect their valuations as more global regulators and governments mandate ESG disclosures. For example, after the European Union announced broader disclosure requirements, the stock market reacted positively to firms with strong ESG disclosure and negatively to those with weak disclosure. In addition, it is not only developed countries that are adopting and enforcing disclosure regulations; so are many emerging markets, including South Africa, Brazil, India, and China.

Furthermore, efforts to ensure sustainable practices will help maintain shareholder satisfaction with board leadership. In other words, as more investors with more assets under management commit to ESG investing, they will have more voting power to effect changes. Shareholders in a growing number of companies have already put forward proposals to improve gender diversity on the boards, garnering a level of support that was unimaginable even 10 years ago.

Finally and most importantly, ESG practices are part of long-term strategy, and every company needs investors who support management's vision and plans for the future.

[22] https://hbr.org/2020/09/social-impact-efforts-that-create-real-value

Concluding remarks

The intersection between ESG (Environmental, Social, and Governance) and due diligence is crucial for businesses to assess and mitigate potential risks, ensure compliance with regulations, and drive sustainable practices. As the ESG regulatory landscape continues to evolve, with initiatives like the EU's Corporate Sustainability Reporting Directive (CSRD) and proposed Corporate Sustainability Due Diligence Directive (CSDDD), companies must stay vigilant and adapt their due diligence processes accordingly.

Conducting comprehensive ESG due diligence not only helps organizations identify and address environmental, social, and governance risks within their operations and supply chains, but also provides valuable insights into their overall sustainability performance. This information can inform ethical investment decisions, mergers and acquisitions, and stakeholder engagement strategies.

However, implementing effective ESG due diligence practices can be challenging due to factors such as data fragmentation, evolving regulatory requirements, and the need for robust data collection and reporting processes. Overcoming these challenges requires a concerted effort from businesses, policymakers, and other stakeholders to establish standardized frameworks, streamline data management, and foster transparency.

Landmark court cases, such as Milieudefensie v. Royal Dutch Shell plc and Marchand v. Barnhill, have set precedents for holding companies accountable for their ESG practices and reinforcing the importance of board-level oversight and risk management related to material ESG issues.

Ultimately, embracing ESG principles and integrating them into due diligence processes is not only a matter of compliance, but also a strategic imperative for businesses. Companies that prioritize ESG initiatives can gain a competitive advantage, attract investors and lenders, improve financial performance, build customer loyalty, and ensure regulatory and stakeholder compliance. As the global business landscape continues to evolve, those that fail to prioritize ESG risk falling behind their more sustainable counterparts.

Navigating the complex landscape of ESG compliance can be daunting. Fortunately, Global Risk Profile's comprehensive Country ESG Risk Indexes and insightful ESG Screening Reports empower businesses to assess their ESG compliance effectively. With these powerful tools at your disposal, you can confidently chart a course towards sustainable growth while mitigating risks and seizing opportunities in the rapidly evolving ESG landscape. Embrace responsible business practices today, and future-proof your organization with Global Risk Profile.