Insurability of ESG risks in the context of M&A transactions

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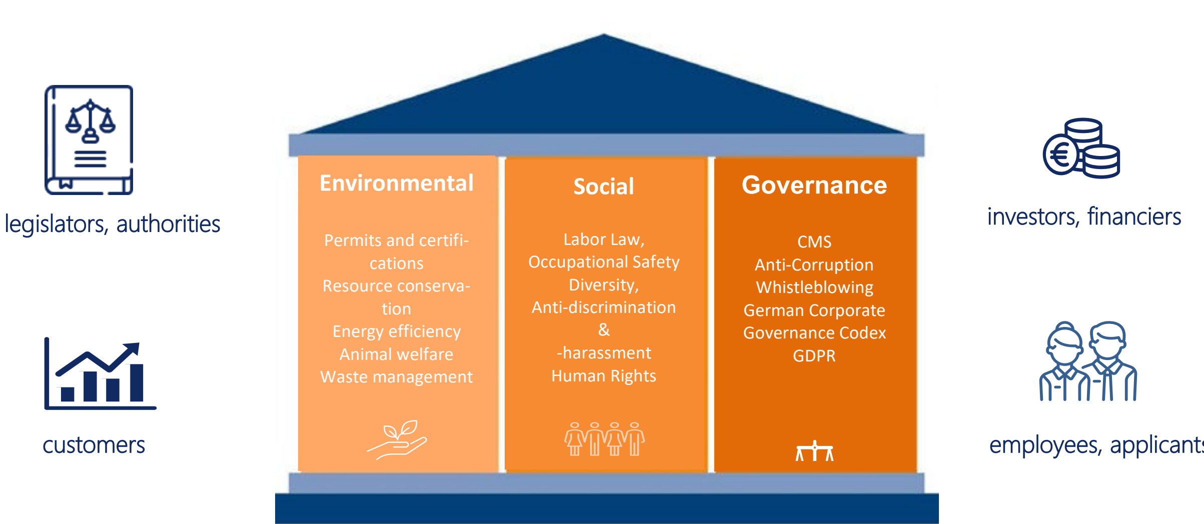
1. Introduction

Environmental, social and governance (ESG) issues have not only become more important for the corporate governance itself in recent years. They have also gained significant relevance in the context of M&A transactions. Private equity investors in particular are more than ever required to take ESG criteria into account in their investment strategy and its implementation for fundraising as well as for investment financing purposes. However, both the assessment of ESG-related risks and the handling of these risks have been difficult up to now. This is in particular due to the fact that many ESG aspects have not yet been the subject of binding legal regulations (hard law) but are instead limited to non-binding and as yet little standardized guidelines and requirements (soft law).

Corresponding to these uncertainties, the handling of ESG-related risks also typically poses challenges for the transaction parties. A consideration of potential risks in the purchase price is usually not possible. Therefore, risk allocation is often reflected in the system of warranties and indemnities in the SPA. In this respect, the question arises to what extent the buyer's claims for damages can be covered by transaction insurance.



2. Importance of ESG criteria in the M&A context

ESG criteria are of major importance in the M&A context from two perspectives. On the one hand, aspects of the (future) management of the target company must be taken into account in the context of a due diligence (see 2.1). Deficits with regard to ESG issues would in this respect be reflected on a post-closing to-do list and thus – at least indirectly – have an impact on the target company's enterprise valuation by the bidder. On the other hand, ESG criteria also have an impact on the execution and feasibility of M&A transactions per se (see 2.2).

2.1 Relevance of ESG criteria for corporate management

Corporate management is increasingly influenced by ESG criteria. Insofar as ESG aspects are already the subject of binding legal regulations, the management of the target company must ensure both compliance with the requirements by the target company itself ("*Legalitätspflicht*") and – by means of corresponding organizational measures – compliance with the requirements by the company's employees ("*Legalitätskontrollpflicht*"). A violation of these management duties can lead to claims for damages against the managers acting in breach of duty of care according to the relevant provisions of German company law (sec. 93 para. 2 German Stock Corporation Act (AktG), sec. 43 para. 2 German Limited Liability Companies Act (GmbHG).

Beyond these basic legal duties, executive managers are also well advised to take an in-depth look at soft law in the area of ESG. This is not only true in view of the tendency for soft law to gradually evolve into hard law, and executive managers can consequently position the target company well for the future by taking soft law into account. Rather, the growing importance of ESG also means that ESG deficits can develop into a threat to the company's reputation, the establishment, maintenance, and protection of which constitutes a liability-bound managerial duty[1]. ESG criteria are therefore increasingly being understood as a component of standard compliance management systems (CMS).

As a result of a takeover of the target company – with a view to the group-wide responsibility of executive managers – any ESG deficits also become the direct responsibility of the executive management of the acquirer. In the M&A context, it is therefore particularly important whether and how the target company can be integrated into the CMS of the acquirer and what costs are associated with this. An insufficient review of ESG risks can result in personal liability of the executive management of the acquiring company if these risks materialize and lead to a measurable financial loss on the part of the acquirer.

2.2 Relevance of ESG criteria from the perspective of the transaction parties

ESG criteria are also increasingly playing a direct role for M&A transactions and the transaction parties involved. This may be mainly due to the EU Sustainable Finance Disclosure Regulation[2], which has been in force since 10 March 2021, and with which the EU – in view of the Paris Agreement – aims to channel end-investor capital into sustainable investments by requiring certain financial market participants, namely professional investors, and financial advisors to disclose specific information about their approaches to integrating sustainability risks and considering adverse sustainability impacts, so that end-investors can make informed investment decisions on this basis.

Against this backdrop, an environment has developed in which credit institutions and other professional investors link the granting of financing to the fulfilment of ESG criteria. The granting of acquisition financing is more and more made dependent on the target company operating sustainably and fulfilling certain internally defined ESG criteria.[3] Meanwhile a specific market for "sustainability-linked" financing has evolved, in which the funds do not have to be used directly for specific sustainable projects, but the award of funds is linked to certain sustainability criteria.[4]

Irrespective of this, the consideration of sustainability criteria in the investment decisions of private equity funds is not an entirely new development; rather, private equity funds have always been concerned with sustainability aspects in the selection of their target companies.[5] This can also be attributed to the fact that companies that take ESG criteria into account often turn out to be more successful.[6]

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[1] Cf. Fleischer in: Münch. Kommentar, GmbHG, 4th ed. 2023, § 43 recital 33 f.

[2] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosure requirements in the financial services sector.

[3] Schröder/Bourgeois/Ilyevich, M&A Review No. 6 2021, p. 199.

[4] Reudelhuber/Baldwin, ESG 2022, p. 69 f.

[5] Cf. Fortt/Huber/Davies, CCZ 2022, p. 191.

[6] Cf. Bünning, BB 2021, p. 235, 237.

Moreover, many investors simply and increasingly expect asset-managing private equity houses to take sustainability criteria into account, so that internal guidelines on how to deal with ESG criteria have long been a market standard for private equity funds.[7] The currently increasing importance of sustainability aspects has also led to the establishment of so-called impact funds (or funds of so-called impact investing), which go one step further and do not see the consideration of ESG criteria within the framework of the corset of the maximization of returns, but rather view the pursuit of sustainability aspects effectively as an end in itself and want to make a measurable contribution to the achievement of defined sustainability goals through their investments.[8]

In view of this market environment, potential sellers are also encouraged to pro-actively position their companies in an ESG-compliant manner in order to expand the circle of potential buyers and to be able to achieve higher valuations.[9]

3. Review and assessment of ESG risks as part of the due diligence process

In view of the enormous economic importance of ESG criteria, the review of ESG risks has become part of the standard scope of due diligence for the implementation of a corporate transaction. When looking at the individual ESG criteria, it becomes clear that many have a legal background and can therefore be covered by the legal due diligence. This applies in particular to the area of "social", which is essentially about the topic of "HR compliance", i.e. the review of compliance with individual and collective labor law as well as social security law provisions. In the context of ESG due diligence, greater attention is also paid to compliance with labor protection regulations, which is not a focus of ordinary legal due diligence.

In the area of "governance", the focus is on classic compliance issues, such as compliance with laws on the prevention of bribery, corruption, and money laundering, as well as the more recent regulations on supply chain due diligence and whistleblowing. In particular, this involves reviewing whether the target company has established a compliance management system (CMS) and other organizational structures that adequately cover these topics. In a digitalized world, the handling of personal data also plays a central role, whereby compliance with applicable data protection laws, in particular the EU General Data Protection Regulation, is part of the standard legal review, whereas the ESG due diligence goes beyond the hard law framework and covers e.g. questions of "digital ethics" and corporate digital responsibility are also reviewed.[10]

In the past, the area of "environmental" risks was partly covered by the legal (especially environmental permits and authorizations) or environmental due diligence (especially environmental impacts emanating from the target company). The scope of ESG due diligence goes beyond these classic environmental topics, especially since the assessment also takes into account the target company's "carbon footprint" and its efforts with regard to climate change and resource conservation in general. Since the classic legal or environmental due diligence may not adequately cover certain ESG sub-areas or may have a different focus on the review, it is therefore advisable to conduct a separate and specific ESG due diligence for ESG-driven transactions, which is increasingly being offered in the consulting market.[11]

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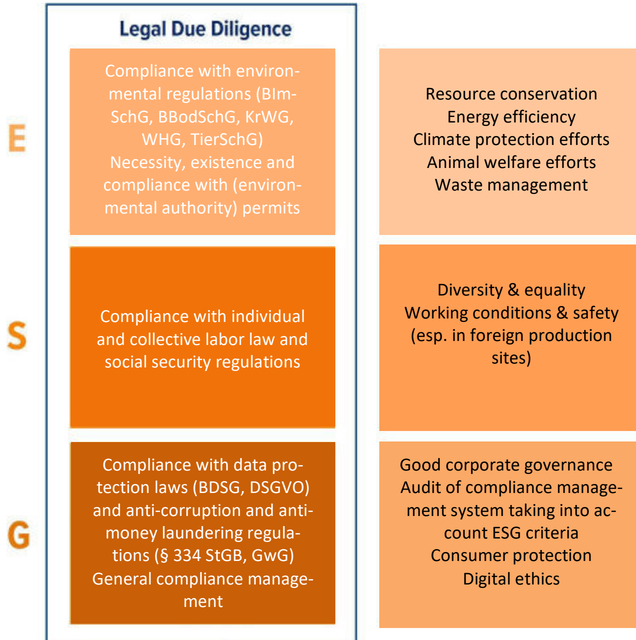
[7] Eberius/Euhus in: Pöllath/Rodin/Wewel: Private Equity and Venture Capital Fonds, 1st ed. 2018, § 24 recitals 2, 5; Schröder/Bourgeois/Ilyevich, M&A Review No. 6, 2021, p. 199.
[8] Nagel/Lorenz/El-Qalqili, BKR 2022, p. 360, 361.
[9] Cf. Bain & Company Global M&A Report 2022, p. 24.
[10] Nemat/Panzer-Heemeier/Meckenstock, ESG 2022, p. 104, 107.
[11] Louven, BB 2022, p. 2178, 2182.



4. Dealing with ESG findings and risks in the transaction.

Depending on how stringent the acquirer's internal ESG policies are, the identification of significant ESG risks or deficiencies in the due diligence may, under certain circumstances, mean the termination of negotiations on the implementation of the transaction or a significant adjustment of the commercial parameters. However, the identification of possible “deal breakers” is rare in practice. Often, ESG-sensitive prospective buyers will already be able to see in the course of a preliminary assessment, for example on the basis of publicly available information, whether the target company in principle takes ESG criteria into account.

If certain ESG deficits or risks are identified, which do not prevent the transaction from being carried out, it must be considered whether the realization of the ESG risk can be prevented, or the risk can be allocated to the seller. It is clear that any ESG deficits that can be remedied, such as organizational deficits, must be remedied for the future. In this respect, post-closing to-do lists are drawn up on the basis of the due diligence results, which also include any ESG deficits.[12] In this context, it may be relevant for the implementation of the transaction which costs are associated with the elimination of ESG deficits, for example through the establishment and expansion of the compliance management system or the data protection organization. The prospective buyer could try to include such costs in the negotiation of the purchase price. It would also be conceivable – provided that there is a certain period of time between the signing and the closing of the transaction as planned and agreed – to include a covenant of the seller to remedy certain ESG deficits in the sale and purchase agreement.

In contrast, ESG risks resulting from past facts or circumstances usually cannot be reflected in the purchase price – often because their financial impact cannot be predicted or quantified.[13] Therefore, the only remaining option is to allocate the risk of the realization of ESG deficits to the seller by agreeing warranties and indemnities. In this context, it must be kept in mind that the buyer – at least according to

[12] Cf. Louven, BB 2022, p. 2178, 2189.
[13] Cf. Louven, BB 2022, p. 2178, 2189.

the usual contractual regulations – cannot derive a claim from the breach of a warranty if he was already aware of the circumstance giving rise to the incorrectness of the warranty at the time of the conclusion of the sale and purchase agreement.[14] Warranties therefore only protect the buyer against risks that are not already sufficiently concrete. If certain risks are already known and their realization may even be expected, the buyer can only try to agree with the seller on an indemnification obligation with regard to the concrete risk.[15]

In addition, there are basically no limits to creativity in the design and formulation of comprehensive warranty catalogues, also with regard to ESG risks.[16] Conventional – at least buyer-friendly – warranty catalogues in business purchase agreements already cover many ESG areas. Therefore, in the case of certain ESG criteria – especially those that are not already the subject of binding legal regulations and would thus in principle be covered by a standard compliance warranty – it is only a matter of the corresponding selective amendments of the warranties catalogue.[17] Both the specific results of the due diligence and the acquirer's internal ESG guidelines serve as a basis for such specific amendments.

5. Coverage of ESG risks in W&I insurance

In practice, ESG risks can often not or only partially be allocated to the seller. In addition to a lack of commercial willingness on the part of the seller to take on the corresponding risks through warranties and indemnities, compelling commercial reasons may also speak against a corresponding allocation. For example, warranties and indemnities may be worthless for the buyer if the seller no longer has the financial means to pay the claims when they are made, e.g. if the seller is a private equity special purpose vehicle that has distributed the purchase price proceeds to the investors.[18] In this respect, the parties to the transaction regularly have an interest in outsourcing ESG risks to third parties, namely transaction insurers.

In the case of warranty and indemnity (W&I) insurance, which is now common in the M&A market, especially in private equity transactions, it must first be taken into account that it only covers claims for damages by the acquirer due to a breach of warranty in accordance with the business purchase agreement. Claims arising from the breach of pre-contractual duties of disclosure in connection with ESG-related risks are not covered unless they are specifically also covered by a warranty. Insurability therefore depends primarily on whether and to what extent the catalogue of warranties covers the non-existence of ESG risks at the target company at all. From the buyer's point of view, even a far-reaching compliance warranty is not necessarily sufficient, as it only guarantees compliance with statutory provisions but not with other ESG-relevant standards. It is rather difficult to reflect non-statutory ESG criteria in the warranties catalogue due to the lack of corresponding market and industry standards, and the content and scope will depend heavily on the industry and the geographical footprint of the target company. As insurers are already rather reluctant to cover compliance warranties due to the complexity and potential economic relevance of the related risks, the coverage of ESG risks that are not subject to clear legal regulations will probably be reviewed even more critically in the underwriting process. Further, the scope of insurance coverage will be limited, for example, by inserting materiality thresholds or restrictions to the best knowledge of the seller in the warranty spreadsheet of the W&I insurance policy which determines the specific insured wording for each warranty.

In addition to the assessment of the risk generally associated with the scope of the warranty, the risk analysis of the buyer itself is also important from the insurer's point of view. In principle, only risks that have been reviewed in the due diligence process receive cover. For this reason, too, ESG criteria are

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[14] See also on the unclear legal situation Meyer-Sparenberg in: Meyer-Sparenberg/Jäckle: Beck'sches M&A-Handbuch, 2nd ed. 2022, § 48 Rn. 63 et seq.
[15] Meyer-Sparenberg in: Meyer-Sparenberg/Jäckle: Beck'sches M&A-Handbuch, 2nd ed. 2022, § 48 recital 121.
[16] See on possible formulations of ESG guarantees Louven, BB 2022, pp. 2178, 2189 ff.
[17] Louven, BB 2022, p. 2178, 2189 ff.
[18] Armbrüster, ZIP 2023, p. 553.

of increasing importance in the context of due diligence and may give rise to an extension of the scope of legal due diligence or the performance of a separate ESG due diligence with a correspondingly separate due diligence report. In practice, since the COVID-19 pandemic, which has led to greater awareness of sustainability issues overall, there has been an increase in the commissioning of ESG due diligence reports in larger mid cap and large cap transactions. While “environmental” due diligence reports were initially supplemented in certain areas by isolated aspects on “health & safety”, today we find more comprehensive ESG reports in which social and governance topics continue to gain importance. This trend is also evident on the sell-side. The presentation of the target company in the information memorandum or teaser no longer only highlights the traditional “green” facets of the target company, but also, for example, the adherence to certain compliance standards or the diversity of the employees concerning the age structure and the women’s quota.

Further restrictions of insurance cover take place at the level of exclusions under the insurance policy. W&I policies regularly provide for an exclusion of coverage for damages relating risks disclosed by the seller or otherwise identified and thus known by the buyer in the course of due diligence. Ordinary W&I policies are therefore generally only suitable for covering abstract ESG risks at the target company for which there are no specific indications. As far as governance is concerned, typical exclusions include the classic compliance areas of bribery, corruption, and money laundering (especially in case of target companies with notable foreign operations in risk areas), as these risk areas cannot be sufficiently assessed in the due diligence and are associated with a high potential for damage.

W&I insurers will also find it difficult to cover warranties relating to compliance with ESG standards in connection with supply chains – depending on the design of the specific warranty – if the relevant risks are not manageable due to a lack of experience with the interpretation of legal regulations and regulatory practice in suspecting violations in this area. Data protection warranties, on the other hand, are now frequently covered by W&I insurers if the performance of proper due diligence has been proven, especially in the underwriting process for the conclusion of the policy. Depending on the quality of the due diligence carried out, other ESG risks are also insurable in principle, provided that no specific risk has been identified. As a minimum requirement, at least a compliance management system should be set up at the target company that also sufficiently takes ESG criteria into account. In practice, this is still often lacking, especially in medium-sized companies.

6. Insurability of identified ESG risks

The insurability of identified, concrete ESG risks is typically not feasible within the scope of a W&I policy. If there is only a very low probability of the risk materializing or if the potential economic impact is only low, an identified ESG risk might still be coverable within the scope of a so-called “affirmative cover” under the W&I policy. In this case, the specifically identified facts and circumstances are explicitly excluded from the general exclusion of disclosed and known risks.

However, if the realization of the risk is potentially associated with a high loss, coverage under the W&I insurance policy is regularly excluded. For such risks, the only remaining option is a “contingent liability insurance”. This insurance solution covers specific identified risks, provided that the realization of the risk is not probable, and the potential loss is large but still calculable for the insurer.[19] The premiums for such a special insurance solution are usually significantly higher than the premiums for W&I insurance policies. Furthermore, insurability under a contingent liability policy requires that the risk to be insured is primarily a legal risk and not a factual risk.[20] The delimitation of risks is often problematic even in the case of risks regulated by law. If there is a complete lack of legal embedding, coverage of identified ESG risks is therefore unlikely to be considered. As the legal codification of certain ESG standards continues to increase, an increase in the number of contingent liability insurance policies concluded can also be expected. .

[19] Boche/Luettges, BB 2020, p. 2764, 2765.
[20] Boche/Luettges, BB 2020, p. 2764, 2765.

7. Summary

Damage claims based on the target company's non-compliance with ESG standards can already be covered by W&I insurance if and to the extent a corresponding warranty wording is included in the insured business purchase agreement. Typically, business purchase agreements have so far only contained warranties on compliance with statutory law and thus cover codified ESG standards. Warranties for compliance with ESG criteria that go beyond the legal requirements are conceivable in principle but are not yet common.

A further insurability prerequisite is that the content of the relevant warranty was reviewed by the acquirer in the due diligence and no risks were identified. The market trend towards extending the due diligence to ESG criteria beyond the areas reviewed in the legal due diligence is also to be welcomed in this respect from a risk management point of view.

The hedging of identified ESG risks in areas not regulated by law is not feasible. From the buyer's point of view, consideration within the framework of the purchase price or negotiation of an indemnity are viable ways of risk allocation. However, the increasing codification of ESG standards will lead to an increase in respective contingent liability policies in the long term.

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