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Risk Management

Variety of Tools Available for Transactions Involving Environmental Risk

Buyers and sellers may have conflicting interests in business transactions that involve potential environmental liabilities, but the parties can avail themselves of many flexible legal strategies and management tools for allocating risk prior to the closing process, an environmental attorney told Bloomberg BNA.

Abbi Cohen, a partner with Dechert LLP in Philadelphia, said buyers need to look closely at the Phase I environmental site assessments during the risk assessment process, but they shouldn't rely on them exclusively. "Phase I's are a vital part of the risk assessment process, but they cannot be the only part," Cohen told Bloomberg BNA Nov. 5.

Cohen's comments to Bloomberg BNA came on the heels of her participation on an Oct. 29 panel discussion, "Transactional Risk Transfer: Then and Now," at the fall meeting of the American Bar Association's Section of Environment, Energy and Resources in Chicago. In addition to Cohen, the panel featured speakers Betty Moy Huber, an attorney with Davis Polk, and Jeffrey Gracer, an attorney with Sive Paget & Riesel PC, both from New York City.

Publicly Available Resources

Large-scale mergers and acquisitions can become incredibly complex when a seller is carrying known environmental liabilities on its books and ostensibly clean real property or business operations that could manifest as environmental liabilities at some point in the future.

The seller naturally will want to negotiate purchase agreement terms that limit environmental representations, covenants and indemnities to minimize its post-closing exposures.

Cohen said buyers can use a wide range of publicly available resources to learn about the assets or business being acquired. When dealing with a publicly traded company, for example, she suggests reviewing disclosures made to the Securities and Exchange Commission and those in capital markets promotional materials.

In addition, Cohen often uses computer-assisted legal research tools to determine whether the target and its current or former businesses or real properties have been the subject of litigation, investigation or remediation or have environmentally intensive operations or features. "Legal articles, trade publications for specific industry sectors, and environmental databases that list information about properties" all can be important resources, Cohen said.

Finally, Cohen said buyers need to pay close attention to reports by consultants assisting in the due diligence process.

It has become very common for sellers, especially in sale transactions structured as auctions, to arrange for their own Phase I Reports to facilitate the due diligence process and reduce the disruption and delay of having multiple bidders seek access to the real property for environmental due diligence.

"In evaluating whether to rely on seller-commissioned Phase I's, I focus on the identity and reputation of the consultant. There are several consulting firms that I see all the time in the M&A world," Cohen said. "If the seller has used one of them, I'm confident that the consultant recognizes that they are just as likely to be working for me in the next deal and that the environmen-

tal reports need to fairly present the environmental risk profile of the facility or target."

In addition, Cohen noted that consultants regularly involved in M&A due diligence tend to understand the business issues surrounding the diligence project and how their diligence results will be used in the parties' decisionmaking process.

Insurance Products 'Game Changers'

Cohen went on to discuss the role environmental insurance can play in mitigating risks associated with unknown potential or new environmental liabilities.

The most common environmental insurance product is a pollution legal liability (PLL) policy.

A PLL policy generally provides legal liability coverage for cleanup; bodily injury; property damage; and defense of preexisting, unknown and new pollution conditions.

Cohen said PLL policies "have been a game changer in the last ten to fifteen years." For example, if a buyer thinks an environmental liability has the potential to be larger than reasonably anticipated by the parties, a PLL policy can offer another tool to manage the risk of cost overruns. Insurance from a rated entity also can address a concern by a buyer regarding the financial ability of the seller to cover potential liability.

Having an environmental insurance policy with a five- or ten-year term also can help a buyer in their exit strategy, particularly if the buyer is a private equity firm.

Representation and warranty (R&W) insurance coverage is a relatively new insurance product that is becoming increasingly common in M&A deals.

A buyer-side R&W policy provides for direct payment to the

buyer for costs due to seller's breach of representations and warranties. A seller-side R&W policy reimburses the seller for indemnity payments made to the buyer for breach of representations.

A R&W policy can supplement a seller's indemnity for breach of representations or serve as buyer's only recourse.

Although some policies cover the full range of environmental representations, some policies have full exclusions or cover environmental compliance representations except those that cover releases of or exposure to hazardous substances. As a result, a party may not be able to cover environmental risks by just using an R&W policy.

Cohen's advice to parties considering environmental insurance? "It's very fact-specific and dependent on what risk the client is seeking to protect against." In her view, environmental insurance provides an extra layer of protection or covers gaps in the protections a party is getting from the other party to the transaction.

While Cohen cautioned that environmental insurance may not work in a number of different transactions,

such as when dealing with a known pollution liability issue, sometimes a deal doesn't get done without it. "I have used environmental insurance frequently over the years to help make deals and bring peace of mind to my clients, so I am a big advocate for insurance."

Reopeners; Regulatory Uncertainty

Cohen also noted the importance of buyers identifying and considering the environmental and regulatory issues particularly affecting the target's business sector and examining the seller's responses to these issues.

Vapor intrusion is an example of one of these emerging trends. "Depending on the nature of the contamination and the manner in which a remediation was completed, there can be a risk of reopener for a closed remediation project due to the potential for vapor intrusion," Cohen said. The regulation of products due to their chemical composition is another emerging trend.

Cohen said parties often negotiate over which party should bear the risk of a future change in law or regulatory standard.

Cohen cautioned that "in evaluating the risks associated with any known or potential environmental uncertainty, it's always important to consider the context in which the issue could arise and to make sure you're accurately assessing the potential impact the environmental issue could have on your client or the business."

The bottom line, said Cohen, is that there are many tools available to help parties identify and estimate the potential impact of environmental risk.

"Once the parties can roughly quantify the risks and develop a range of potential costs, it helps the parties immensely in figuring out how to allocate the liability."

"As soon as you can estimate the magnitude of an environmental issue using dollars," said Cohen, "business people are more comfortable with the environmental risk and can manage such risks as they would any other nonenvironmental risk in the deal."

Cohen co-authored a report, "Current Environmental Considerations in Business Transactions," for the fall meeting of the ABA's Section of Environment, Energy and Resources. The report is available at <http://src.bna.com/SN>.