Environmental Due Diligence and Risk Management in a Seller's Market

Merger and acquisition activities should be significant in 2018, driven in part by recent changes in the nation's tax laws. Various factors will lead to a seller's market, resulting in unique due diligence and environmental risk management challenges for bidders. This article, authored by attorney Abbi L. Cohen, a partner at Dechert LLP in Philadelphia, and John M. Ix, special counsel with Dechert, examines how bidders can strategically approach due diligence in a competitive market, as well as insulate themselves from environmental risk.

231.3041 Introduction*

Notwithstanding the recent volatility in the stock market, mergers and acquisitions (M&A) activity should be significant in 2018. With large corporations repatriating cash, perhaps for acquisitions, due to the change in tax laws, and the fact that private equity is sitting on significant dry powder, we are likely to continue to experience a seller's market. Although the latent nature of many environmental conditions means that environmental due diligence in M&A transactions is never perfect, conducting environmental due diligence and managing environmental risks in a seller's market present particular challenges.

(a) Tailoring Environmental Due Diligence in a Competitive Bid Process

The existence of a seller's market makes it more likely the seller will have to manage multiple bidders conducting due diligence. A sophisticated seller with an environmentally sensitive target business may anticipate that multiple bidders will need robust environmental due diligence and procure current sell-side Phase I Environmental Site Assessment Reports, compliance audits, and/or other such reports. Many bidders are willing to rely on sell-side reports prepared by reputable environmental consultants. In a seller's market, a bidder may find its bid heavily discounted if it takes issue with the scope of the review or consultant performing the assessment and insists on commissioning its own Phase I Environmental Site Assessments.

Competition among bidders also can reduce an individual bidder's leverage in connection with seeking and obtaining diligence information. If the seller environmental information is limited, the bidders will need to be strategic in what information they can develop themselves and what they request from the seller. To maximize the competitiveness of its bid, a bidder might focus its environmental due diligence—at least initially—on information volunteered by the seller directly or available from sources other than the seller. For example, the scope of the bidder's initial due diligence may consist of a review of the environmental documents posted by the seller in the virtual data room, a review of information available on the target's website and other general internet sources, and searches of government and proprietary environmental databases.

Even if the seller wouldn't object to the bidder undertaking Phase I Environmental Site Assessments, they still take time, both from the perspective of the number of days necessary to complete the assessments and the perspective of the target personnel who must interact with the consultants. The monetary cost also can be significant. Until the bidder has some reasonable expectation a deal will be made or it has exclusivity, the bidder may not want to spend significant time and money on performing more expensive environmental due diligence. When a bidder is one of only a few or has exclusivity, the seller in turn may be receptive to more rigorous due diligence requests. However, if the seller places a significant value on how quickly the deal can be completed, a savvy bidder may want to limit the scope of its due diligence to increase the attractiveness of its bid. Accordingly, it is important to consider whether to ask for additional due diligence, what to ask for, and when to ask for it.

(b) The Impact of Representation and Warranty Insurance on Environmental Due Diligence

In a seller's market, it isn't uncommon for sellers to resist indemnity demands in more circumstances and insist buyers take the risk or look elsewhere for mitigation. Representation and warranty (R&W) in-

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surance is an increasingly common alternative either required by sellers or offered by buyers in a competitive market to make their bids more attractive. When R&W insurance is used, the seller is able to significantly reduce its post-closing exposure for breaches of representations and warranties. In many such deals, except for certain fundamental representations, the seller may be on the hook only for breaches up to a small percentage of the purchase price placed in escrow for a limited period of time. And in some deals, the seller may be able to shift all of its risk to the buyer and get a complete walk-away. R&W insurance policies transfer risk to the insurer. To manage that risk, R&W insurers will seek confirmation that the buyer conducted sufficient due diligence to identify issues or reasonably confirm there are no significant issues.

Environmental due diligence always involves balancing the need for information against cost, time, and availability. Where that balance strikes for a buyer typically depends in large part on the buyer's judgment and experience, its risk tolerance (and that of its lender, if financing is being used), and the nature of the target's operations. Sometimes a buyer might reasonably conclude that the target's environmental footprint justifies only a minimal level of due diligence, but the need to satisfy an R&W insurer might prompt additional diligence work. In the R&W insurance context, the party seeking coverage not only must exercise good judgment in the due diligence review but also demonstrate to the satisfaction of the R&W insurer that the level of environmental due diligence has been sufficiently robust. Even with low-risk targets, insurers will expect the buyer to show some environmental due diligence effort. If the seller-provided environmental information is fulsome, that may be enough to satisfy the insurance carrier.

Even without seller-provided environmental information, there are steps buyers can take to show diligence. For example, as noted above, a target's U.S. facility addresses and entity names can be searched in government and/or proprietary environmental databases. In addition, the environmental provisions of the target company's real property leases can be reviewed for any unusual assumption of liability by the target. Credit agreements and prior acquisition or sale agreements and related schedules also can be a source of useful environmental information. It isn't uncommon to have due diligence calls with appropriate seller representatives early in the process as well. All of these efforts can help satisfy R&W insurers without having to engage in a full court diligence press. If the target presents a potentially larger environmental risk, including with respect to current real property and/or operational risks, the R&W insurer may expect more significant due diligence efforts, including Phase I Environmental Site Assessments and compliance reviews for appropriate assets. If a buyer requires assurance of R&W coverage and related premium information early in the deal evaluation, a buyer may need to commission more substantial environmental due diligence earlier in the bid process than it would prefer. In that circumstance, the buyer still may be able to limit the scope of its due diligence requests and the cost and timing of its due diligence efforts by prioritizing those properties that will be subject to environmental consultant site visits versus those properties that will have so-called "desk-top" reviews based on historic or current use or operations. It also can save time and money to have the environmental consultants prepare letter reports or summary charts for certain properties or operations in lieu of full Phase I Environmental Site Assessments. In either case, the buyer would want its insurance broker to confirm that such an approach would satisfy the R&W carrier. Of course, if the buyer will be relying on outside financing, the lender also will have to be satisfied with the final due diligence product.

R&W coverage doesn't just impact the scope of the environmental due diligence, it can impose additional focus on how environmental issues are presented in the environmental disclosure schedules and environmental reports. A buyer considering the practical ramifications of a specific environmental matter reasonably may be agnostic regarding how the matter is listed in the disclosure schedule or whether it is characterized in the environmental report as a recognized environmental condition (i.e., conditions indicative of a release of hazardous substances or REC), business risk, or de minimis condition. However, R&W insurance typically excludes from coverage any known issues and may exclude any RECs identified in the Phase I Environmental Site Assessments or environmental matters listed on the disclosure schedules. As a result, a buyer relying on R&W insurance should evaluate and discuss with its environmental consultants any speculative contingent matters or issues (e.g., "there is a possibility that the facility has been impacted by its long-term industrial use") the consultant contemplates characterizing as RECs. For the same reason, buyers relying on R&W insurance might resist sellers' efforts to include the disclosure

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of speculative contingent matters in disclosure schedules.

(c) Managing the Environmental Risk With Pollution Legal Liability Insurance

Like R&W insurance, pollution legal liability insurance offers risk management to buyers where sellers won't provide an indemnity. Pollution legal liability insurance can be particularly useful where the nature of the target's operations result in the exclusion of environmental representations from R&W coverage. In addition, pollution legal liability policies sometimes will cover known issues (often limited to third-party claims and tied to an exclusion for voluntary investigation or capital improvements), and their limits aren't shared with nonenvironmental matters. Such policies also have a much longer claims history. Moreover, pollution legal liability policies can offer broader and more certain coverage than R&W insurance because such policies can cover (a) existing and new conditions; (b) divested properties, nonowned disposal sites, natural resource damages, property damage, personal injury, and business interruption; and (c) defense costs. Sometimes a target already will have adequate pollution legal liability insurance in place.

However, where a new policy is sought in the context of a deal, reliance on pollution legal liability insurance can present a timing issue. Policy underwriters require time to review and evaluate the available environmental due diligence. Particularly in a seller's market or bid situation, the time required to underwrite the policy could extend well beyond that permitted by the deal schedule. Therefore, parties exploring the potential for risk mitigation through pollution legal liability insurance need to initiate the process early in the deal. In addition, they should work with experienced environmental lawyers and insurance brokers to identify insurers sensitive to deal-timing issues and properly organize and communicate the salient environmental due diligence information.

(d) Environmental Risks in Unexpected Targets

Certain industries are known to have a greater likelihood of historic environmental impacts or more serious consequences if hazardous materials were released into the environment. Buyers and sellers may expect relatively robust environmental due diligence when the target operates in one of these industries (e.g., petrochemical, metal plating, etc.). Where there are multiple bidders for a deal, the pressure to minimize environmental due diligence could be acute even for deals involving these industry sectors.

Where the target typically presents a relatively low environmental profile, there likely will be even more resistance to doing due diligence that can involve management time or potentially disrupt operations, including site visits. Nevertheless, as experienced environmental lawyers know, so long as an M&A transaction involves real property or regulated business operations, some thought must be given to the potential for environmental risks and liabilities. For example, since certain environmental laws hold current owners or operators strictly liable for the environmental condition of real property, any fee ownership or operation of such property can present a risk of potential environmental liabilities based on a prior owner or operator's activities. Therefore, an M&A target with environmentally benign operations still can have some level of potential environmental risk based on its real estate portfolio. Consider, for example, a portfolio of retail operations that has targeted busy intersections to increase store traffic. Frequently, such locations have a history of gasoline station operations.

Warehouses, wood products assembly, and retail operations are some other examples of relatively benign site usage or operations that nevertheless still may warrant some diligence. Warehouse operations can be subject to environmental regulatory filings and notifications. For example, the existence of a certain number of battery-operated forklifts at a warehouse facility can trigger the reporting requirements of the federal Emergency Planning and Community Right-to-Know Act (due to the quantity of lead and/or sulfuric acid in the batteries). In addition, depending on the circumstances, businesses involving just the assembly of wood products can be subject to the federal Lacey Act. The Lacey Act prohibits the import, export, sale, receipt, acquisition, or purchase of wildlife or plants taken, possessed, transported, or sold in violation of U.S., state, or foreign laws. In a widely reported case, in 2012 the Gibson Guitar Company agreed to pay $300,000 to resolve allegations that it violated the Lacey Act by purchasing and importing ebony and rosewood. Moreover, the federal Environmental Protection Agency (EPA) has imposed significant penalties on certain convenience stores and other retail operators for failure to comply with hazardous waste management laws in accepting product returns. In one well-publicized case, the re-

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tail operator was required to pay a multi-million dollar fine.

In a seller's market, where the target's operations don't seem to pose a high risk of material environmental liabilities, neither seller nor buyer is likely to tolerate a deep environmental due diligence dive. Often, the diligence will be limited to a review of any environmental data room documents and searches of government and proprietary environmental databases. The proprietary databases providing spill, tank, and permit history for specified real property addresses are particularly useful in evaluating risks from the target's real estate portfolio. Depending on the buyer's risk tolerance and other factors, these due diligence activities may be more than adequate to assess the buyer's risk in moving forward with the deal. However, in some circumstances, even relatively benign operations will warrant a second look by the environmental members of the deal team.

(e) Final Word

Few M&A transactions involving operating businesses or real property are free from the risk of environmental liabilities. Particularly in a seller's market or competitive bid process, buyers must be strategic in designing their environmental due diligence efforts. A savvy buyer working with experienced environmental counsel will consider the level of environmental risk posed by the target's operations and real estate portfolio; depth and breadth of environmental due diligence information required to satisfy its risk tolerance and that of any involved lender and insurer; and means of obtaining such information given cost, timing, and competitiveness considerations. Each deal might result in a different calculation, but all deals benefit from early and careful consideration of these issues.

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