



THE CORPORATE SUSTAINABILITY REPORTING DIRECTIVE AND M&A DUE DILIGENCE

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Introduction

The Corporate Sustainability Reporting Directive (CSRD) mandates enterprises to report on sustainability efforts under the reporting framework of the European Sustainability Reporting Standards (ESRS). In Denmark, this entails that more companies than previously must report on ESG and that the reporting requirements are stricter and more detailed. The CSRD must be implemented into national law during 2023 and apply to fiscal years starting on or after 1 January 2024 for large public-interest companies as well as banks and insurance companies (which are already subject to the Non-Financial Reporting Directive (NFRD)) and during 2025-2028 for certain other enterprises.

In this insight, we review the main impact areas of the CSRD and the ESRS in contractual frameworks and what to consider in an M&A due diligence process in this regard.

Enterprises Subject to the CSRD

The CSRD applies to the following enterprises:

- (i) From 1 January 2024, large public-interest undertaking (including credit institutions and insurance companies) already subject to the Non-Financial Reporting Directive (NFRD) exceeding 500 employees;
- (ii) From 1 January 2025, large companies exceeding two of the following three: (a) 250 employees, (b) EUR 40m net turnover and/or (c) EUR 20m balance sheet total;
- (iii) From 1 January 2026, listed small- or medium-sized entities (SMEs) and other undertakings (with SMEs being able to opt out until 2028)

Furthermore, non-EU companies that have a net turnover exceeding EURm 150 in the EU must also comply with the CSRD.

In addition to the enterprises directly impacted, the CSRD will likely have a spillover effect on companies engaging with the affected enterprises due to the reporting standards focusing on the entire value chain of the businesses. As such, even if the target of an M&A process is not directly subject to the CSRD, the reporting requirements may still be relevant to consider in the target's contractual framework due to its business partners having to live up to the CSRD.

Reporting Requirements

The ESRS set out the detailed standards for reporting on environmental, social and governance areas. Currently, the broad (non-sector specific) reporting standards include areas such as climate, pollution, biodiversity, circular economy, workforce, affected communities and business conduct. The latest version of the broader standards was submitted to the European Commission in November 2022. The Commission is expected to adopt this first set of standards by June 2023. Subsequent hereto, separate sector specific, SME and third country standards are expected to be adopted as well.

The ESRS are subject to the CSRD's reporting principles, which include a double materiality requirement, pursuant to which the reporting must both have a focus on the enterprise's impact

on ESG matters (inside-out) and the impact of ESG matters on the financials of the enterprise (outside-in). Additionally, reporting should consider the enterprise's upstream and downstream value chain, i.e., how its business relations and supply chain impact the areas covered by the ESRS as well as the enterprise's sustainability due diligence on this value chain.

Enterprises must report on the entire value chain both inside the EU and outside. If enterprises are not able to collect data to satisfy the requirements, the CSRD allows a three-year grace period during which the enterprise must describe why the information was not obtained and what mitigation measures will be taken to ensure the relevant data is collected in the future.

Compliance with CSRD and the ESRS

The comprehensive reporting requirements presume that the enterprises subject to the CSRD have established adequate processes for correct information gathering. This includes updating relevant internal guidelines such as procurement policies to ensure identification of ESG-related impacts as well as assessment of select suppliers' effect on ESG matters, e.g., country of origin, common sub-suppliers, materials delivered etc. Internal policies for follow-ups and monitoring could also be considered.

In addition to monitoring the current value chain, measures could also include amendments to the contractual framework for upstream and downstream partners of the value chain in order to facilitate compliance with ESG requirements more broadly as well as the reporting requirements of the CSRD specifically. Aside from directly demanding that suppliers live up to certain ESG objectives, e.g., as code of conduct warranties or similar, contractual provisions could also take the form of information and auditing rights, extended breach provisions and/or penalties for non-compliance or delays in receiving input. All ways to ensure that the particular enterprise is able to comply with the CSRD as well as to set sustainability goals and take steps to mitigate negative impacts on ESG matters.

CSRD in M&A Due Diligence

From a transaction perspective, the implementation of the CSRD is another set of rules which impact the analysis of a target's operations and risks from a legal perspective. As with all new regulations applicable to an enterprise, the focus from a due diligence perspective should be three-fold; (i) assess the existing (contractual) framework in which the business operates, (ii) determine the impact and materiality of the new regulation on said framework and (iii) analyse to what extent any gaps can be mitigated, e.g. by updating terms or having opportunities to renegotiate existing terms.

Firstly, a due diligence review should focus on the existing contractual frameworks and what rights and obligations are already in place to satisfy the reporting requirements of the CSRD. To the extent updates are needed, the due diligence review should ascertain to what extent renegotiations of current long-term agreements are possible (and feasible) and what – if any – the impact of such renegotiations may be on the profitability of the business. For instance, inserting additional provisions on specific ESG goals, information and audit rights, extended breach provisions etc. to comply with the CSRD may lead a supplier to counter with longer delivery times or a higher price to account for the extra costs associated with new requirements.

Secondly, the due diligence review should also focus on the business relationships with material suppliers and customers, as compliance with CSRD will likely require extensive cooperation with them to meet the reporting requirements (aside from what can be agreed contractually). As such, having already established close relationships and good communication channels with key stakeholders in the value chain should (also) from a compliance perspective be of value in ensuring that the target adheres to the CSRD, whether it is directly subject to the rules or impacted indirectly as part of the value chain of another enterprise.

Our Comments

While the ESRS have yet to be finally adopted and the CSRD has yet to be implemented in Danish law, it is our assessment that with the current drafts, enterprises should already now consider the necessary steps to prepare for the full implementation beginning from 1 January 2024.

Going forward, our recommendation is that companies revisit their contractual frameworks and consider to what extent they need to be updated in order to comply with the ESRS in the areas most relevant to them. From an M&A perspective, this advice is even more important for owners looking to prepare an enterprise for sale. To begin with, we recommend assessing ESG-related impact areas of the business and considering what contractual provisions and relationships with the value chain are needed in order to enable compliance with the CSRD. Having this work done ahead of commencing a sales process can be just another “tick-the-box”-exercise in some cases. In other cases, particularly businesses in ESG-heavy sectors such as energy, logistics or retail, a good ESRS setup can be one less headache for the prospective buyer.

If you have any questions or wish to learn more about how to meet the new standards set by the CSRD, please do not hesitate to contact us.

If you have any questions or require further information regarding any of the above, please do not hesitate to contact us.



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