

# DUE DILIGENCE IN THE AGE OF ESG AND COVID-19 (JAPAN)

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Legal Briefings - By **James Donnelly, Timothy Stutt**

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Even before the Covid-19 pandemic, the increasing focus of external stakeholders on corporate purpose, accountability and resiliency was driving environmental, social and governance (**ESG**) matters higher up the corporate agenda. The Covid-19 pandemic has magnified the spotlight on ESG issues, further accelerating the shift of ESG from a 'compliance' issue to a core 'commercial' consideration touching on almost every aspect of a company's business.

Many predict a wave of distressed M&A opportunities to emerge from the economic turmoil caused by Covid-19. Given corporate Japan's reputation for having significant cash on its balance sheet, investors across the globe are waiting to see how it will respond to the distressed M&A opportunities created by Covid-19.

For those looking to capitalise on the opportunity, the heightened focus on ESG across all sectors means that consideration must be given to ESG factors in the analysis underpinning investment proposals, due diligence and post-transaction integration. This article seeks to provide a brief overview of what due diligence for ESG risks may look like, and what are some of the developing areas of ESG risk.

## **WHAT DOES DUE DILIGENCE FOR ESG RISKS LOOK LIKE?**

Unlike traditional legal due diligence used to verify asset ownership and key contractual risks, due diligence for ESG issues requires a much broader analysis of potential risk exposures for the target company, having regard to sector, products and jurisdiction.

Although some ESG risks may be identified from traditional legal due diligence, due diligence for ESG risks is a markedly different process. In general, ESG due diligence will require “mapping” of potential risk areas across the business, having regard to its structure, operations and governance. Risk exposures will differ from business to business, but may include topics such as climate change, anti-bribery and corruption, alleged breaches of labour rights, human rights and modern slavery risks in supply chains, sexual harassment and bullying allegations, workplace culture, tax avoidance and more.

By way of example, the table below shows possible risk areas and how “ESG due diligence” would extend consideration of those risk areas beyond the scope of traditional legal due diligence.

<b>Possible Risk Areas</b>	<b>Scope of Traditional Due Diligence</b>	<b>Possible Questions to Understand ESG Risk</b>
Governance	Review of constitutional documents and core governance documents	<ul style="list-style-type: none"> <li>• Does the target maintain a risk register? What are the top self-identified risks?</li> <li>• Does the target have an internal audit function and who do they report to?</li> </ul>
Workplace culture	Review of unusual terms in contracts of key executives	<ul style="list-style-type: none"> <li>• Have there been any sexual harassment allegations against the target’s senior executives?</li> <li>• Does the target’s board of directors receive reporting on whistleblowing and code of conduct complaints?</li> </ul>
Human rights	Analysis of any proceedings against the company	<ul style="list-style-type: none"> <li>• Have human rights breaches been alleged against any of the target’s key suppliers?</li> <li>• Does the target source goods or labour in specified high risk jurisdictions?</li> <li>• Are the target’s suppliers permitted to sub-contract labour? Is consent required?</li> </ul>
Environment	Confirming whether the company is compliant with environmental regulations	<ul style="list-style-type: none"> <li>• Has the target undertaken climate scenario planning?</li> <li>• What analysis has the company undertaken regarding the market impact of decarbonisation?</li> <li>• Does the target have continuity plans for climate-related operational interruptions?</li> </ul>

## DEVELOPING AREAS OF ESG RISK

The range of potential ESG risks areas is exceptionally broad and ESG risks will differ from business to business. However, current areas of particular focus include:

- **Decarbonisation:** Growing concern regarding climate change, and the inevitable shift towards a lower carbon future, has resulted in a clear trend for increased scrutiny of the long-term sustainability of significant carbon-emitting assets and, conversely, the opportunities presented by new technologies and renewable energy businesses which may be beneficiaries of the global decarbonisation movement. The effects of Covid-19 on commodity prices in particular has caused some to describe the pandemic as a pivot point for the energy transition, further magnifying the focus on decarbonisation. Our recently launched [Decarbonisation Hub](#) sets out some key challenges as well as a five-step model which serves as a basis to help companies develop a successful approach for their decarbonisation initiatives.
- **Modern slavery and ethical sourcing:** Transparency in supply chain and other anti-modern slavery legislation in the UK, France, Australia, Brazil and California has increased the importance of understanding and risk mapping the supply chains of potential targets, including with respect to geography, sector and labour, outsourcing and recruitment practices. As more countries enact anti-modern slavery legislation, and with human rights due diligence regulation proposed for the European Union, the focus on supply chain transparency is widely expected to continue to increase.
- **Anti-bribery and corruption:** In the context of global trends towards anti-bribery regulation, which place an onus on companies to take positive steps to prevent bribery within their businesses and include significant financial sanctions which can apply for breaching those requirements, understanding the internal anti-bribery processes of potential targets is an important tool for understanding the scope for, and level of risk in relation to, potential future regulatory action.

The increasing focus on ESG reflects the development of global regulation in relation to ESG, with 'soft law' frameworks such as the UN Global Compact and UN Guiding Principles on Business and Human Rights and the Principles for Responsible Investment giving way to increased 'hard law' in relation to environmental sustainability, modern slavery, bribery and corruption, and various other ESG issues. With 'hard law' legal frameworks coming into force, and heightened expectations in relation to ESG from investors investor and broader society, identifying key ESG risks through the due diligence process will be critical to successfully capitalise on the distressed M&A opportunities that arise as the global economy emerges from the Covid-19 pandemic.

For further information on how Herbert Smith Freehills helps businesses navigate this complex landscape, please visit our [website](#).

## KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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