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Are you conducting ESG counterparty due diligence?

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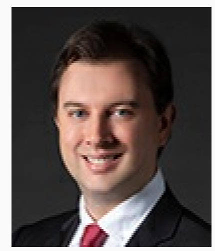

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Due diligence has long been a cornerstone of an effective compliance framework, especially when engaging third parties. The gathering of relevant data about a counterparty enables a company to make a risk-based assessment about the propriety of engaging that party, allowing companies to effectively mitigate risks related to noncompliance by the third party and the reputational damage that could follow.

The risks that companies have sought to identify by conducting counterparty due diligence have historically been heavily weighted toward bribery and corruption risk, financial crime risk, or links to politically sanctioned individuals or entities. However, in recent times, the range of risks has broadened to include, for example, those relating to a counterparty's environmental, social, and governance (ESG) standards.

This article will examine the value of ESG counterparty due diligence and how it should be conducted. It will then consider the implications of ineffective ESG due diligence in the context of supply chain due diligence, first by considering an example of potential reputational/business damage and then by looking briefly at recent legislative activity that suggests heightened expectations by regulators, shareholders, and board members as to how businesses assess ESG risk.

Factoring in ESG standards

The rise of ESG as part of the cost of doing business has manifested in connection with the due diligence conducted in a transactional context. As with other forms of due diligence, any red flags identified with respect to ESG factors can have a material impact on deal structure (for instance, through the inclusion of indemnities or even a reduction in purchase price).

These considerations have also arisen in the context of how companies conduct counterparty due diligence, both at the time of onboarding and periodically during the lifetime of the engagement.

The factors that ESG counterparty due diligence can cover are broad and potentially encapsulate one or more of the following areas:

- **Environmental impact**: For instance, the extent to which the counterparty's business operations create waste, pollution, or other forms of environmental harm (e.g., animal welfare concerns).
- **Social/employee relations**: For instance, any human rights or forced labor issues in a company's workforce, suboptimal workplace conditions, and whether the counterparty permits any form of collective

bargaining with its employees.

- **Corporate governance**: For instance, board governance and a company's commitment to business ethics.

The means by which ESG counterparty due diligence is conducted is largely similar to how other counterparty due diligence is conducted. One common method is through desktop database searches, often accessed through external providers, which collate and leverage access to a variety of public domain databases such as sanctions and other watch lists issued by national governments, company registry searches, litigation databases, and media reports. With respect to ESG counterparty due diligence, the sources covered by these searches can assess ESG risk at a national level (e.g., whether nongovernmental organizations have reported high incidences of child labor in a particular jurisdiction) or sector level (e.g., whether a particular industry is more prone to causing environmental impact), as well as analyzing a wider range of public sources to identify adverse media reports or regulatory issues (e.g., if a company has been fined for unsafe working conditions or has been alleged to promote poor corporate governance).

However, notwithstanding the breadth of information that desktop database searches provide, it is imperative that companies do not overemphasize its value in demonstrating effective counterparty due diligence. It may be appropriate (or even necessary) to supplement these searches with more targeted measures, such as interviews with representatives of the counterparty or (where available) exercising audit rights on a periodic basis to check whether the counterparty's records demonstrate acceptable compliance. With respect to ESG compliance specifically, it may be appropriate to consider on-site visits, as many of the ESG factors mentioned above cannot readily be detected through desktop database searches or virtual interviews.