

ESG RESEARCH REPORT SERIES | PART 4

ESG due diligence – are businesses asking the right (or any) questions?

In the fourth and final part of our ESG research report series, we focus on ESG due diligence in the context of corporate M&A transactions, including key questions corporate Ireland should ask to understand the ESG risks their businesses face.

5 MIN READ

ALG research

More and more companies are beginning to consider environmental, social and governance (ESG) issues when entering into business dealings with partners, target companies, investees, suppliers and even customers. For our **ESG research report** we surveyed over 100 Irish companies, 69% of respondents indicated that they have a due diligence policy in place in respect of the companies that they do business with. For some larger companies this may be driven by a need to comply with upcoming legislative requirements, such as those being introduced by the Corporate Sustainability Due Diligence Directive (CSDDD). For others it may simply be driven by an increased sense of awareness or social responsibility, or perhaps their perception of market expectations.

While the data here, on one level, seems positive and indicates a willingness to move in the right direction, time will tell

whether these policies are complied with in practice or left to gather dust. Do Irish businesses really have the time and resource to diligence the ESG credentials of all of their local and international suppliers? How will this work in practice? Will businesses really be willing to move away from low-cost suppliers with potentially questionable human rights records to suppliers of more expensive fair trade, organic and ethical products? While for some the answer is unequivocally yes, with margins tightening in many key industries in Ireland, such as fashion, retail, hospitality and agriculture, it may become increasingly difficult for Irish businesses (particularly SMEs) to give sufficient weight to ESG considerations when selecting and maintaining business partners and suppliers. Without a legal obligation to conduct due diligence on environmental and human rights impacts of the operations of a business and those of its business partners, will there be sufficient impetus on Irish companies to act?

In a world of complex interconnections and a shifting perspective on what was previously understood to represent good

vs. evil, do businesses really want to know the answers to the questions that they could and should ask? If they do ask the questions – will it always be possible to assess whether a response is correct or appropriate? How should businesses take cultural, socio-economic, religious, political and historic considerations into account when assessing the correctness or otherwise of the actions of their business partners? Without doubt, this is a complex area and it is no wonder that some may be keeping their heads in the sand for now.

The growing backlash against ESG considerations in the United States and other countries, as well as the proposals to simplify certain sustainability related legislation in the EU (such as CSDDD), has probably been seen by some as a licence to divert their attention away from ESG considerations and diligence. For such companies, the focus may unfortunately be returning solely to getting the deal done at all costs, growing revenue, increasing margins and boosting profitability as the short-term way to increase valuations and exit multiples. But at what long term cost?

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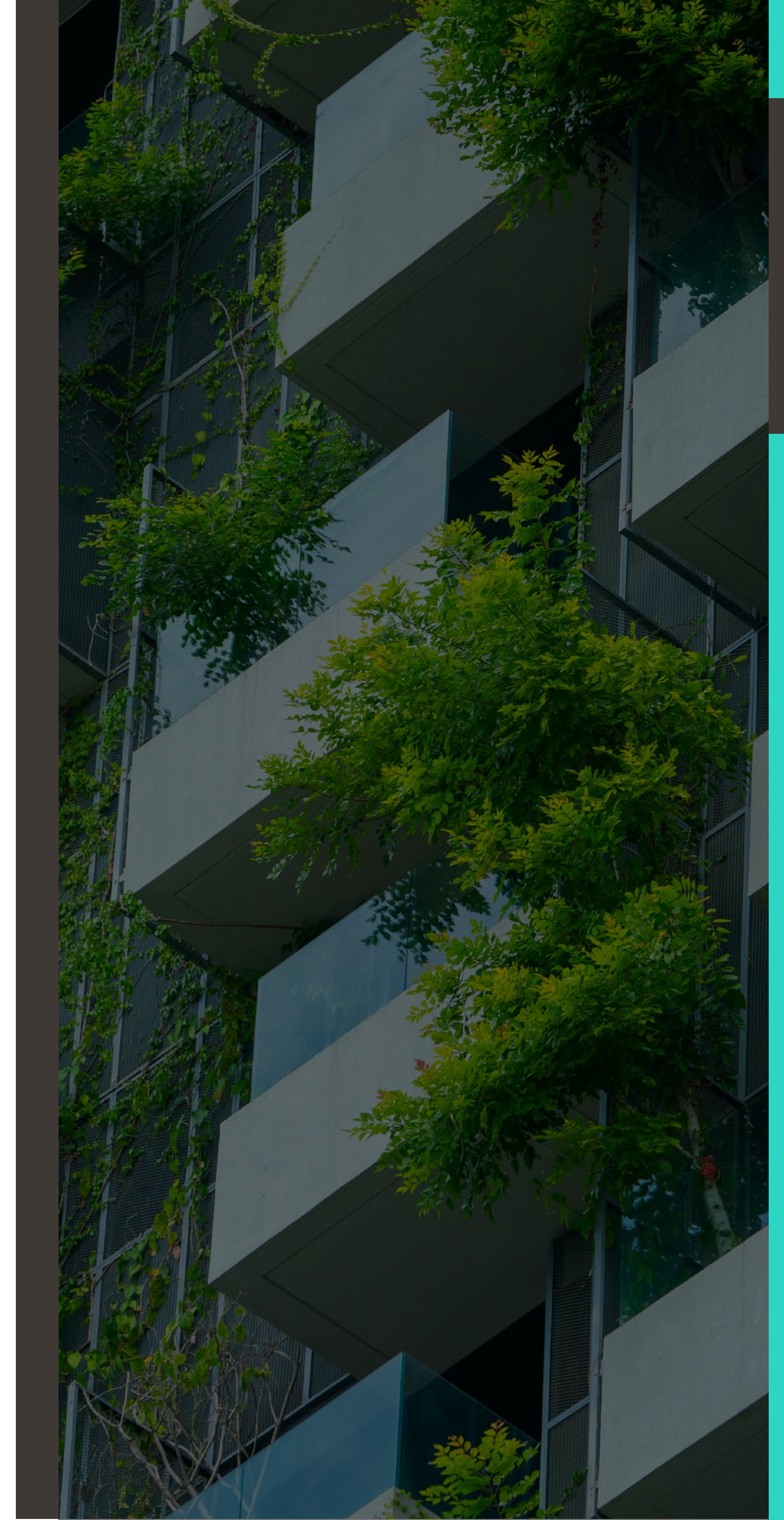
Over **100** Irish companies surveyed, **69%** of respondents indicated that they have a due diligence policy in place in respect of the companies that they do business with.

As a mergers and acquisitions lawyer in Ireland, I have certainly noticed that there is still, to an alarming level, very little focus on ESG matters in many mid-cap and even large M&A transactions. With more and more transactions these days being backed by private equity funds with a relatively short-term investment horizon, the focus of due diligence remains firmly fixed on financial matters (revenues, earnings, margins and growth) as well as traditional legal and tax diligence. ESG considerations are simply not seen as a source of value and are not something that is focused on. There seems to be a perception that ESG issues, should they exist, can easily be rectified following closing of a transaction. While obvious traditional risks (such as environmental risks, pollution, sanctions and governance failures) will be assessed, more nuanced ESG related risks are often overlooked or ignored – and increasingly this is what can irreparably destroy long term value in any organisation.

Buyers and business partners need to start asking more considered and nuanced questions to identify the real ESG risks facing an organisation in the current environment, and some examples of how

businesses can and should think outside the box are set out below:

- When carrying out real estate due diligence, it is no longer enough to assess the current state of repair of a building. Climate change is a key factor here and an assessment needs to be made as to how a building will cope with the increase in catastrophic weather events such as storms, hurricanes, floods and blizzards worldwide. Another key consideration is whether the target company's insurance policies pay out on damage caused by such events.
- It is no longer enough to assess the performance and longevity of a workforce based on traditional KPIs, a review of data in a spreadsheet or the terms of an employment contract. It is necessary to understand the culture of a workforce, its diversity and the fairness and equality afforded to its employees. If a workforce is acquired that is infested with a toxic management culture or affected by bullying or sexual harassment, or full of over-worked and burned-out employees, then it is unlikely to a good long-term investment.
- Is it really sufficient these days to assess the suitability of new business partners and customers by reference to sanctions checking? When it is judges and officials from the International Criminal Court, rather than war criminals, who appear on sanctions lists, it is difficult to see how this is the correct standard. Businesses may be better served by relying on their own interpretation of natural law, rather than the strict letter of the law, when it comes to assessing the actions and behaviours of their business partners and investees (as well as their own).
- Has a business made efforts to transition to cleaner forms of energy – a short-term cost for a longer-term saving? While the ESG related benefits for doing so are obvious, the less obvious benefit may be in finding a business partner or investee with a longer-term value horizon and a more holistic perspective of value.



- Are businesses assessing whether ESG related claims made by a business partner or investee are genuine? Careful consideration should be given to the claims being made by a target company. While they may seem like positive claims at a superficial level, you could be inheriting a substantial fine and conviction for a greenwashing offence in a few years' time. Although perhaps the most significant consequence is the associated reputational damage.
- Has a business partner or target company taken genuine steps to identify and mitigate the overall risks of human trafficking, forced or compulsory labour, modern slavery, or servitude in its business and supply chains? Is it really enough to tick this box just because there is a modern slavery policy in a data room?
- Generally speaking, companies should assess all things (including governance structures, culture, business practices, environmental impact, treatment of employees, etc.) not just by reference to

whether or not they comply with the law. Businesses should query whether they are fundamentally right, ethical and fair, and ask, how will history remember them.

While revenues and earnings will always be critical indicators of the short-term success and value of any business, increasingly a more holistic assessment needs to be undertaken in order to understand the longer term risks associated with this success and value. It can take decades to generate financial value in a business, but it can take days, or even hours, to completely destroy it. The reputational and value risks associated with ESG factors have never been greater, and are only set to increase in years to come. If preservation of long-term value in a business is the goal, difficult questions need to be asked of its business partners and investees and the company needs to be prepared to assess the answers holistically, and to make the correct decisions based on that assessment.

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